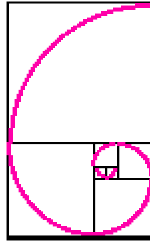


Sand Spring Advisors LLC

Expert Short Picks

by,

Barclay T. Leib

May 6, 2001

Twice a year, some of the most sophisticated investors in the world – bull and bear alike – gather in a ballroom atop the St. Regis Hotel in New York to hear perspectives from a list of speakers chosen by Jim Grant of *Grant's Interest Rate Observer.* This spring's conference took place on Wednesday, May 2nd, and was appropriately entitled "Finding Profits in Two-way Markets." It featured as its leadoff speaker hedge fund manager James Chanos of Kynikos Asset Management.

Chanos, for those that don't know him, is a bottoms-up equity analyst who has been running a short-only hedge fund since 1985. Although in several of the bull market years of the late 1980's and 1990's, he had his head handed to him, overall he was astute enough as a short seller to actually earn about a T-bill rate of return on average per annum over the last 16 years. This was a non-trivial accomplishment considering the bull market he was previously doing battle against. In 2000, his short-only fund showed a +38.6% performance after all fees and expenses.

Now, as we type this, and per the title of Grant's conference, two-way markets continue to hold sway. Here at Sand Spring, we turned bullish the NASDAQ 100 back at 1459 on April 4th, but suggested exiting to the sidelines this past Friday in the 1850 region. Although we may have done so prematurely and well short of our idealized 2150 target previously espoused, playing around in the current chop from the long side increasingly holds little appeal to us from a risk-reward perspective.

Everyone knows that the fundamentals are still horrific in the tech world, and that the Fed has now shot its best rate-cut bullets. All that is left to maintain bullish optimism are perhaps residual excitement over the Bush tax-cut and congressional action on upping the IRA investment income and contribution caps. We will allow that these factors are sufficient to keep the market from falling apart for the moment. But with a Princeton Economic cycle date due June 2, 2001 (that we have long expected to be a high), we think it appropriate to mentally start getting ready to go short again around then.

Yes, yes, we remember writing last month that extended 5th waves usually get retraced twice, and that a NASDAQ Composite rally was possible all the way to near 2800. But also look

at the view of the NASDAQ Composite below. The Fibonacci bands depicted here certainly allow for one more gut-wrenching new low. This could happen straight away off of a June high (our now favored view, depicted below in purple), or it could happen after a more complex and time-consuming rally period (depicted in blue). Either way, prices toward 1409 on the NASDAQ Composite now appear likely to us. The trick is simply interpreting the path of getting there.

Other market indices such as the S&P 500 have also recently rallied in a fast and furious fashion. But in its descent earlier this year, the S&P 500 intersected the high from 1998, and thereby sent us a powerful warning message: <u>This has not been a Wave 4 corrective move.</u> It is something else still unclear. The trendline up off the 1997 and 1998 lows has held for now -- as one might expect it would on first touch -- but if that trendline breaks, 814 could easily be in the cards per the extrapolated Fibonacci work below.

The only fly in the bearish view ointment is the Dow Jones Industrials. Just what is this odd-looking formation we face?

The Fibonacci bands pulled up from the Oct 1997 low fit the price action nicely to the early 2000 high, and we also experienced some overlap of the 1998 high when the Dow plunged lower the week of March 23, 2001– a bearish portent as it is with the S&P 500. But to be fair, the Fibonacci bands would also fit the price action nicely if stretched all the way up to approximately 13,196. In addition, the length of time that the Dow has spent chopping through the 9100-11,750 range is suggestive of a continuation pattern rather than the typical isolated top that comes at the end of major moves.

If this is a topping pattern, the only chart pattern in our memory that slightly resembles it is the way the Australian dollar topped out in late 1996 through early 1997 between 76 and 82 cents. In that instance, it took a full 13 months for the Aussie to finally roll over and fall off of the proverbial cliff. Even so, in the current DJIA case, two years have now passed since 11,000 was first touched back in May 1999. The chop and churn is overly long in the tooth. This formation is the current bane of many a technician, including myself.

On a sector-specific basis, we also look at individual financial sector stocks such as Morgan Stanley, Bear Stearns, Lehman Brothers, JP Morgan, and Fannie Mae, and they all look extremely vulnerable. Even GE, momentarily back from the dead, has recently rallied too far too fast and looks set to turn lower once again. Given the fragile appearance of some of these important names, we find it hard to imagine the Dow plowing ahead in oblivious nirvana.

