Facebook's Libra May Be A SuckerBit (http://pe4fams.com/facebooks-libra-may-be-a-suckerbit/)

By Rob McCreary

Mark Zuckerberg would be one of the last people on the planet I would trust with my financial information, but obviously his Board of Directors must see it differently.

Facebook announced that it would introduce its own cryptocurrency called Libra tied to a market basket of world currencies and backed by real assets. A group of passive investors like MasterCard, Visa, PayPal, Uber, Spotify, Coinbase, VC firm Andreessen Horowitz and many others will capitalize a subsidiary of Facebook called Calibra with $1 Billion. Here is how *Forbes* describes Calibra:

"*A centralized subsidiary of Facebook, that promises to act independently, Calibra* (https://calibra.com/) *,is a wallet for all your Libra coins! Calibra will require (you guessed it!) KYC of all users. Calibra will be available as a stand-alone app, and integrate directly into your WhatsApp and Messenger App. The app is primarily meant for sending funds peer to peer, as well as paying for everyday transactions. The announcement is vague on the question of fees, but promises for them to be reasonable.*"

What *Forbes* means by "KYC" is Know Your Customer which is a banking concept to prevent crooks and terrorists from laundering money through the US Banking System. This will require Libra users to divulge their financial information to Calibra (Facebook) just like Mastercard or Visa or your bank gets your financial info. Alternatively, Calibra will likely accept a bank transfer of currency to buy Libra.

Just recently Facebook introduced their own white paper (https://libra.org/en-US/white-paper/) explaining Libra which they promote as a "universal stablecoin"- an instrument impervious to the violent swings of markets in periods of doubt and uncertainty.

Seductive and Laudable Objectives

This white paper is seductive. The notion of a universal currency available to the masses (including a wide swath of the world population that is not within the banking system) is laudable. The Libra white paper presents a wonderful dream which Facebook with its 2.4 billion users across the world is well suited to sponsor. But I have enough reservations about the likelihood of more mercenary objectives that I prefer to call Libra "FakeBits or, if you like to rhyme, SuckerBits".

Libra Is Just Another Payment Cartel

My first caution is the unbanked members of the Facebook community will probably find they have to open a bank account or deliver all their financial info to Facebook to get credit or swap their local currency for FakeBits. In countries with totalitarian, repressive regimes your financial anonymity is often life itself. Facebook's own white paper contrasts FakeBits to cryptocurrencies like BitCoin that operate outside the banking system. That is exactly BitCoin's founding principle- don't buy into a system where central banks can print money and control yours or where your anonymity as an ordinary citizen (not a crook) is existential.

There is also a fundamental difference between Bitcoin whose value is primary and not backed by anything other than users' confidence and coin scarcity and Libra whose value is derivative and backed by a mountain of assets that may be highly

leveraged. There is also the difference that the validators of bitcoin are paid in bitcoin while the owners of Libra are paid in a special Libra Token that is different than the Libra currency you will use to buy coffee. I am suspicious that the Libra Token may trade as a security thus giving owners a path to liquidity in hard currency?Finally, bitcoin is not owned by anyone while Libra is owned by a cartel of really wealthy interests.

It is true Bitcoin has had problems becoming a universal currency because of its volatility and costs of validating its blockchain, but I am much more comfortable with its model than Libra. Here is Bitcoin's chart since inception. Notice how the Libra announcement has helped Bitcoin's valuation:

Independence Will Be Assured By Switzerland

FakeBits will serve as the first commercial attempt at an internet or universal currency and Facebook with 2.4 billion users has the heft to make this market. Evidently there is a concern that, like its users' data, Facebook will be tempted to monetize Libra's

financial info. Ostensibly, an independent Libra Foundation in Switzerland will assure secrecy and resolve other conflict of interest concerns. At inception Facebook will control Libra Foundation but promises to transition control after 2019. I will take the over bet on that promise because I can't see Facebook's Board allowing Switzerland to control its Calibra subsidiary.

Currency Volatility Will Be Muted By Owners' Capital

The stablecoin will be pegged to a market basket of real currencies. Yikes- I can't think of anything more unstable than real currencies. Nonetheless, The Reserve Fund will dedicate trading capital to buying and selling the tracking currencies to stabilize the peg.

The Big Recession convinced the founder of Bitcoin of the need for a worldwide currency that was not controlled or manipulated by central banks printing money or a small group of owners whose capital disappeared when the going got tough. One of Libra's the biggest risks is lack of support by the ownership cartel for the underlying currencies in an economic meltdown. Even worse the owners may monetize the Libra Reserve Fund with leveraged dividends and destroy its capital base.

The Reserve Fund May Be Like Lehman Brothers- Thinly Capitalized

The group invited to make a $10million investment in Calibra is among the smartest money in the financial world. When the fog lifts on Calibra they are unlikely to have any real capital at risk. Their $10 mil contribution will likely be returned in profits in the first 12 months, if not before then from a loan against the business model. It is completely possible The Reserve Fund will be capitalized with borrowings from banks and lenders who will loan against the future cash flows of the payment processing model which will include transaction fees and float on Reserve Fund Assets. The numbers are staggering. The Economist suggests the Reserve Fund could hold more than a Trillion Dollars:

"*What's not to like? Mr Zuckerberg's initiative, which has been cooking in Menlo Park for 18 months, has two problems (see article* (https://www.economist.com/business/2019/06/20/what-facebooks-new-currency-means-for-the-banking-system)*). First, it could disturb the stability of the financial system. America's biggest bank, JPMorgan Chase, has 50m digital clients. Libra could easily have ten times that number. Were every Western depositor to move a tenth of their bank savings into Libras, its reserve fund would be worth over $2trn, making it a big force in bond markets. Banks that suddenly saw lots of deposits leave for Libras would be vulnerable to a panic over their solvency; they would also have to shrink their lending. And the prospect of huge sums flowing across borders will worry emerging countries with a fragile balance of payments.*"

After All This Is Facebook's Casino

Would you withdraw $100 from your bank account insured by FDIC and backed by the taxing power and full faith and credit of the United States to buy a poker chip with Marc Zuckerberg's face on it? Recognize his casino will cash out your poker chip, if at all, when it pleases him and his investors and at a price that clears them of any financial responsibility. Watch the movie "The Big Short "and ask yourself why the mutts who bet correctly on a meltdown in the housing market could not get out of their winning trades? They held poker chips in someone else's casino – in this case it is Zuckerberg's casino.

I am sure Libra is just the same playbook. Buy SuckerBits at your risk.

Newspapers And The First Amendment (http://pe4fams.com/newspapers-and-the-first-amendment/)

By Rob McCreary

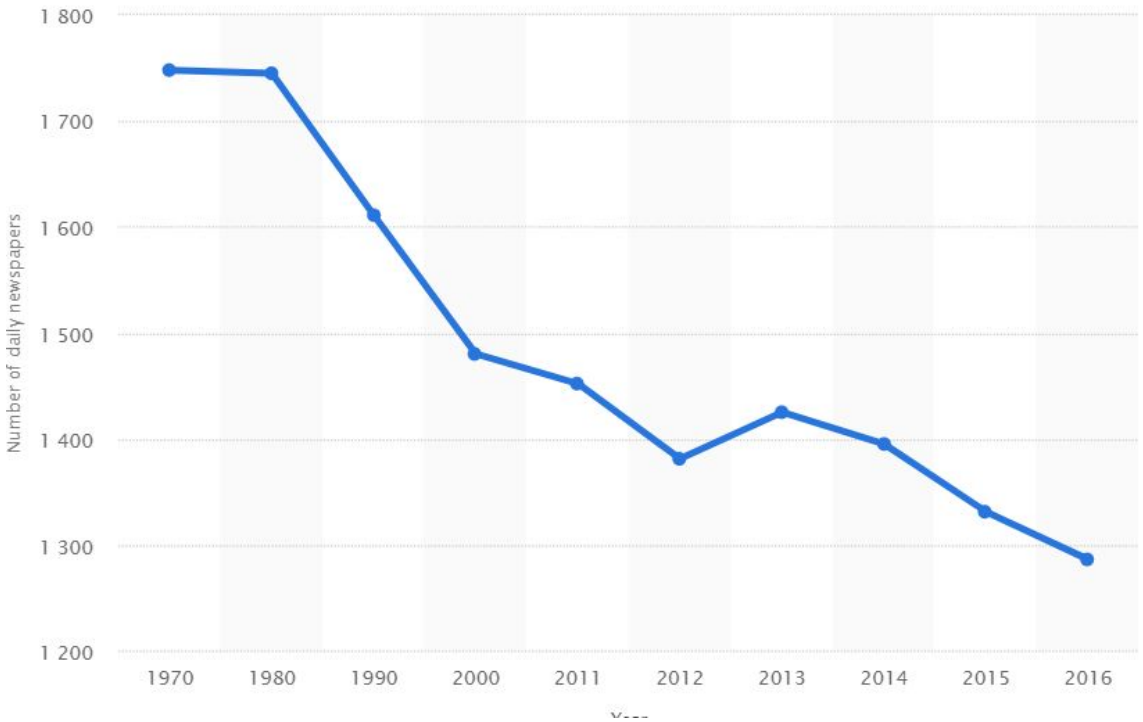
A recent article in the weekend edition of *the Wall Street Journal* "**News Industry, a Stark Divide Between Haves and Have-Nots**" highlights the demise of the newspaper industry in the United States. Even though digital is taking over print, the speed of the death spiral is nonetheless surprising. What we lose with this trend is diversity of thought and any notion of local watchdogs committed to Superman's Truth, Justice and The American Way. A recent example is the Ralph Northam racism accusation and how the news story and Northam literally disappeard with the cooperation of an amazingly well organized cartel controlling the news of his racist sympathies in medical school.

