Sand Spring Advisors LLC

In Search of Survivable Themes

by,

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It is somewhat amazing how quickly Wall Street can turn on a dime. Not that long ago investors warmed to any company that used innovative leverage and borrowing to goose the corporate bottom line. Today, debt is truly a dirty word, and the market is trading as if certain companies have so much of it that bankruptcy is almost inevitable. For some complete insolvency may well be in the future, but at the same time, money is currently flowing with great abandon into distressed investing, where hedge fund managers are trying to nimbly pick out the survivors from the doomed – the sheep from the goats.

Indeed, hedge fund investing has become so popular that financial columnist James Grant and Morgan Stanley's Barton Biggs both point toward a possible "bubble" developing in that space. In an April 2002 missive Grant writes:

> "Breaking story, Bloomberg reports: "Carrefour SA, the world's No. 2 retailer, said it's started a hedge fund that allows shoppers to bet on markets for as little as 1,000 euros. The supermarket chain is allying with Societe Generale SA to invest in other funds that focus on price discrepancies in securities and in funds that seek to gain by predicting shifts in the global economy …"We aim to achieve gains of 9% after paying a 2% fee on the original stake," a Carrefour spokesman explained. "Investors will at least get their money back if they invest it in the fund for five years."

Grant then goes on to bemoan the twin event of hedge funds coming to the masses and the growing use of leverage within hedge fund investing as a disaster waiting to happen. He asks with some incredulity:

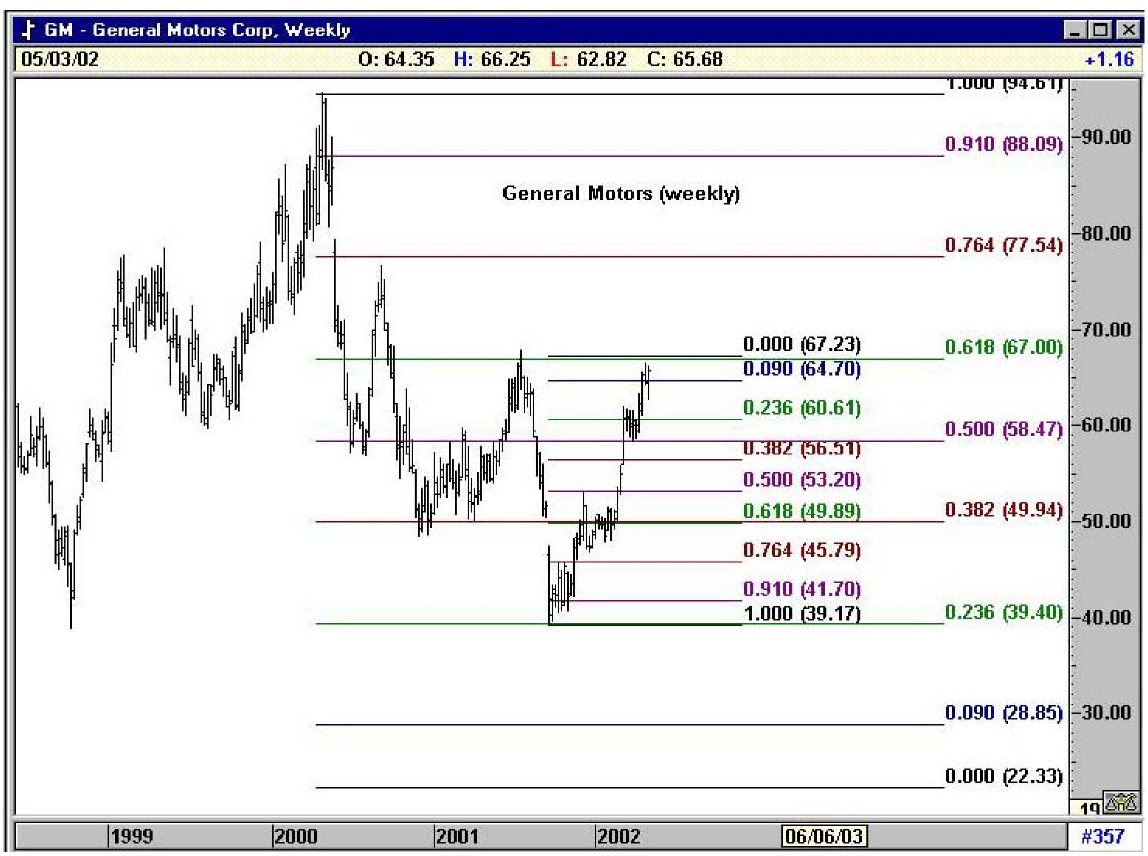
> "Isn't this like writing hurricane insurance with only 10 years of weather observations?… If you buy into a fund of funds on leverage, and the fund-of funds manager purchases the underlying hedge funds with leverage, and some hedge fund managers use leverage to buy stocks in companies that are, themselves, deeply in debt, how many real assets do you own for every dollar you invested? Most investors don't (and can't) know the answer to that question."