We think Bear Stearns (a chart we have not focused on before here at Sand Spring) is still missing at least one more new low toward $38 a share.

The GE up-move has been too fast. It is likely a false suckers rally.

So overall, we're moving from short-term bull, to psychologically getting ready to sell this market once again -- particularly in the financial sector stocks, and particularly come early June.

But we also promised you this month some more fundamental short picks from short selling expert, Jim Chanos.

Mr. Chanos basically cannot tell you what the market will do this week or next (maybe our services would help him from time to time there). But what he can do with amazing prescience is spot a company with deteriorating fundamentals that is overvalued. Last Wednesday he presented several such companies that he humorously broke down into five different categories of short selling candidates:

- A growth stock that doesn't grow;
- A hedge fund in disguise that isn't performing;
- Sub-prime lenders engaging in Ponzi-like activity;
- A "One Trick Pony" that's shot its single-product bolt;
- A failed science project that's likely to explode;

We present them in order, together with our own technical commentary.

The Growth Stock that Doesn't Grow: Coca-Cola (KO – price: 46 53/64)

Music to our technical ears (given previous Sandspring.com commentary), Chanos hates Coca-Cola. "Here's a classic growth stock of yesteryear promising 10% revenue growth," he explained, "coming in at a nominal 6.7% growth rate, but after one makes several adjustments, actually delivering just 3.9% annual growth in earnings for the past five years."

Chanos sees the world now fully saturated with Coca-Cola and Pepsi products, and points out that Coca-Cola has been playing fun and games with its balance sheet. For the past several years, Coke has been making payments to its bottling companies for their bottling and infrastructure support, and repaying bottlers for advertising costs. The parent has capitalized these payments on its balance sheet as an asset, while the bottling companies have taken the payments directly to earnings. According to Chanos, there is a gross inconsistency in this accounting practice that he is amazed Coke's auditors have allowed.

With Coke still priced at 35 times trailing earnings, Chanos sees the stock as yet another Gillette-like disaster waiting to happen. And technically Coke's chart pattern is of course sick. As we previously wrote on Sandspring.com back on February 13, 2001, we see a technical target on Coke basis its Fibonacci rhythm of at least $32 per share. That was the case then, and despite any broader move higher in the equity indices that has or might continue to transpire, it remains the case now.

A hedge fund in disguise that isn't performing: Enron (ENE – price: 59 1/2)

Enron may have reported $1.40 per share in earnings last year, but strip out a series of one-time items and Mr. Chanos puts its real earnings at closer to $1 per share. For all the hoopla about this company's wonderful positioning within the broadband and energy worlds, Chanos also points out that Enron has historically only been able to generate a 6.3% return on capital and 9.5% return on equity -- hardly deserving of a 49 P/E ratio or a 4 times book valuation.