Northam and The Cartel

Recall that Northman is the current Governor of Virginia and he was accused of using blackface in a yearbook photo – a charge he first admitted and then denied. This was February 2019. In a era where racism is the the number one rallying point for students on almost every college campus there is virtually nothing being said, published, tweeted, reported, blogged, podcasted, videoed or instagrammed about Northam.

How can it be that a Google search takes me to February links and then nothing in March or April 2019 until a link to a PBS article on May 21 2019 saying that an independent report had been undertaken by a law firm hired by Virginia Medical School? The article does not say what the report found.

At its heyday in the 1970's there were 1748 newspapers in the United States. Those dailies and weeklies provided local news and a validation of the diverse opinions of the nation at large.



The internet changed everything. As newspaper circulation declined, the industry consolidated and Gannet became the largest owner of dailies. USA today began to repurpose local news to attract local print advertisers. The revenue model was a combination of subscribers and advertisers.

Model Shifts To Digital Conversion

Facing the headwinds of social media and news on demand from Twitter, Facebook, Instagram and You Tube many newspapers attempted a digital conversion. They found, however, the prices for digital advertising were a fraction of print advertising. Also Facebook and Google dominated the local ad spend. Today 77% of local digital advertising is dominated by these two giants.

At the same time as the newspaper industry was diving like a Max737, the media world was consolidating. Billionaires like Jeff Bezos (Washington Post). Patrick Soon-Shiong (*Los Angeles Times*) and Warren Buffet (many including *Omaha World-Herald*) were buying the best newspapers. Large media conglomerates were emerging with a span of control over TV, radio, movies, social media, cable, satellites, podcasts, magazines. That consolidation has resulted in 6 corporations and 16 Billionaires controlling all

forms of media and two giants, Google and Facebook, controlling most of social media. By comparison, in 1983 90% of media was owned by 50 companies and multiple individuals. Here are the six corporations and a few of the Billionaires:

Money Buying Influence Is A First Amendment Right

As alarming as this is on its own, a Supreme Court decision in 2010 called *Citizens United* decided that money buying political influence was protected speech under the First Amendment. In that case a conservative film about Hillary Clinton was banned under election laws. The Supreme Court ruled that conservative groups are entitled to buy votes by portraying Ms. Clinton in a critical light. Since that ruling wealthy people and corporations can buy political influence as a First Amendment Right.

One of my college roommates pursued a law career working for clients without money or power and has studied metamorphoses of the First Amendment and the state of play after *Citizens United*. He was obviously a Rhodes Scholarship finalist for a reason:

Monopolies Abound

"I agree that monopoly or near-monopoly issues afflict much of modern life — if you want to fly, or have a smart phone, or bank, (or ski) etc., nearly everything is controlled by a very few providers with similar interests and enormous public influence. Citizens United gave such centers of power huge leverage by effectively making money political "speech." So, it's hardly surprising that the "fourth estate" of the press has followed the same path to consolidation in order to survive — and consolidation almost always puts a premium on profit at the cost of all other values. And yes, CNN and Fox aren't about news any more than Facebook is about "community."

I've long said that changing a few words in the First Amendment would level the political playing field and would restore some of the balance of the pre-electronic age, when you had to build consensus to be heard. Right now, the First Amendment protects those with the most power, and maybe those with the least (like prisoners and other have-nots), and is mostly irrelevant for the vast middle class. If commercial "speech" were excluded from the First Amendment we'd all be better off.

I think if you read history, you'll see that in the early days of America things weren't all that different — there was lots of chicanery and powerful newspapers could control the national messaging. But the web has changed the world, and I think we need new rules to restore balance. But it's hard to fight the forces that want to monetize and politicize everything – even time and attention – and that have no allegiance to truth, honesty, integrity, or fairness (let alone beauty, contemplation, solitude, silence, depth).

Phone A Friend (http://pe4fams.com/phone-a-friend/)

By Rob McCreary

In the Game Show "Who Wants To Be A Millionaire" when they were unsure of their final answer contestants had three lifelines. My favorite was **Phone A Friend** because the interaction was often hilarious, usually unexpected and often wrong.

Who Wants To Be A Trillionaire?

I could not stop thinking about a similar game show being played by Apple right now. With A Trillion Dollar market cap in sight earlier this year there were nonetheless a few unanswered questions about Apple's future. The first was whether Apple would be permitted to sell its iPhone's in China. The second was how could Apple pressure their suppliers, especially Qualcomm, to lower royalties to improve cell phone profitability.

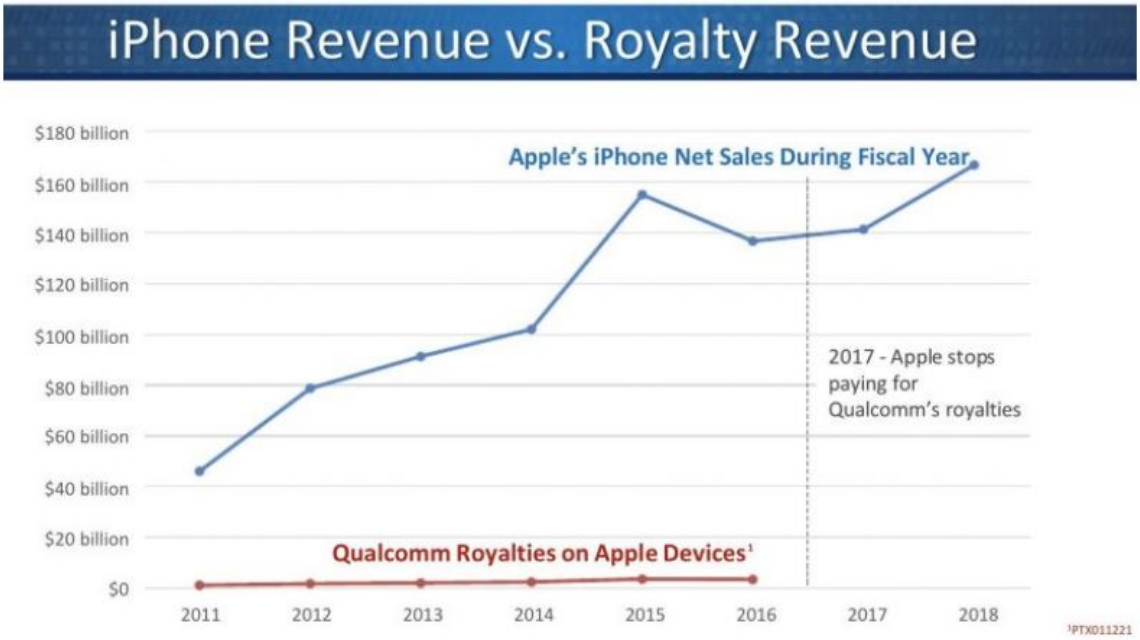
By way of background Qualcomm is a chip maker for cell phones, but its real profitability derives from a prodigious patent portfolio that has a monopoly on how cell phones connect to the internet. That monopoly is a legal monopoly because it is secured by patents and billions of dollars of R&D investment by Qualcomm.

Phone A Friend On Different Continents

Apple decided to phone a friend in 2016 and 2017 when it filed a formal complaint with The Federal Trade Commission alleging that Qualcomm was using its monopoly power by charging patent royalties based on the price of cell phone instead of the price of their chips as well as withholding chip supply to any party who would not accede to their royalty arrangement. The FTC agreed to investigate Qualcomm.

Interestingly, Qualcomm also phoned a friend. While Qualcomm is a US company headquartered in San Diego it prevailed on the courts in China to enforce Qualcomm's patent portfolio against Apple. Apple had been using Qualcomm's proprietary

technology for more than two years without paying royalties.