So in general, leverage has now become a dirty word on Wall Street, but ironically, it is still an OK word in hedge fund investing, and Grant thinks that this will end in tears. Our view on this is that Grant will likely be correct in his prognostication, but we severely doubt whether this hedge fund "bubble" will burst anytime soon. Instead, we believe that because pension managers and public investors still only have a very tiny share (less than 5% of total investable assets) in hedge funds at this time, the current hedge fund environment is a bit akin to the world of tech investing in 1995-1996 – starting to attract attention and become frothy, but nowhere near the stage where any bubble will go pop. Someday this could be the case of course – particularly if the percentage of funds invested by institutional investors in hedge funds were to grow to 10% or perhaps even 20% of total assets. In that event, one might have cause for concern. But how can we have a bubble with so little money yet at stake? No, Mr. Grant – alternative investing is a trend, not a bubble at this time. And while one can query whether some may be using a bit too much leverage – given all these new structured products on top of other products -- hedge fund investing is generally a good trend. It represents the average investor admitting that professional fund management and a more balanced long-short portfolio is a better and more prudent way to build wealth than investing along side of CNBC hype.

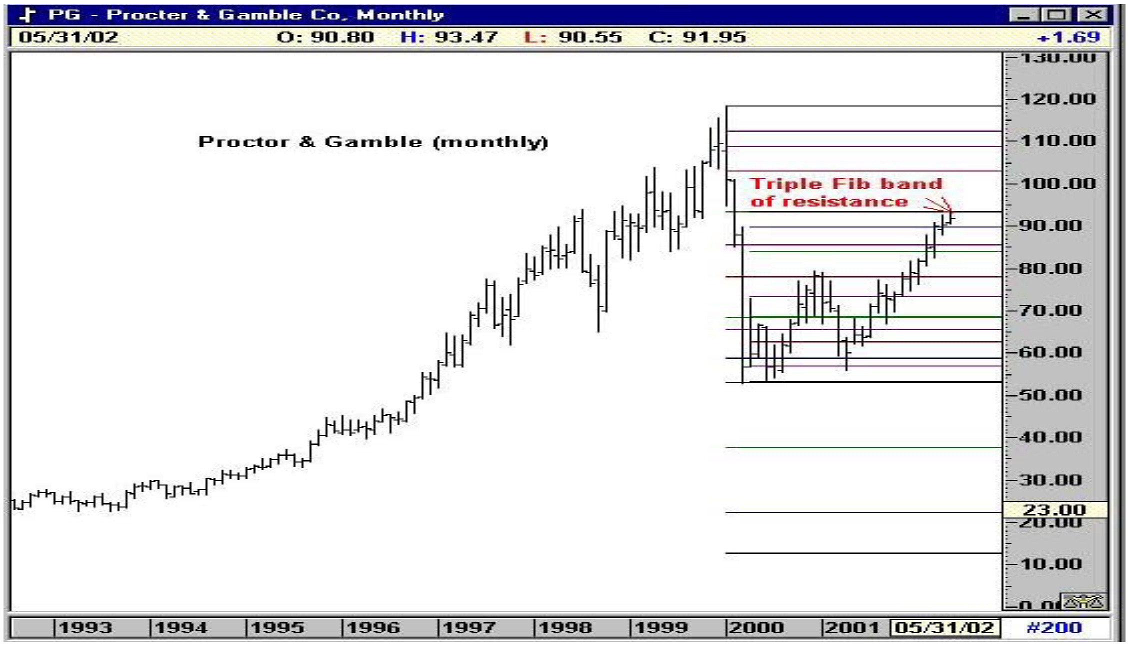
In any case, completely forgiven (at least for the moment) from the current purge against companies using leverage are stocks such as Proctor & Gamble and General Motors – household names deemed too big to fail.