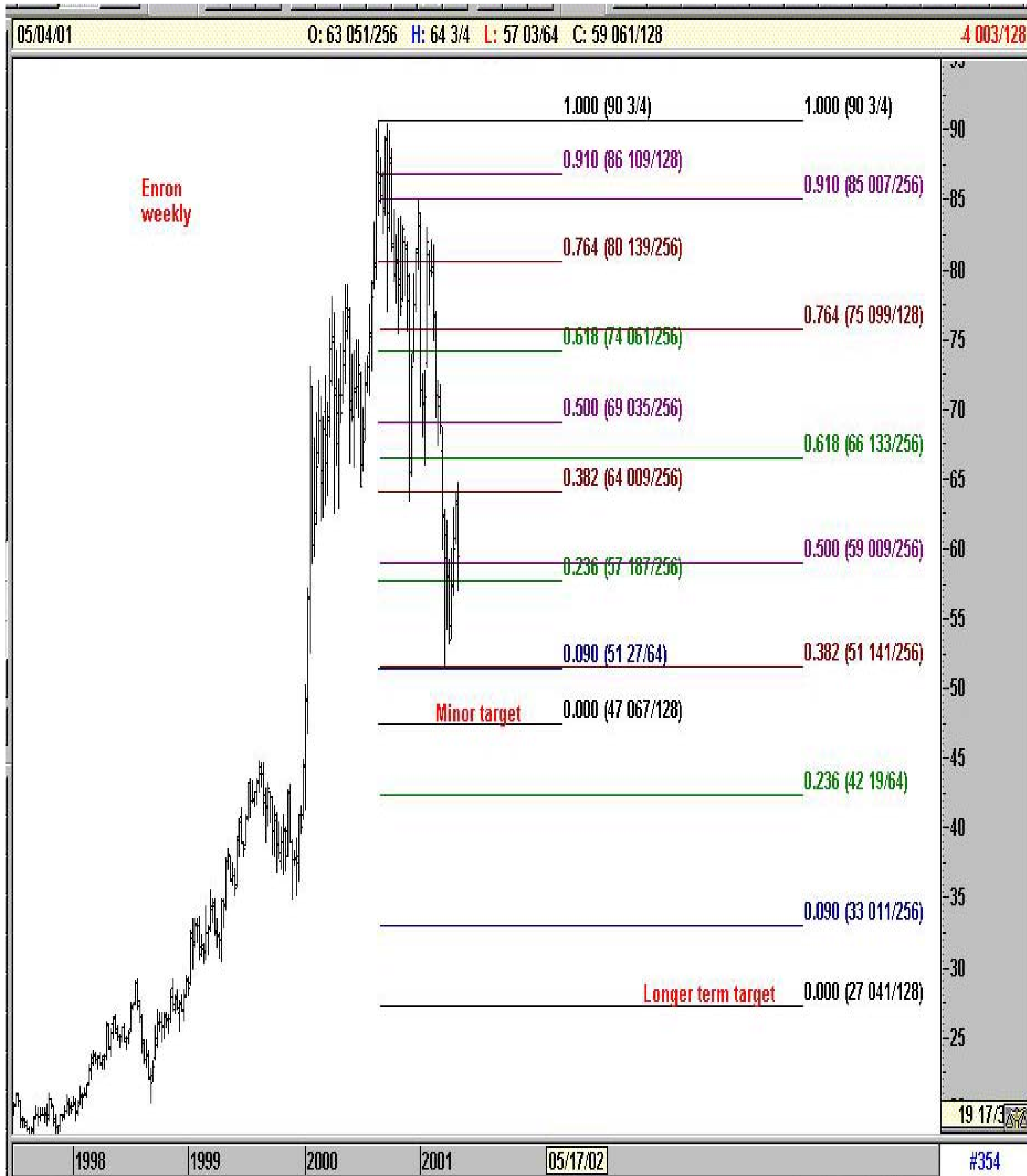
Chanos chastens the company for recently announcing that it had no exposure to the power problems in California, only to later reveal that it had actually established a loan loss reserve of some $600 million for the problem. Apparently what the company meant to say was that because it had already reserved for its California credit exposure and bought credit insurance against it, no ongoing problem existed – a slight obfuscation of the truth.

Chanos further points out that Enron now regularly trades 5-10 year energy derivatives contracts that because no benchmark market extends out that far, they must mark-to-market themselves. Depending upon how conservative or generous they care to be in their own marks in a given month, there is a great deal of potential earnings wiggle-room. Meanwhile the company has already sold off many of its traditional hard assets such as natural gas pipelines, wanting instead to simply specialize in trading the products that flow through these formerly owned facilities. Hence we have Mr. Chanos's allusion to Enron being a huge hedge fund in disguise.

Finally, Chanos believes that there is a huge amount of new power capacity within the U.S. soon set to come on line. Specifically, within a year or two, he believes America's power generation capabilities will move higher by some 40%. Our proclivity would be to contest Mr.

Chanos on this last point, but he's looked into this far more closely than we have. Our guess is that new capacity will arrive with time, but that it might just take longer than Mr. Chanos thinks.