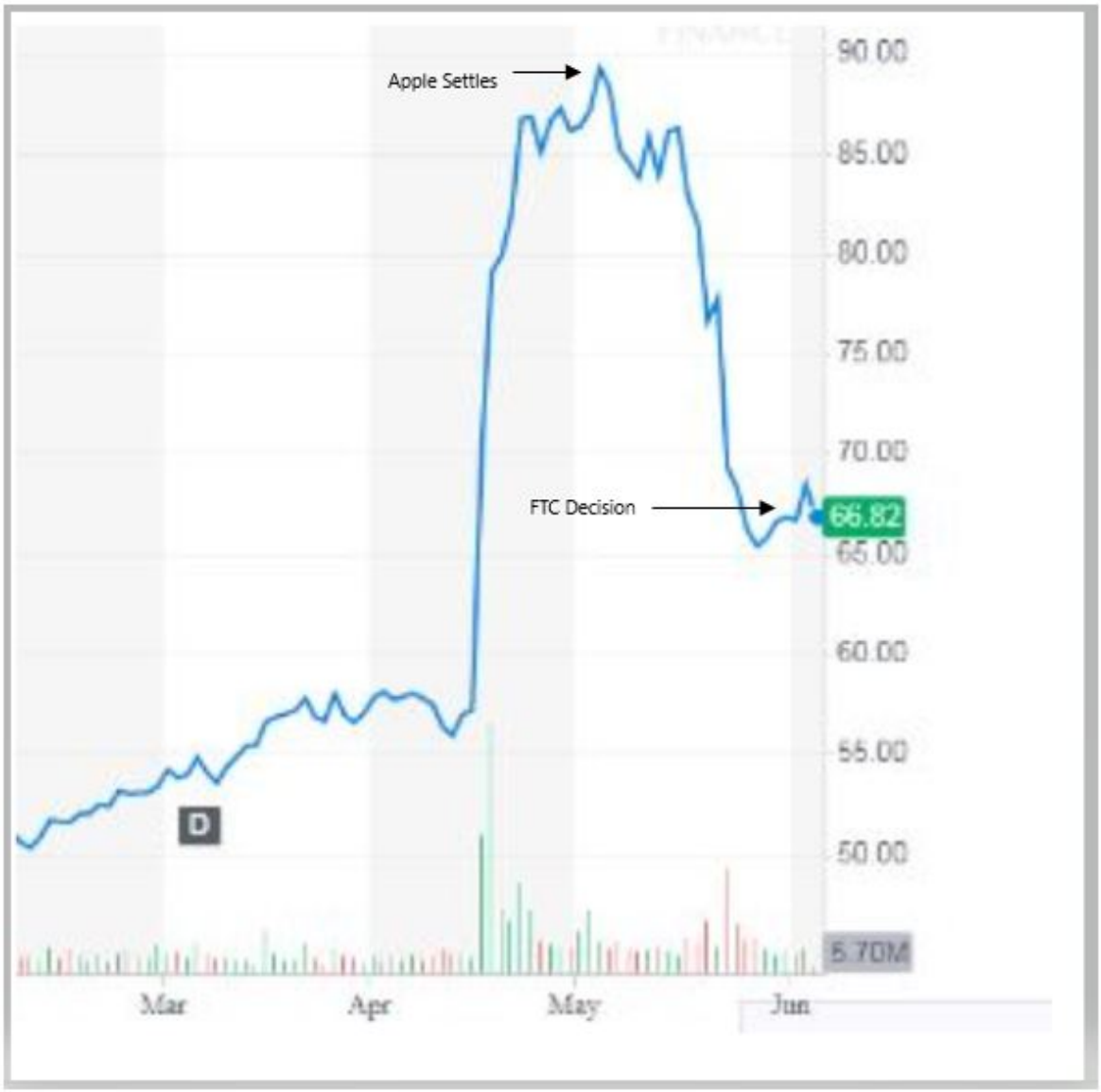


Qualcomm used slides like this in its case against Apple to illustrate how it wasn't compensated for its work — but the company has been found guilty of abusing its own monopolistic position in the market.

It is ironic that China, not the US, in response to Qualcomm's allegations of infringement by Apple suspended Apple's sale of iPhone's in China on the basis that Apple was infringing Qualcomm patents.

Then File A Lawsuit Against Qualcomm

Independently, Apple phoned their best real-world law firm in January 2017 to sue Qualcomm in a private action to obtain the same remedies they were seeking from the FTC investigation. The pre trial discovery started in 2017 and the parties actually arrived in the courtroom on April 14, 2019. Opening arguments had not been completed when Apple and Qualcomm agreed to a global settlement of all open claims including the claims of monopolization, unfair pricing, failure to ship, and withholding intellectual property as a hammer in negotiations. The details of the settlement are sealed and we can only conjecture about how much of their royalty structure Qualcomm gave up in the six year arrangement. Here is a chart of Qualcomm's market cap rising by $41 Billion in the days after the settlement was announced and then cratering when the FTC announced its decision one month later.



Legal observers suggest the real world legal settlement was prompted by three coterminous events:

1. China decision to bar Apple cell phone sales in China until Apple stopped infringing Qualcomm's patents.
2. Intel's decision after losing more than $1 Billion to abandon being a second source of supply for Apple on chips for next generation technology called 5G.
3. Pre-trial discovery uncovered Apple's own highly favorable assessments of the quality and distinctiveness of Qualcomm's intellectual property based on patents (a legal monopoly). Apple had asserted that Qualcomm was charging much more that a fair and supportable royalty – the standard for royalties based on essential patents- by saying Apple's intellectual property was no more valuable than other

suppliers like Huawei, Samsung and Hitachi. It turns out Apple admitted internally that they could replace other suppliers, but Qualcomm's patents were irreplaceable. This set the table for irrefutable admissions by Apple they saw a commercial rationale for a sky-high royalty approach.

The real world had spoken and commercial foes had settled on the basis of truth found in the Apple files. The little guy's modem turned out to be irreplaceable and Apple had to use it. While Apple is 10x the size of Qualcomm, here David slew Goliath on the courthouse steps.

US Regulators Undeterred

The FTC case, however, continued. The judge overseeing the monopolization claims was undeterred by Apple's capitulation and one month later the Honorable Lucy Koh issued a 233 page opinion finding Qualcomm had abused its monopoly. The FTC press release summarizes its finding as follows:

"Yesterday's decision that Qualcomm's practices violate the antitrust laws is an important win for competition in a key segment of the economy. FTC staff will remain vigilant in pursuing unilateral conduct by technology firms that harms the competitive process by taxing its competitors' baseband processor sales, reduces competitors' ability and incentive to innovate, and raises prices paid by consumers for cell phones and tablets."

Qualcomm has appealed to the Ninth Circuit Court of Appeals in San Francisco. One of the remedies requires Qualcomm to submit to the supervision of the FTC for seven years. Another remedy might require it to supply its Chinese and Korean competitors who are attempting to win the fight for next gen 5G dominance.

In fact, phoning the friend may end up being a windfall for Apple competitors but no help for consumers. It appears Apple and Qualcomm's six year settlement is not affected by the FTC ruling and US consumers won't get cheaper cell phones after all.

The largest irony is just like I Want To Be A Millionaire the Phone A Friend at FTC is probably wrong and oblivious about the real commercial stakes. The FTC's analysis contradicts many aspects of antitrust law under the Sherman Act. The Justice Department has already asked the FTC to hold hearings on modifying the remedies. This never happens.

Our Chinese and Korean competitors are quite pleased.

The stock market was not pleased with another situation where a zealous regulatory body funded by taxpayers with nothing but reputation at stake had overruled a real-world contest worth Billions of market cap in complete contradiction to how the real contestants had already settled the dispute.

Moneyball For Hedge Funds (http://pe4fams.com/moneyball-for-hedge-funds/)

By Rob McCreary

Business and sports understand the importance of a scorecard. But what if CEOs only got the final earnings number, or if Jordan Speith's only input for improving his game was his 18-hole score instead of fairways hit, greens in regulation, sand saves and putts? Similarly, what if Mookie Betts only input was his final batting average or Corey Kluber only knew his year end ERA?

You Can't Improve Something You Can't Measure

Most sports and most businesses understand you cannot improve without measuring each aspect of performance. In business we look at a balance sheet, an income statement and a cash flow statement to give us different views of overall performance. In baseball hitters and pitchers have coaches, sabermetrics, video, and heat maps to help players understand strengths and weaknesses- both their own and their opponents.

It has even come to a point where three Major League hitting coaches for the Cardinals, Pirates and Mets have no pro baseball experience at all, but they are really good at data.

In this era of data analytics how can there be a multi trillion-dollar industry that mostly looks at results and, to my knowledge, only recently started looking at the behavioral tendencies of its best players? It is like telling Jordan Spieth he has moved from #1 in golf to #40 without menti-ning it might be his putting. More importantly, wouldn't that industry be a target rich environment for the right set of coaches?