But given our last article's discussion of GM's pension fund problems that are unlikely to go away, and given the general cost of an average new car these days, we wonder if GM doesn't stand at serious risk of missing its earnings forecasts again and again going forward. Certainly we believe that the increased proclivity by the U.S. consumer to lease cars is a trend that leads directly to a wider selection of well-preserved "pre-owned" cars, which may in turn, lead eventually to a dearth of new car sales. Every lease is counted as a new car "sale" in our government statistics, but is it really? If the U.S. were to fall into a truly nasty debt-deflation environment in 2003-2004, might GM be under-pricing the imbedded put option on each car that it leases out, and end up with tons of pre-owned cars (as well as unsold new cars) collecting dust in showrooms across the country? If you can't tell, we're not particularly bullish on the auto business at present.

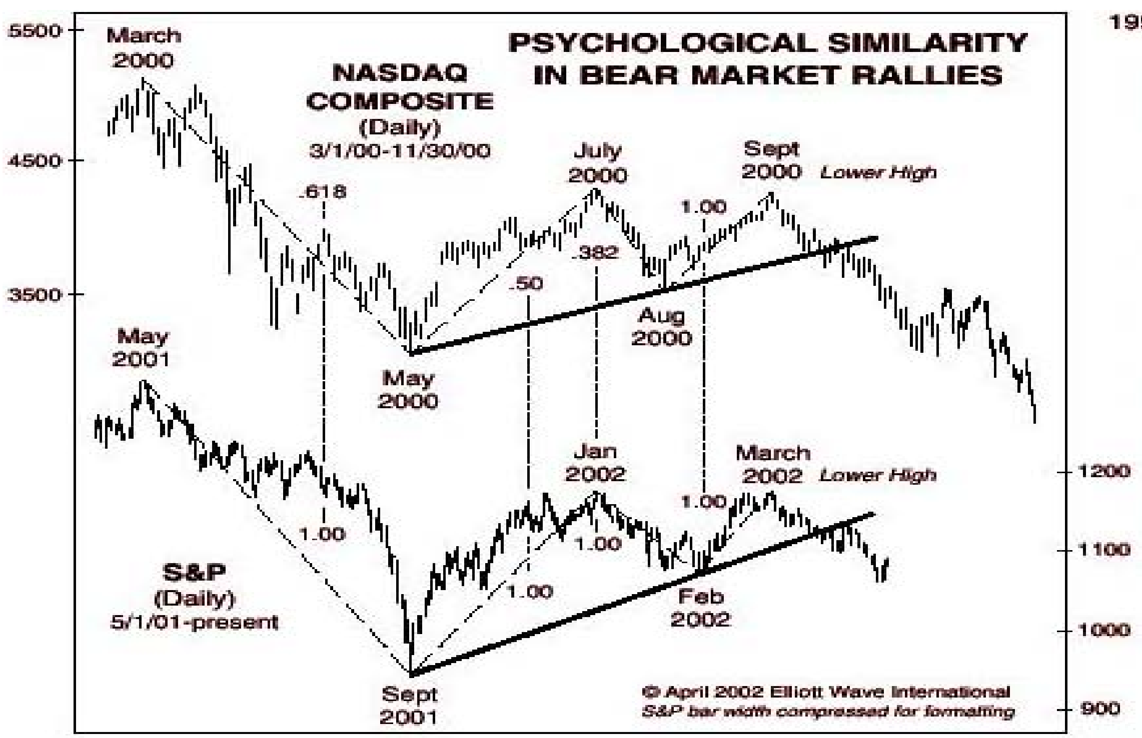
On a Fibonacci rhythm basis, we also see some stiff resistance for GM just below its July 20, 2001 $67.80 high, and wonder with time if GM might not end up being worth closer to $22 a share than $67 a share – or just a third of its current value.