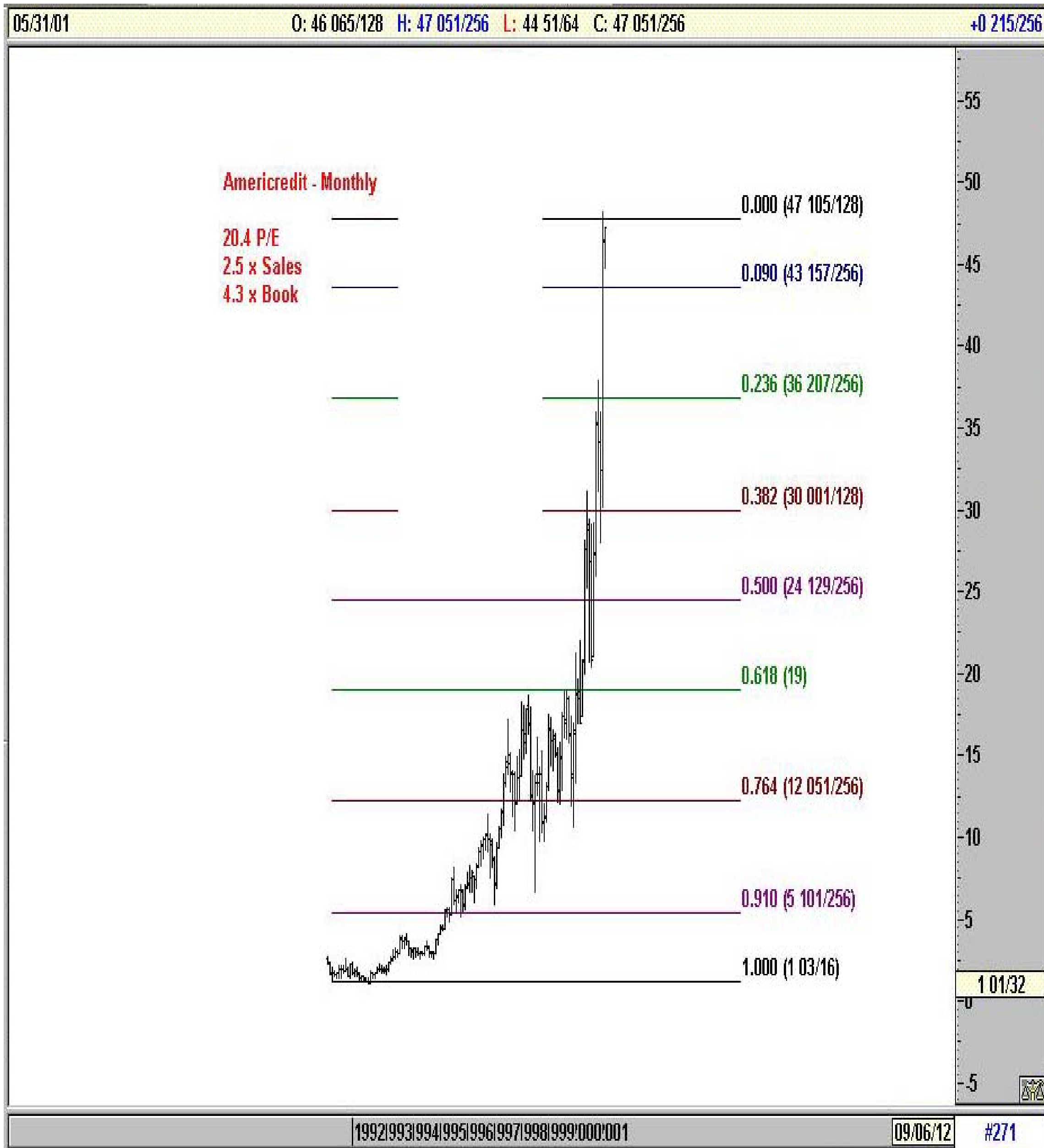
Technically, in our January subscriber-only article "Portfolio from Hell: Janus Dissected," we pointed to Enron likely reaching moving average support near $40 a share. A minor Fibonacci target also exists near $47. But putting our long-term visionary glasses on, we even see prices as low as $27 as possible.



Sub-Prime credit card lenders engaging in Ponzi-like activity: ACF, COF, and PVN.

Leverage and credit card debt have long been staple American habits, and sub-Prime lending companies such as Americredit, Capital One Financial, and Providian Financial have recently been high flyers. Each claim that they can uncover all those poor credits out there willing to pay a high interest rate, but who continue (for now) to make their debt payments.