Zero Alpha For The Last Ten Years!!!

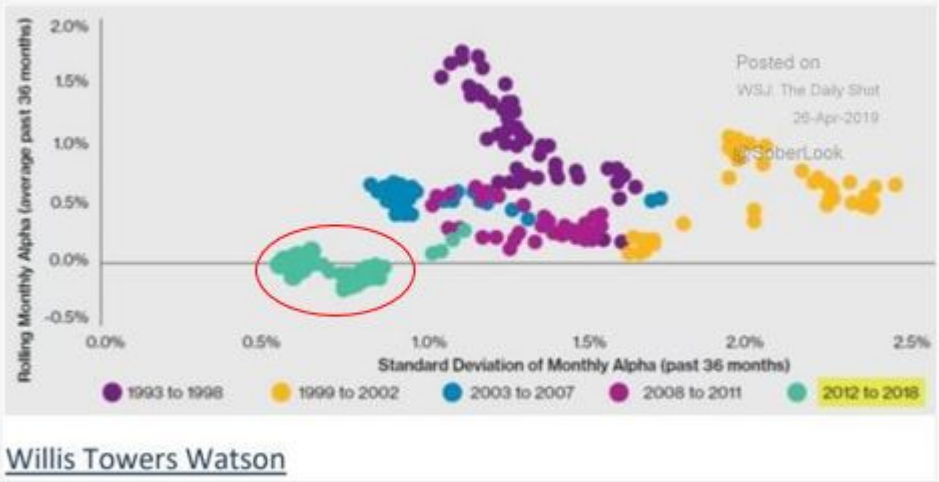
That industry is hedge funds and notwithstanding endless data on buying, selling and sizing trades for each manager and each trade there has been little analysis of behavioral tendencies that add or subtract from manager ALPHA- their demonstrable outperformance against an index. In "Managing Equity Portfolios" Michael Ervolini, founder of Cabot Research describes how his firm marries data analytics based on proprietary software to the behavioral tendencies of the best investment managers. He has discovered pros underperform just like the rest of us because of the way our brains are wired to override even the most disciplined approaches to investing:

- Regret Aversion-initial sizing is small and manager won't add
- Endowment Effect- overvaluing stocks we own
- Risk Aversion- harvesting gains too early
- Loss Aversion- hold losers too long

- Avoidance of Pain- selling temporary losers that later bounce back

These days the active managers need some Alpha or to use Austin Powers characterization they need to get their" Mojo" back." Here is a look at the hedge fund's Alpha by decade. Notice the most recent 10 years circled in red show ZERO ALPHA:

- Hedge fund alpha over time:



Source: Willis Towers Watson, Skënderbeg Investment Management

Cabot has targeted the high end managers for its data analytics and Ervolini's sales pitch is compelling. How would you like to improve your batting average by 20% or your greens in regulation by 15%? How about increasing a 7% investment return by 100-200BPS?

Bottom line book review- this is Kahneman & Tversky meets Billy Beane for the hedge fund industry. The book is an excellent read for any serous investor. What shocks me, however, is why active managers are among the last athletes on the planet to get help- after all they are managing almost $1.4 Trillion of our money.

An even more important question to ask Mr. Ervolini is whether computers can be programmed to avoid behavioral tendencies that subtract from manager ALPHA? If algorithmic trading can consistently avoid all the human frailties like "endowment effect" and" loss aversion" maybe the hedge fund industry will continue to experience drawdowns?

A Gutsy Call on Interest Rates (http://pe4fams.com/a-gutsy-call-on-interest-rates/)

By Rob McCreary

I guess I am just a sucker for contrarian thinkers, but when I first read Stephanie Pomboy's investment guidance in an article by ***Barron's*** Leslie Norton on March 22, 2018, I was a little skeptical about her thesis. In the face of a new Fed Chairman's committed interest rate increases for 2018, Stephanie was telling her clients to buy 10 year treasury bonds as her best investment idea???

This is a single direction trade with no place to hide. The only way you get any increase in bond value is dramatically lower interest rates than anyone could foresee at that point.

Stephanie Pomboy is the founder of MacroMavens and she is a frequent contributor to ***Barron's***. In February of 2018, when she was interviewed by Leslie Norton of ***Barron's.*** She was then a lone voice on the subject of interest rates:

"*I know everyone thinks the 10 year is going to 4% or 3.5% or whatever, but we are more leveraged today than ever; our threshold for pain is lower than the market recognizes, so I would be overweight long dated treasuries and underweight the dollar. Those four rate*

hikes will be chopped to three and then two, and people will actually start to talk about maybe they have to pause quantitative tightening."

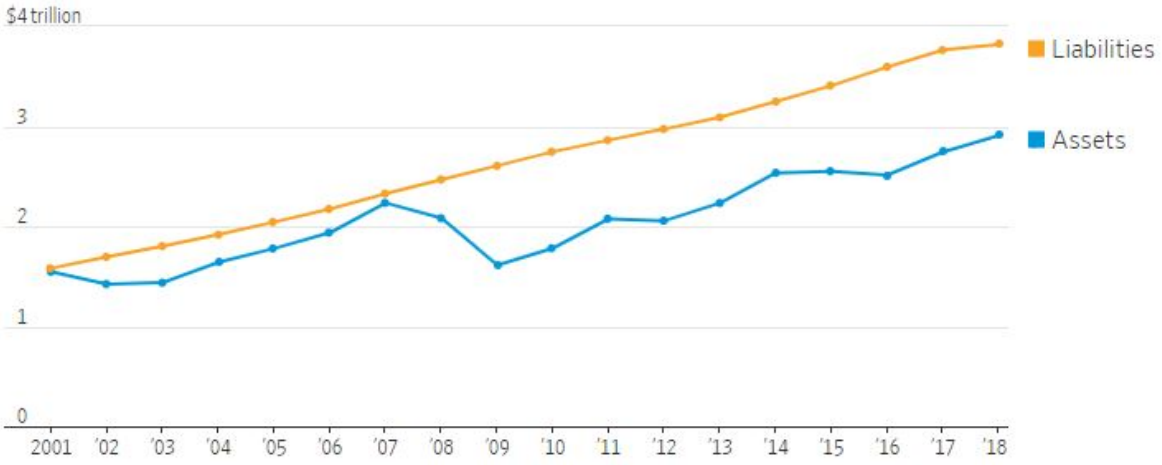
Ms. Pomboy's call has proved to be prescient. She had the correct view of the consumer being "tapped out" and more likely to save the Trump tax cuts than spend them. She also showed a keen appreciation of the costs associated with debt-based prosperity.

The Fed blinked in November 2018, when the 10 Year Treasury rate touched 3.2% and since then the yield on the 10yr treasury has fallen to 2.3% in March 2019, and now stands at 2.58%. The S&P 500 has rallied from a low on December 24, of 2,351 to 2,905 on April 15, for a YTD gain of 23% and all is well again.

The elephant in the room, however, is still the consumer as well as underfunded public and private pension promises. ***The Wall Street Journal*** highlights the extent of the pension problem in its April 10, 2019 edition in an article by Heather Gillers.

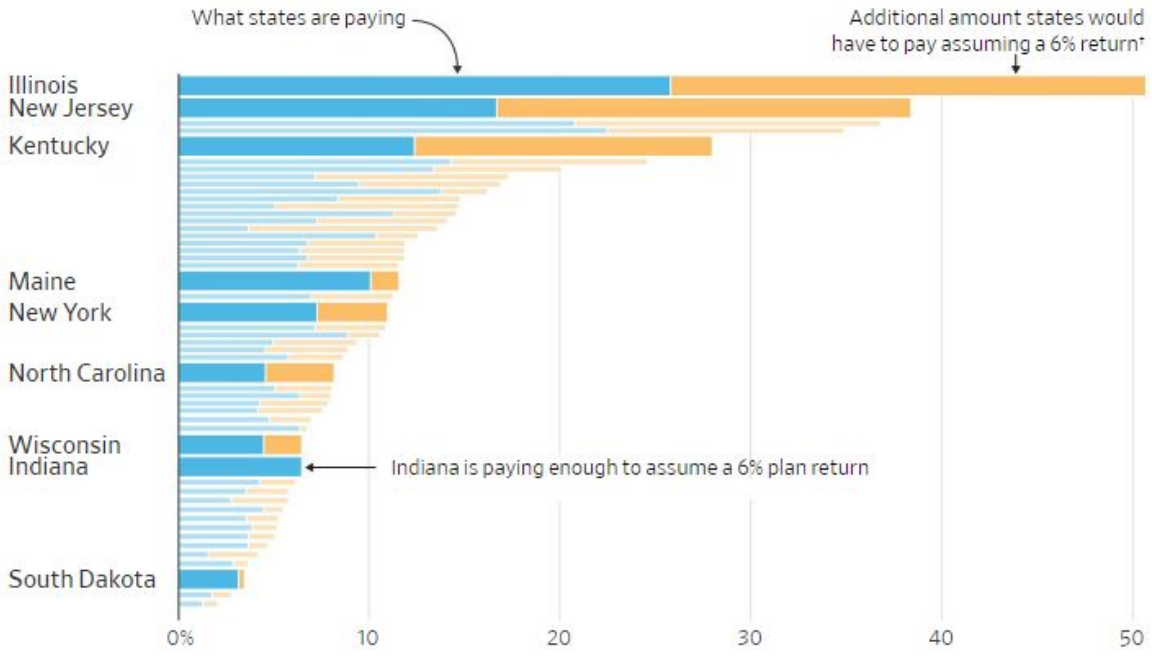
Ms. Gillers looked at state and city underfunding and concludes that even though there has been a phenomenal recovery in the stock market since 2008, the investment returns did not keep pace with the increase in liabilities; "Liabilities of major U.S. public pensions are up 64% since 2007 while assets are up 30%, according to recent data from Boston College's Center For Retirement Research." For example, in 2010 the assets were valued at $1.78 Trillion and the liabilities were $2.75 Trillion – about a $1 Trillion underfunding. Today the assets are $2.91 Trillion and the liabilities are $3.82 Trillion- about the same $1 Trillion underfunding. These charts show the math problem and why the Fed must continue to provide liquidity induced stock market returns:

Liabilities and assets for major U.S. public pensions



Note: Data cover 109 major pensions for which 2018 data is available.
Source: Boston College Center for Retirement Research

Pensions and other long-term costs as a percentage of 2017 state revenues*



*Costs include retiree healthcare and interest on bonded debt. †Also assumes unfunded liability is paid off over 30 years in level payments.

Source: JPMorgan Asset Management

A logical question to ask is how we can ever close the $ 1 Trillion gap? We have had perfect conditions for a decade and now most of the variables are turning against any further reduction.

- Return assumptions for the future are dramatically lower.
- Fewer workers support more retirees who are living longer.
- Future stock market returns cannot replicate the last 10 years without consumer spending

- Cutting pension promises is political suicide.
- Yields on risk free assets are miniscule.
- Many states cannot afford their current promises.
- Infrastructure everywhere needs attention.
- Millennials are sitting on their wallets

Pomboy was prescient to see a strong relationship between the economic welfare of the U.S. consumer and the growth of GDP. Just by looking at unfunded public retiree pensions you can predict they are likely to get about 1/4 less in promised pensions than they expect and that may fall even more if the stock market starts to trade on future growth prospects, not momentary liquidity. When it is clear that spenders must become savers to survive retirement what will sustain a 25x PE multiple?

What Baseball Teaches You About Talent Recognition and Retention (http://pe4fams.com/what-baseball-teaches-you-about-talent-recognition-and-retention/)

By Rob McCreary

When pitchers and catchers report for spring training the winter of my mind officially ends. My seasonal affective disorder of endless nights fades to a new dawn of clarity and understanding. I begin to see baseball as a metaphor for business.

There is a significant problem in baseball right now with team owners not giving really great stars like Bryce Harper and Manny Machado long-term, big money contracts. The union is calling it collusion. The owners are mum.

2014 Detroit Tigers….

The Miguel Cabrera experience still has owners twitching. In 2008 at age 25 a future Hall of Famer was paid $152 million for 8 years to play for the Detroit Tigers. Moving forward to 2014 the Tigers decided Cabrera was their franchise player and awarded him a contract extension of 8 years for $248 million. Including the 2 years left on his 2007 contract this became a 10-year commitment for $292 million through 2024 at which time Miggy would be 41.

The interesting dilemma for Mike Ilitch, the Tigers owner and Dave Dombroski, Tigers general manager was the cohort of Tiger superstars on that 2014 team that were not given the big contract:

- Max Scherzer, RHP won 3 NL Cy Young Awards and 6x All Star selections and has a combined win/loss of 159-82 for the Washington Nationals.

- Justin Verlander, RHP- won 1 Cy Young, a World Series ring with Houston in 2017, MVP of World Series and has a combined win/ loss record of 204-123 for Detroit and Houston.

- David Price LHP- 1 Cy Young in 2012, won a World Series ring for Boston in 2018 and has a lifetime win/loss of 142-75.

- Rick Porcello, RHP – 1 Cy Young Award, World Series ring for Boston in 2018 and lifetime 135-106 win/loss record.

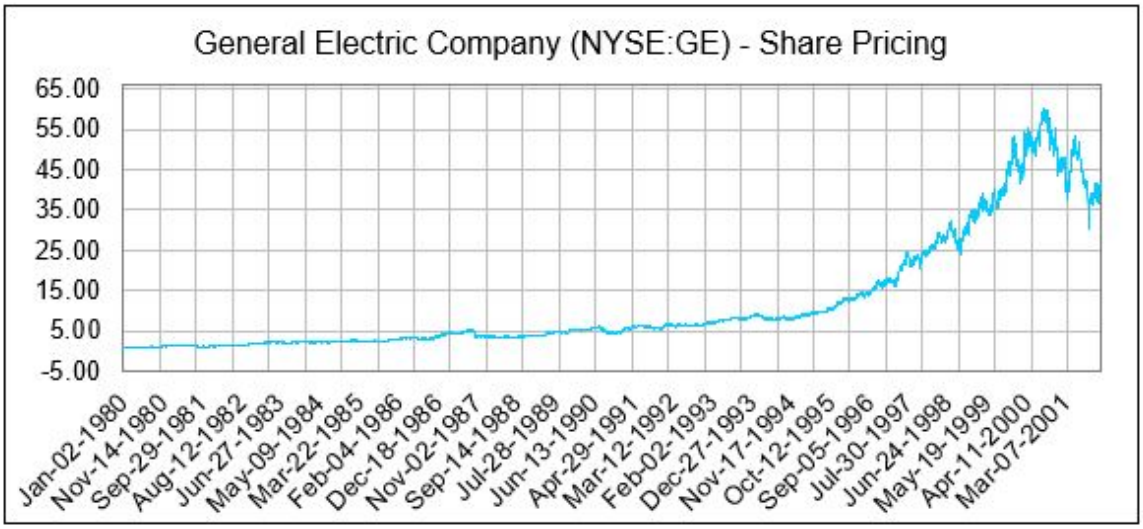
- JD Martinez- World Series ring in 2018, AL RBI leader in 2018 and 2x All Star

Became The 2018 Boston Red Sox

Dave Dombroski left Detroit to become the General Manager of the Red Sox in 2016 and promptly signed the nucleus of the 2014 Detroit Tigers- Price, Porcello and Martinez. They won a World Series in 2018.

General Electric in 2001

In a parallel universe another fabled franchise, General Electric, had just finished a world series parade of Jack Welch successes spanning 20 years and succession was almost an afterthought. The investment community was convinced Welch had set things on autopilot and long-term property for GE shareholders was similarly linear. Insert GE stock chart from 1980 to 2001.



Should I Wish Upon A Star?

I wonder if Miguel Cabrerea has ever met Jeff Immelt. They bear little resemblance other than being internal, “can’t miss” superstars each of whom got big contracts and proceeded to lead their franchises to the basement. In GE’s case they lost Gary Wendt

who ran GE Finance and whom Jack Welch feared would overshadow other CEO aspirants who went into private investing, James McNerney who then became CEO of 3M and later Boeing, Robert Nardelli who became CEO of Home Depot and then Chrysler.

For the Tigers, the eventual loss of Verlander, JD Martinez and David Price without a world series trophy doomed a great American east franchise to perpetual rebuilding.

Maybe the "Moneyball" educated baseball owners are getting the message about giving long term contracts to can't miss candidates. I am sure Board of Directors all over America are thinking about the Immelt effect as well.

When the star culture overtakes a team culture you get GE and the Tigers. Good stewardship often means having many high achievers under one roof. It is equally important for company Boards and baseball leadership to find a process for recognizing talent and then retaining it.

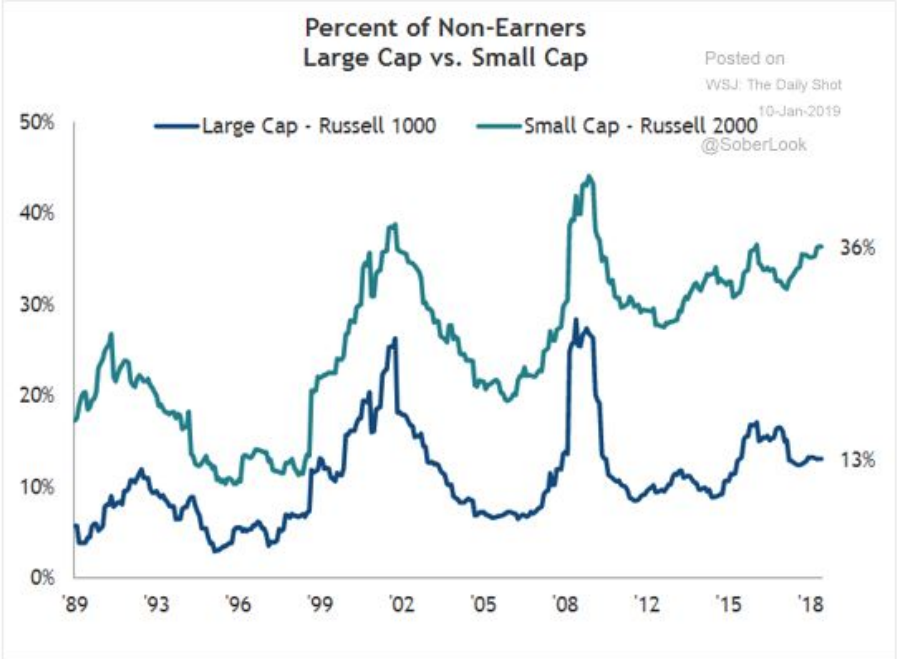
Experts Looking At Corporate Balance Sheets (http://pe4fams.com/experts-looking-at-corporate-balance-sheets/)

By Rob McCreary

Barron's recently invited 10 leading financial minds to look into their crystal balls and predict how capital markets may fare in 2019. This round table is always interesting, but you have to remember panelists' perspectives are usually tied to the industry that pays their salary. Abby Joseph Cohen is still representing Goldman Sachs.

This year a few of the panelists broke rank and gave a sobering look at the issues corporate America is facing on account of debt based tactics to goose earnings at the expense of balance sheets. Debt based prosperity is suddenly a significant concern.

By way of background, *The Daily Shot* also rang the same bad weather bell when it showed this surprising capitalization factoid:



Source: SunTrust Private Wealth Management

(http://pe4fams.com/wp-content/uploads/2019/01/Small-Cap-Losers.jpg)

It is hard to believe that 36% of small publicly traded stocks do not have earnings but this is consistent with a blog I published earlier about the noticeable rise in so called Zombie stocks ("Zombie Stocks Look Pretty Lively" and also a blog I wrote in October

("You Know It Is A Top When") suggesting the equity market was peaking as management teams leveraged their companies to buy back their stock.

Those two themes were also voiced by a number of *Barron's'* panelists:

Jeff Gunlach, CEO and CIO DoubleLine Capital: " The biggest risk is in the corporate bond market…A Morgan Stanley research report suggests that, based on leverage ratios alone, 45% of investment grade corporate bonds would be rated "junk" right now. The report further suggests that around 60% of corporate bonds currently rated BBB would be rated junk right now." This situation arises as Central banks around the world are removing liquidity, and in the US, raising rates.

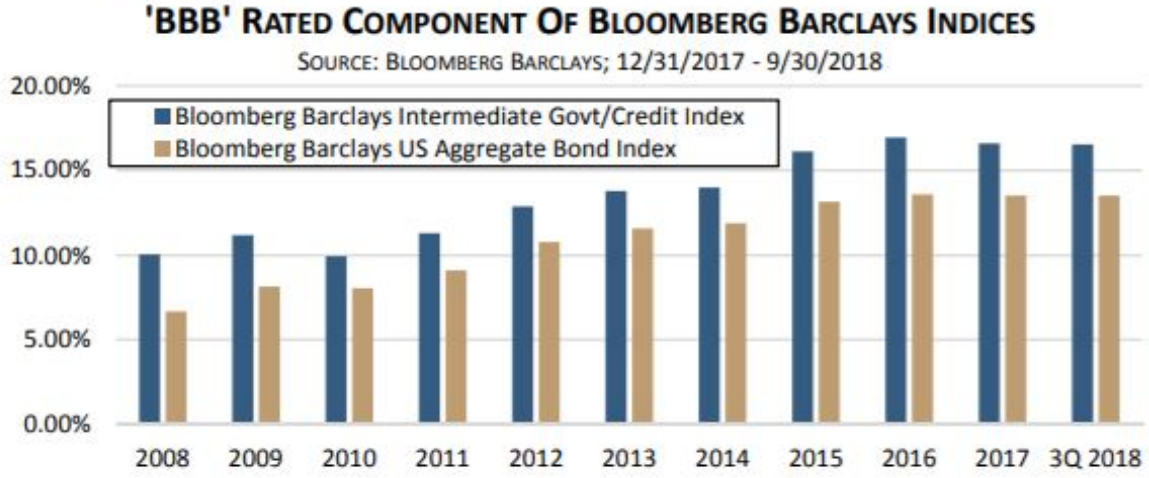
William Priest, CEO and co-CIO of Epoch Investment Partners:" Quantitative tightening, or QT, impact will be profound. In my view, quantitative easing was necessary after the financial crisis to offset liquidity and solvency issues. We probably should have stopped QE in 2011, but that's hindsight. QE artificially drew down the discount rate for all financial assets and was a fantastic stimulus to the stock market."

Rupal Bhansali, Chief Investment Officer, Ariel Investments "Cash will no longer be a four-letter word. Debt will be a four letter word. The thing to bet on the coming years is net-cash companies"…Investing is ultimately about figuring out the unexpected because the expected is already in the price. That's why corporate leverage isn't just a problem for fixed income markets, but is a bigger one for equity markets. Equity investors need to remind themselves of their status in the corporate structure."

Fixed Income Manager Sounds same Warning

Piling on with its own warning, the fixed income experts at Wasmer Schroeder & Company published a year-end review of corporate debt markets. Here is what Christopher Sheehan, Vice President, Senior Portfolio Manager wrote about the proliferation of BBB rated debt in almost all indices:

As seen below, the Bloomberg Barclays Intermediate Govt/Credit Index contained nearly 17% in 'BBB' rated exposure in 2018 compared to approximately 10% a decade ago. Similarly, the 'BBB' rated portion of the Bloomberg Barclays US Aggregate Bond Index nearly doubled between 2008 and 3Q 2018. The Bloomberg Barclays broad corporate bond index contains 50% 'BBB' rated bonds.



(http://pe4fams.com/wp-content/uploads/2019/01/Wasmer-BBB.jpg)

I have to admit that it is rare to see so many panelists pointing to the same unrecognized risk factors. I also can't recall anyone talking about corporation balance sheets this much since I started investing in the early 1970s. Maybe deep value, active investment will be back in style soon?

Opportunity Zones- Gimmick or Gamechanger? (http://pe4fams.com/opportunity-zones-gimmick-or-gamechanger/)

By Rob McCreary

A little-known provision of the Trump Tax Reform Act of 2017 was bipartisan support for an interesting tax incentive around investments in Opportunity Zones. This is the hottest tax dodge since tax shelters in the 1980's, but whether it will serve its purpose of distressed community development is uncertain.

Here are a few Q&A clarifications from a recent IRS publication explaining how the tax regimen will work:

Q – What is an Opportunity Zone?

A – *An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service. Click here to search your geography https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml*

(https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml) (the box to type the address into is up in the top right corner). ***You will need to have or download flash for the link to work correctly.***

Q – How do Opportunity Zones spur economic development?

A – *Opportunity Zones are designed to spur economic development by providing tax benefits to investors. First, investors can defer tax on any prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. If the QOF investment is held for longer than 5 years, there is a 10% exclusion of the deferred gain. If held for more than 7 years, the 10% becomes 15%.* ***Second, if the investor holds the investment in the Opportunity Fund for at least ten years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that investment is realized (emphasis added)***

Q- I sold some stock for a gain in 2018, and, during the 180-day period beginning on the date of the sale, I invested the amount of the gain in a Qualified Opportunity Fund. Can I defer paying tax on that gain?

A – *Yes, you may elect to defer the tax on the amount of the gain invested in a Qualified Opportunity Fund. Therefore, if you only invest part of your gain in a Qualified Opportunity Fund(s), you can elect to defer tax on only the part of the gain which was invested.*

What Does This Mean For Qualified Opportunity Zones?

Interestingly, investments in real estate as well as businesses located in those designated communities could qualify for tax deferral on the source of the investment capital as well as tax forgiveness on the gain from the new investment. The applicability to real estate development is clear, but the rules for business investment are quite tricky.

Let's take the example of an apartment development in Tremont, a trendy neighborhood just south of Cleveland, Ohio. A developer owns a property which he has permitted for a 5 Floor Apartment Building with construction planned for 2019. His project construction costs are $7.5 million of which $2.0 million is equity. The developer forms an Ohio limited partnership "QOF Fund I, LP." to invest in the Tremont apartment building project and, possibly, a follow-on project across the street.