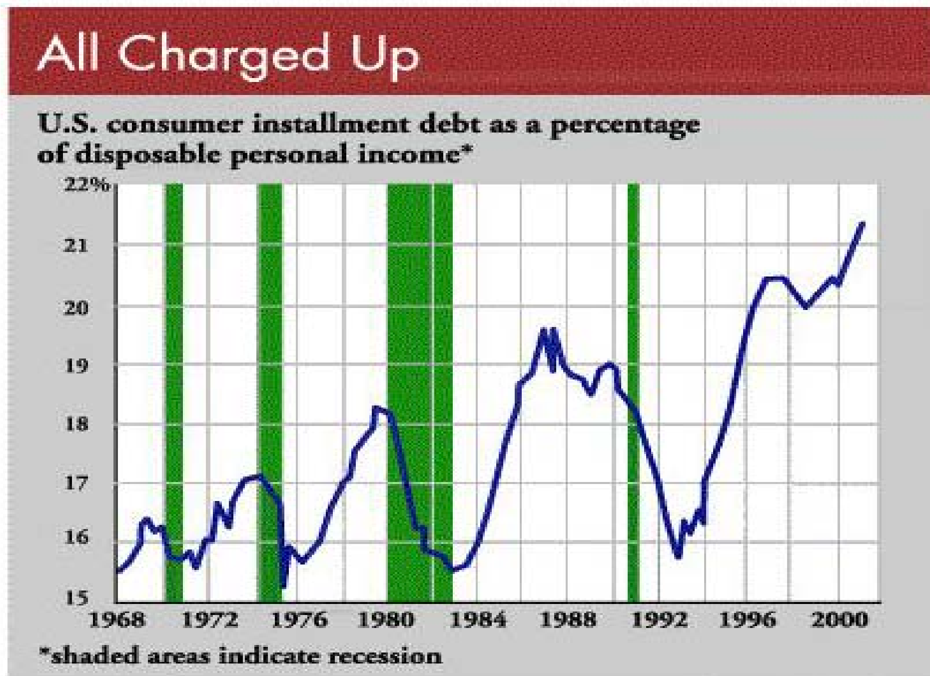
The fact of the matter is, however, that over the past several months there has been a marked increase in lagged delinquencies that all of these companies are trying to slough off and gloss over. The problem is that at 20-30 times earnings, and 3-5 times book earnings, these stocks are priced for perfection and are likely overdue for a stumble. In past recessionary periods, many of these stocks have fallen to prices just 8 times earnings and close to book value.



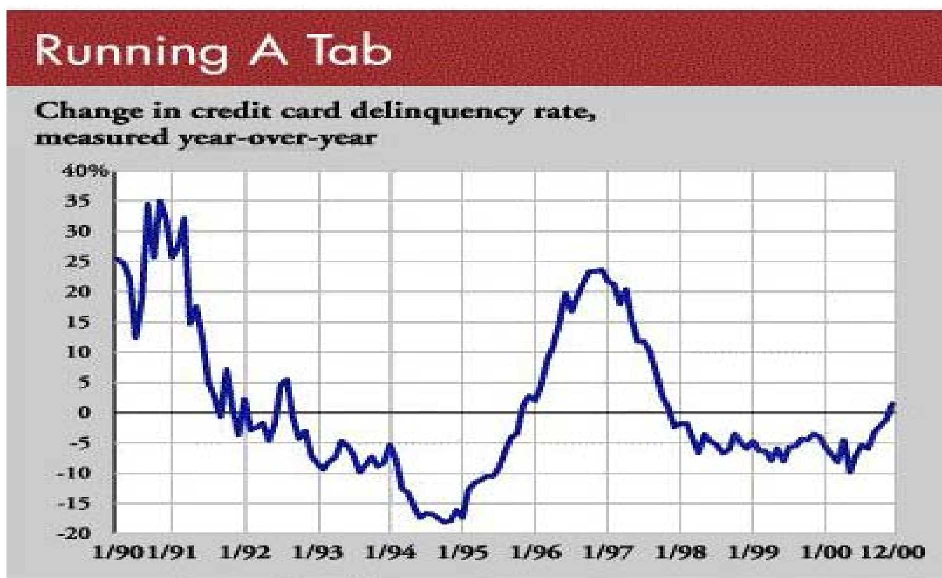
Capital One Financial - monthly
27 P/E Ratio
6.4 x Book
0.000 (73 1/4)
0.090 (67 015/256)
0.236 (57 03/64)
0.382 (47 009/256)
0.500 (38 15/16)
0.618 (30 215/256)
0.764 (20 53/64)
0.910 (10 209/256)
1.000 (4 5/8)