Luckily, the developer has a relationship with the Gotrocks family who just sold their family business in early 2019 for a substantial gain. The developer suggests the Gotrocks invest $1.0 million in QOF Fund I. He then makes the same proposal to several other families with a similar capital gains and cash to invest. They pool their resources and fund all $2.0 million of equity. Non-rollover investors can participate in the investment but they will not get any of the tax benefits.

Gotrocks family has a good accounting firm, Counter, Beans and Sheets. They advise Gotrocks to claim a deferral of $1.0 mil of the large gain from the sale of the family business on their 2018 1040 tax return even though that event was late 2018 and the QOF investment was early in 2019. Counter Beans explains that any capital gain is eligible for deferral if the QOF investment is made within 180 days after the date of sale (for pass through entities it is year end regardless of transaction date).

Counter Beans also explains to Gotrocks that the $1.0 million deferral is until 2026 (or earlier if the replacement project is realized) and, if the apartment investment is held for 5 years Gotrocks can also exclude 10% of the $1.0 million family business gain and 15% if they hold the apartment project for 7 years (2026)!

The Real Tax Benefit

That is just the icing on the cake. Gotrocks can also exclude 100% of its share of the gain on the sale of the apartment building project if it is held for 10 years (2029). Not surprisingly, it looks like the developer (think Trump Enterprises) can also exclude 100% of his gain from a carried interest even though he would have made only a nominal capital investment.

Counter Beans says IRS is still developing rules on whether debt is included in tax basis for purposes of calculating gain on the sale of the projects. There should also be clarification about the tax treatment for promoters.

What About Small Businesses?

The rules are more complicated. For a business investment to qualify its revenues and income must be "principally" generated within the boundaries of the Opportunity Zone. According to recent IRS clarifications, "Principally" means 70% of 90% or 63%. So, if a yoga studio had three locations inside the Zone and one outside the Zone and each had similar revenue, the QOF could invest in all four and, if those 4 studios were held for 10 years, still write up the QOF tax basis in all four to fair market upon realization in a sale transaction.

Many Unanswered Questions

There are still interesting questions. If a QOF project or a business distributes capital gain profits before selling in year 11, do those profits qualify for a tax refund? How can a high growth business with sales mostly outside the Opportunity Zone qualify? Will this tax break really stimulate community redevelopment?

This tax change has stimulated a significant buzz at holiday gatherings, especially because many investors have taken gains in the stock market. While the motivation is tax savings, it may turn out that some good community redevelopment work also takes place?

Zombie Stocks Are Alive And Well (http://pe4fams.com/zombie-stocks-are-alive-and-well/)

By Rob McCreary

The zombie motif was popularized by the horror movie "Night of the Living Dead" where zombies and vampires morphed into aggressive and deadly undead preying on humans. The zombie concept moved into finance with the advent of Zombie Banks in Japan in the "lost decade" of the 1990s. Those Zombie Banks were kept alive by accommodative central banks ,even though a majority of their assets were often non-performing.

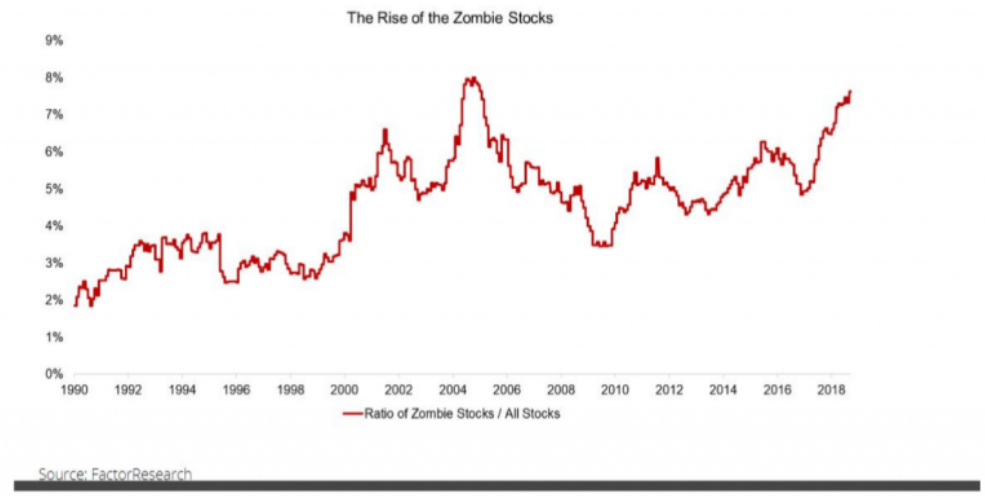
Recently, the Zombie Bank discussion has focused on Chinese financial institutions who are insolvent because they have financed "see through" apartment complexes and also participated in shadow banking activities.

In all these cases it is accommodation from a government or central bank as part of monetary policy that keeps these undead institutions going. However, I never would have expected similar support for undead corporations from supposedly Darwinian capital markets around the world.

US Capital Markets Have Many Zombie Companies

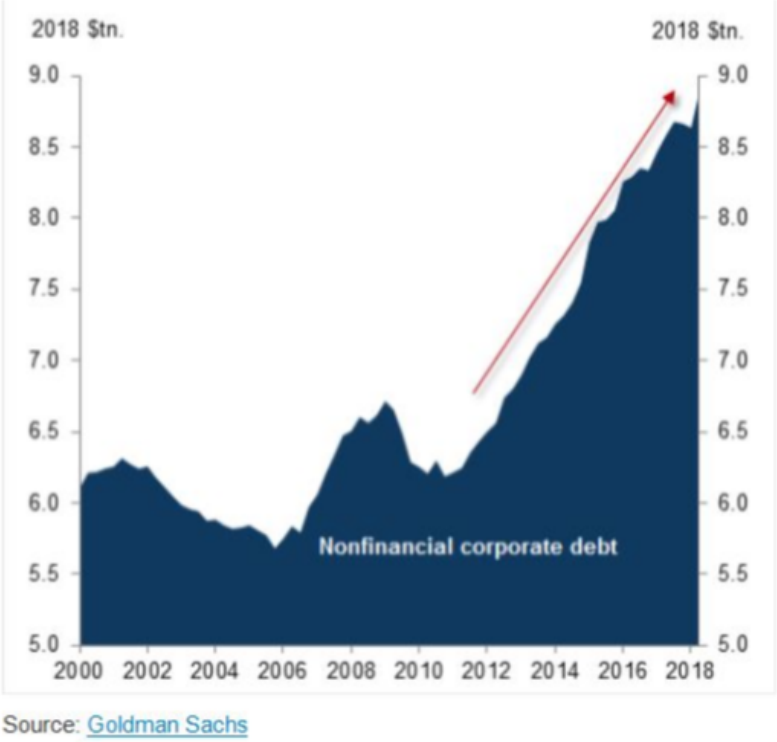
The number of undead public companies trading in the US capital markets surprised me. According to *The Wall Street Journal* "Daily Shot" and an article by Nicolas Rabener from Factor Research more than 10% of publicly traded stocks in 14 advanced

economies with market caps in excess of $500 million have higher interest costs than operating earnings . In the US capital markets that number is 8%, matching the Zombie percentages from 2006.



(http://pe4fams.com/wp-content/uploads/2018/11/Rise-of-Zombie.png)

In these studies by the Bank of International Settlements (BIS) a public corporation is a Zombie if its interest coverage ratio (ICR) has been less than one for at least three consecutive years and if it is at least 10 years old. By comparison, healthy public companies have a worldwide ICR of 4x and a US ICR of 9.7x. This chart shows the general rise of indebtedness of non-financial publicly traded companies in the US. Notice the almost 50% increase from 2008.



(http://pe4fams.com/wp-content/uploads/2018/11/Zombie-Corp-Debt.png)

In fact, these "Zombie public companies" which are functionally insolvent are actually trading at a surprisingly small discount to the S&P 500:

(http://pe4fams.com/wp-content/uploads/2018/11/Zombie-v-SP-500.jpg)

The BIS and Rabener research conclude that a persistent falling interest rate from 1986 to 2016 has actually made these zombie companies look like they are improving because, even though they are not paying down principal, their ratios improve as their interest burden falls. The research also concludes that weak banks do not demand restructurings and bankruptcies in periods of low interest rates. The Zombie banks are keeping the Zombie corporations alive.

By Comparison PE Banks Are Quick To Act

This is a major divergence from the banking world we live in.. In the private equity world if you have a small company with an EBITDA to interest ratio of less than 1:1 you are on your way to a special assets group where the bank's work out people will direct cash flows to debt retirement by shrinking available leverage. You have to wonder how these Zombie companies in the public realm avoid similar treatment, especially in a period of rising interest rates where their ratios are now deteriorating?