Providian monthly
22 P/E Ratio
7.43 x Book
0.090 (62 041/128)
0.236 (52 125/128)
0.382 (43 163/256)
0.500 (36 021/256)
0.618 (28 135/256)
0.764 (19 03/16)
0.910 (9 27/32)
1.000 (4 009/128)

Listeners in the conference audience may not have been hearing about these stocks for the first time -- at least if they had been keeping abreast of earlier articles published by *Grant's*. In one such article published in March 2001, Eric Frye of GrantsInvestor.com pointed out that the consumer installment debt burden has never been as high as it presently stands going into an economic slowdown. The chart he trotted out, courtesy of the ISI Group, is a dramatic one:



Frye also pointed out that according to Moody's Investor Service, the credit-card delinquency rate – generally on the decline year-over-year through the 1990s -- was once again starting to creep higher:



Then Frye asked the question: Are either Capital One and Providian worried about these trends?

The answer: Not on the evidence. "Capital One increased its account base by over 40% last year…Providian did not trail far behind, boosting its account base 31%." Moreover, both companies have been moving down market. "Middle-market and sub-prime accounts represented only about 20% of Providian's balances two years ago. Today, these two categories represent more than half the total…Over at Capital One, sub-prime loans constitute about one-third of its total balances."

I personally must get at least three junk mail solicitations from Capital One each week. It's almost as if the company is desperately trying to land further business growth to subsidize and disguise past credit card loans starting to turn sour.

And delinquencies are already a fact. PVN reported at year-end that 9% of its on-balance-sheet loans were overdue by 30 days or more, up from 6.8% at the end of the previous year. COF's overdue loans stood at 7.2% of their outstandings, 1.54% higher than a year earlier.

In an earlier article penned by Mr. Grant himself last November, and in spite of Capital One being awarded four Alexander Hamilton Awards by *Treasury and Risk Management Magazine* for excellence in financial management, Grant points out that Capital One's reserves for possible credit losses are significantly lower than those of its closest competitors. It has reserved just 3.6% of the total loans on its balance sheet, whereas Providian has at least reserved for 10.1%.

Of course, just before the proverbial shit hits the fan, the business of these companies always tends to look its best. This is because of all the added earnings from past-due fees the companies can bill. In 1995, such late penalty payments constituted just 5% of Capital One's revenues; in 1999 12.1%; and more recently, 14.8%. This led Grant to conclude:

> "It is a curious and anomalous fact that, in the midst of a great boom, an important driver of revenue growth at COF is the apparent inability of a meaningful number of its 27 million customers to come up with money to meet their debt-service deadline."

What beautiful and succinct prose Mr. Grant can write. Grant further questioned whether COF's board has not at times authorized stock buy-backs just in time to keep COF's price trading above important vesting levels for its executive stock-incentive program. Taken together with its other growth tactics, Mr. Ponzi would certainly be proud of Capital One.

Capital One currently sports nothing short of a $13.1 billion market cap, much of which in a real economic downturn could and likely will someday go puff. Both fundamentally and technically, we find ourselves most heartily agreeing with the Grant and Mr. Chanos on this sector. It hasn't been an easy group of stocks for bears to date, but that is likely to change shortly.

"One Trick Pony:" Plantronics (PLT – price of $21.55)

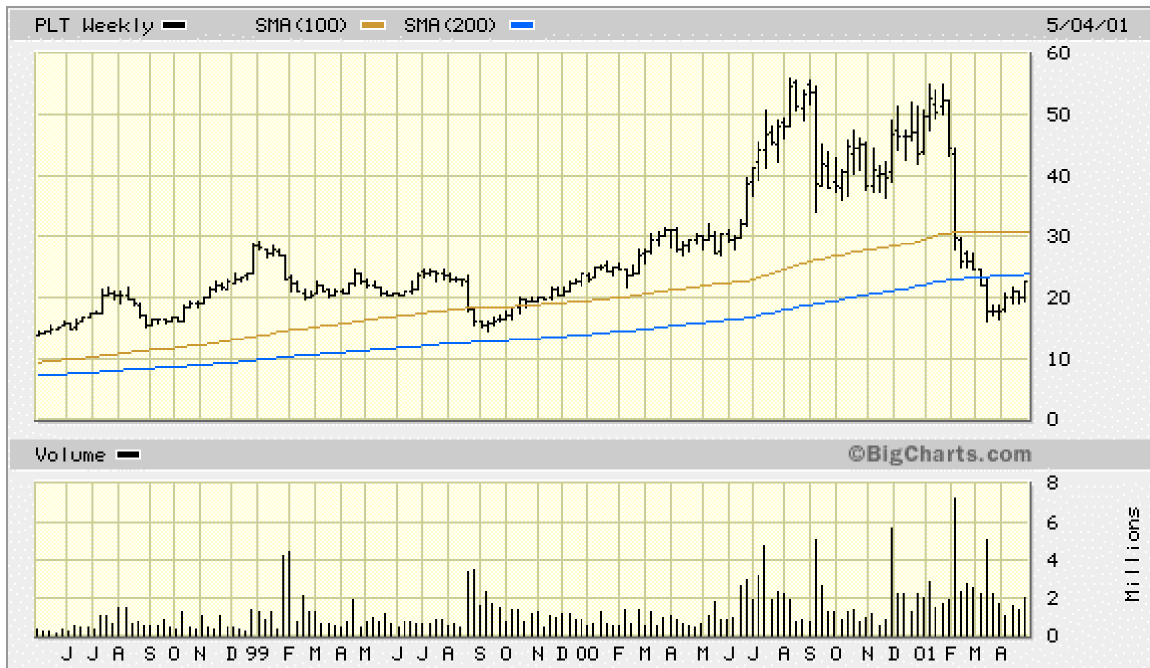
Plantronics has been in the great business of manufacturing earpiece headsets for cell phones. The problem is they effectively have just one product, and in the last half-year, eight Asian-based competitors have invaded their space and are undercutting their pricing. Verizon for example offers Plantronics headsets for $39.95 apiece (and have tons of inventory) while they also sell an almost identical Asian-built model for $24.95 (that sells out at a far brisker pace).

According to Chanos, Plantronics' previous 50% gross profit margins currently stand at substantial risk of being eroded away, and he sees the company as barely being profitable in 12 months time.

And yet, when the stock of Plantronics recently fell from $50 to $20, the company announced that it was going to use its free cash to buy back shares – a crazy path in Mr. Chanos's mind given the company's deteriorating core business. Conversely, insiders have also done nothing but file Form 144s registering their intent to sell. This has including Citigroup Venture Partners that recently filed to sell over 2 million shares.

We do not have PLT within our database from which we can run Fibonacci retracements and extrapolations, but currently residing below both its 100-week and 200-week moving averages, the stock certainly looks suspect to our technical eye. It may easily be in a wave 4 period at present, with a final 5th wave down period ahead of it. Chanos sees the stock reaching single digits.

Plantronics (weekly)



<u>Failed Science Project: CheckFree Corporation (Price -- $39.50)</u>

The last in Mr. Chanos's line of short selling candidates is a company called CheckFree Corporation (CKFR), an electronics payments processing company. This company provides services that allow consumers to receive electronic bills through Internet, pay any bill and perform customary banking transactions. It also offers investment services and portfolio management and information services for fee-based money managers and financial planners within investment advisory firms, brokerage firms, banks and insurance companies.

If that all sounds like pretty sexy space, it most certainly is, and the market has given CheckFree a market capitalization of $3.3 billion. The company currently trades at a multiple of 7 times revenues, almost twice its book value, but still has substantially negative earnings.

In Mr. Chanos's opinion, however, CheckFree's business is "not scaling well," and the company was recently forced to pay $400 million to do a joint venture with Bank of America simply to gain some credibility. The $50 million in revenues from that joint venture have yet to create any bottom-line profitability at the company.

Mr. Chanos further believe that because of CheckFree's competitive threat to lucrative bank clearing business, most banks will fight them tooth and nail to protect their turf.

Here at Sand Spring, we can't gauge whether CheckFree's business model is a failed "science project" or not, as Mr. Chanos suggests. But technically, we can stretch our Fibonacci bands, and we can certainly envision this stock trading down at $14.

There were other speakers at the Grant's Conference. We heard a fine self-effacing speech from Jack Byrne of GEICO turn-around fame who recently came out of retirement to take the helm of White Mountains Insurance (WTM). He's gotten Mr. Buffet to pony up a 20% stake in that company as well. Byrne's voice and presence was the spitting-image of 60-Minutes Mickey Rooney, and in his quiet New England manner was clearly representative of what a good insurance man should be. Even at $309 a share, White Mountain might be deserving of attention for those so inspired and partial to Mr. Buffet-styled investments. After all, at just 4.5x trailing earnings, with someone honest and immensely experienced at the helm, how much more can one ask for?