One piece of useful research would be debt prices on public debt issued by Zombie corps. The debt markets always focus on repayment so their trading prices usually assess survival risk in the right way. How many of these Zombies have public debt that trades at a discount to par?

Is There An" ETF Effect" Lifting Zombie Prices?

I also wonder whether it is the ETF effect? With the shrinking number of publicly traded companies and the proliferation of financial products that attempt to mimic an index, is it conceivable that ETF managers mimic the indexes by buying undead companies in their tracking portfolio. If Zombies are 8% of the market above $500 million market cap, does the ETF portfolio intentionally include Zombies to make the ETF a true proxy? Without price discovery on an individual basis, these undead may just be pulled along by a tide of capital inflows?

If this is what is happening, maybe the ETF prospectus should warn: "**The manager will buy securities of ZOMBIE publicly traded companies that have the inability to generate operating profits in excess of their annual interest**

expense”

In any event, keeping Zombies alive might be important enough monetary policy for full employment , retirement funding and bank health that Jerome Powell and the FED have another reason to think about getting to the neutral rate fast and showing accommodation rather than tightening?

China Debt- Opportunity or Contagion (http://pe4fams.com/china-debt-opportunity-or-contagion/)

By Rob McCreary

Remember when a Japanese investment group bought Pebble Beach Golf Blub September 1990? It seemed like every important asset was being gobbled up by an ascendant Japanese economy. Soon thereafter in 1992 the Japanese real estate market crashed and then, in a great imitation of a kamikaze, the Nikeii followed suit Now, more than 25 years later, the Japanese economy is just starting to shake off the chains of asset deflation.

In the rearview mirror,the miracle of Japan was really a debt financed bubble and Bank of Japan’s monetary policy of keeping bad investments alive and preserving “zombie” banks spawned 4 decades of decay.

Murky As The Yangtzee

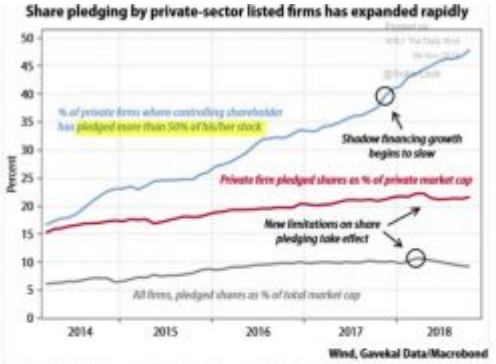
No one knows for sure how much debt is now supporting the China miracle? In his book on the subject, "China's Great Wall of Debt" Dinny McMahon, a financial journalist with the *Wall Street Journal* specializing in China, will not speculate about the debt burden (government, banks, shadow banks and private debt). Other sources like Wikipedia speculate the debt burden (on and off-balance sheet) could be $11 Trillion or about 90% of China's GDP. This may not capture the funding for China's Belt and Road infrastructure initiatives for which there is virtually no reported financial information.

Shadow Banking Products Are The Wild Card

Mr. Mc Mahon is especially concerned about the shadow banking system where banks sell their own "wealth management products" (WMPs) to customers where the holder is completely unsecured and bears the complete risk of loss. The US analogy might be a special purpose off balance sheet investment vehicle that is selling annuities (promises to pay) but has no assets. The difference in China is the state has always made good on bad debts, especially if generated by the banking system, and citizens trust the state's implicit guarantee. But according to McMahon the enormity of WMPs is staggering:

" In 2008, the future pillars of China's shadow banking barely existed. At the end of 2014, the amount of credit that had been generated by the shadow banking system was about 40% of China's GDP. By mid 2016, that had doubled to about 80%.

A recent factoid from *Wall Street Journal's* "The Daily Shot" was also pretty alarming. Apparently, business owners have been pledging listed shares for personal loans, and defaults are accelerating. The analogous situation is 1929 in the US. Once there is a default on the bank loan, the value of the collateral disappears quickly because there is no orderly downside market for stocks being liquidated in distress. If the securities cannot be liquidated, the banks will try to make a distressed sale of the underlying companies. The deflationary spiral is hard to stop. Just ask the Bank of Japan. Here is the information. The blue line is the percentage of listed firms where more than 50% of a company's shares are pledged.

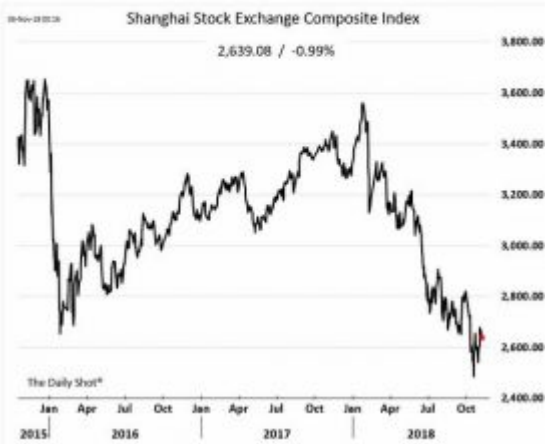


As the tide in Chinese stock markets has receded, it seems that many firms have been swimming naked. The controlling shareholders of hundreds of private-sector companies have pledged large quantities of their stock as collateral against loans from brokerages, who are starting to make margin calls as share prices fall. This is raising fears of a vicious cycle in which brokerages liquidate the collateral to recoup their losses, sending prices down further and sparking more margin calls. To avoid this danger, central and local policymakers have announced that a variety of state funds stand ready to provide liquidity to shareholders. Yet this cure for the illness risks causing another: if private shareholders sell out to these state funds, it will mean a big advance in state ownership of the private sector. In fact, state investments in private-sector companies have already picked up sharply this year as financial stress has increased.

(http://pe4fams.com/wp-content/uploads/2018/11/China-Margin-Calls.jpg)

The Shanghai Stock Exchange has lost almost 30% of its value since the beginning of the year which puts even more strain on the credit system which is increasingly secured by pledges of stock collateral in material decline.

3. Private-sector firms are frequently pledging their company's stock as collateral for loans. That collateral has not performed well this year.



(http://pe4fams.com/wp-content/uploads/2018/11/China-Pledge-Shares.jpg)

Luckily most of China's creditors are its own banks and citizens. As long as they have confidence that China will provide, the moment of financial truth may never arrive. Unfortunately, recent experience suggests that all financial bubbles eventually burst and miracles turn to contagion overnight.

1 2 3 … 14 →

(http://pe4fams.com/page/2/)

Private Equity for Families

Private Equity for Families provides information for successful families who want to include private equity or direct investment in privately-held businesses in their portfolios. The blog is written by the principals of CapitalWorks, LLC, (http://www.capitalworks.net/) a private equity firm in Cleveland, Ohio.

RECENT POSTS

Facebook's Libra May Be A SuckerBit (http://pe4fams.com/facebooks-libra-may-be-a-suckerbit/)

Newspapers And The First Amendment (http://pe4fams.com/newspapers-and-the-first-amendment/)

Phone A Friend (http://pe4fams.com/phone-a-friend/)

Moneyball For Hedge Funds (http://pe4fams.com/moneyball-for-hedge-funds/)

A Gutsy Call on Interest Rates (http://pe4fams.com/a-gutsy-call-on-interest-rates/)

Team

(http://www.capitalworks.net/info/mikel-b-harding/)

(http://www.capitalworks.net/info/richard-r-hollington-iii/)

(http://www.capitalworks.net/info/w-todd-martin/)

(http://www.capitalworks.net/info/robert-g-mccreary-iii/)

CAPITALWORKS (http://capitalworks.net)

About PE4FAMS.com

Private Equity for Families provides useful information for successful families who want to include private equity or direct investment in privately-held businesses in their investment holdings. The blog is written by the principals of CapitalWorks, LLC, (http://www.capitalworks.net/) a private equity firm based in Cleveland, Ohio.

Recent Posts

Facebook's Libra May Be A SuckerBit (http://pe4fams.com/facebooks-libra-may-be-a-suckerbit/)

Newspapers And The First Amendment (http://pe4fams.com/newspapers-and-the-first-amendment/)

Phone A Friend (http://pe4fams.com/phone-a-friend/)

Moneyball For Hedge Funds (http://pe4fams.com/moneyball-for-hedge-funds/)

The Team (http://natural-hydrant.flywheelsites.com/team/)

Robert G. McCreary III (http://natural-hydrant.flywheelsites.com/team/)

Richard R. Hollington III (http://natural-hydrant.flywheelsites.com/team/)

W. Todd Martin (http://natural-hydrant.flywheelsites.com/team/)

Mikel B. Harding (http://natural-hydrant.flywheelsites.com/team/)