Meanwhile, fund manager Murray Stahl of Horizon Asset Management ($700 million under management) sang the virtues of a 3% bond trading at 55 cents on the dollar and convertible into shares of American Barrick at less than 11% premium to the stock's current level. Here at Sand Spring, we're currently looking into that one.

All we know to date if that the bond was originally issued by Canadian company Horsham Corporation (previously owned in large part by Barrick founder Peter Monk), with Horsham later being taken over by real estate company Trizec Hahn --now ultimately responsible to repay this debt. According to Stahl, Trizec Hahn (TZH) is a reasonable credit, and the bond's cheapness is mostly a function of "how few know about this security, and how negative the sentiment toward gold has been." But we'll come back with more on that front if we can dig up more information.

Lastly, Mr. Grant himself praised the virtues of gold mining royalty company Franco Nevada – although he admitted that this is more of a passive play on gold that has survivability in a bear market rather than the optimal play in a bull move. Overall, there was a definite last line in the sand type of attitude pervading the room about gold and its risk-reward potential at the current price level.

Which brings us to a last mention of that barbarous metal. It's been rallying ever so quietly at late – creeping higher as if to tease. For our fund of funds product, we actually established a small allocation to the Tocqueville Gold Fund (our only mutual fund allocation) at the end of last month, and thankfully have experienced a 12% gain on it to date.

Present at the Grant's Conference was John Hathaway, Tocqueville's fine manager. In a private chat with me, he indicated that there were rumors in the market that American Barrick had locked in its "lease rate" borrowing costs on short gold hedging going out 10-15 years. If true, some bank must have been able to find a central bank gold lender willing to lend for a similar or slightly shorter period. That metal is now pre-sold by Barrick and a central bank can't re-sell it a second time for a long while. A firm like Goldman Sachs is likely standing in the middle with a margining arrangement on the Barrick forward sales.

Those close to the industry remember of course that the last time gold advanced in late 1999, Goldman Sachs encountered untold problems. Goldman lost an undisclosed amount of money (some say upwards of $100 milllion) when African miner Ashanti could not pony up margin calls on underwater forward gold sales. Goldman ended up being forced to take an equity position in Ashanti in order to gain any chance of recouping the lost money, and metals head James Riley was forced into early retirement. We wonder if anything equal or worse is currently brewing there or elsewhere now.

Certainly if stocks like COF or PVN ever come undone (as we think they will), and a crisis of confidence begins to unfold in our credit markets, central bankers may regret and be embarrassed to have 10-15 year gold loans on their books.

On a micro-perspective basis, gold itself has been struggling so much to rally just a few dollars lately, that we must admit to being mildly disappointed with it– anxious and impatient to see a confirming breakaway move. We're also a bit nervous that over the past three decades the May-June period has often been a seasonally soft one for the gold market before Christmas jewelry demand for the metal starts to ramp the price higher in July.

With this in mind, and overly long the stuff, we actually pared a few of our gold mining positions in a very minor way late last week. We did so just to stay nimble and perhaps bring ourselves better luck for that elusive breakaway move. If the XAU pulls back into the late May-early June period, we'll likely buy these stocks back once again. If the metal goes straight up from here, we'll still be happy—even with our marginally reduced position.

All contents are Copyright © 2001 by Sand Spring Advisors, LLC, Morristown, NJ

Send us your comments at info@Sandspring.com.

AN IMPORTANT DISCLOSURE

Sand Spring Advisors provides information and analysis from sources and using methods it believes reliable, but cannot accept responsibility for any trading losses that may be incurred as a result of our analysis. Our advice should be deemed our personal opinion and not a recommendation to invest. Individuals should consult with their broker and personal financial advisors before engaging in any trading activities, and should always trade at a position size level well within their financial condition. Principals of Sand Spring Advisors may carry positions in securities or futures discussed, but as a matter of policy we will always so disclose this fact if it is indeed the case. We will also specifically not trade in any described security or futures for a period 5 business days prior to or subsequent to a commentary being released on a given security or futures contract. Despite certain sales of gold-related positions in the week of April 30th, Sand Spring remains net long of this sector.