Meanwhile, we also mentioned Proctor & Gamble as another safe haven favorite currently being coveted by the market. But away from the market's psychological attraction of late to P&G, technically we see this stock now having reached what we will refer to as a "Triple Band of Fibonacci resistance." Fibonacci bands stretched from the year 2000 highs and lows hit near 93.47. The rhythm of the market's more recent ascent since June 2000 looks like a relatively tight "fit" near 93.47. And 93.47 would also be a natural Fibonacci stopping point if we stretch our bands way to the downside and an extrapolated low (somewhere over the moon – December 2004?) near $12.76.



Oof! We sound pretty bearish don't we. When we then move on to look at the Elliott Wave International's comparison below between the current S&P 500 and the NASDAQ chart pattern of 2000-2001, and must admit that a continued slip-slide to the downside certainly seems likely.



Previously, we have pointed toward a possible low being formed into either the Full Moon/ Long Weekend of May 27th or alternatively, on our next PEI cycle date of June 30th. For what it is worth, astro-market analyst Arch Crawford is now calling for May 31st to be a period of "bankruptcies and maybe more War" (although in our own mind, the maxima in sunspot activity associated with War is already ebbing – see earlier "Cycle of War" article). Perhaps the first date will represent a final sharp market plunge, with the latter date representing a successful retest. That leaves us of course with the prospect for yet another negative, or at least potentially sloppy, equity market for the month of May. But a question remains as to the degree of magnitude of any further price declines.

To be completely honest, different indices all suggest different things. When we look at the Amex Biotechnology Index, for example, we see the possibility that recent weakness may just be a false 4th wave break on the way to eventual 5th wave new highs. This would imply very shallow pressure to the downside in May. On the other side of the spectrum, however, we think that the PHLX Semiconductor Index has the possibility to eventually be cut in half to at least 2477. The month of May could thus be pretty savage to that sector.

Indeed, the NASDAQ 100 shown below could be setting itself up for a "three-thrusts to a low" type of bottom formation. The first thrust down started in late January '01 near 2772 and lasted just over **2 months** into a 1348 low, thereby shaving some **51%** from the NASDAQ 100. The second thrust started in late May '01 near 2070 and ended **4-months** later at 1089 – a **47%** fall. Moving on from this basic pattern of almost halving in price over longer intervals of time, perhaps the current decline that began in early December 2001 from the 1695 level needs to extend for **6 months** and represent a **38.2%-45%** type fall. If that were to be the case, then we'd be looking for an early June low somewhere in between 932 and 1047 on the NASDAQ 100.

In terms of the S&P 500, we face a sloppier chart pattern with far more levels of possible support. Basis the weekly chart, we do think that the S&P 500 is shaping up into a huge Head and Shoulders formation, but we somehow doubt that the neckline of this formation, currently down near 951, will give way without a significant push and pull between bulls and bears first. For this reason, we have continued to expect that any June low this year would still result in a rally attempt between June and November, before true ugliness arrives for the S&P in 2003-2004. This latter period will likely be one of capitulation by the public, and a general acknowledgement that a bear market truly exists. For now, people are still trying to rotate between stocks but want to remain fully invested in the equity market "for the long-term." This attitude needs to change to one of disgust and demoralization before any sustainable low in the market will be possible.

All we can say for sure is that once the S&P neckline is ever blown away to the downside, 800 would be the first obvious Fibonacci price target here. It's just that realistically, we can't quite see that happening this year. It's far more likely next year.

And within this worrisome equity environment, where pray-tell might one find something to invest in? Surely this is all good news for ongoing gold bulls?

Well, over the long-term it should be. Within my lifetime, I fully expect to see gold above $1,000. But over the short-term, and considering the relatively modest amount that gold has rallied since its 1999 $251 low, gold stocks are likely a bit ahead of themselves. As I recently pointed out within the Sandspring.com chatroom:

1) The gross long position of large specs as a percentage of total open interest is as high as it was in early 1993 – a period which ended as a $380ish high.

2) Small specs are also running net long, carrying positions above 100 tons for only 4th time since 1987. In all three prior instances this type of behavior was indicative of a significant high.

These are worrisome signs. In addition, the XAU will shortly face significant resistance between 817 and 856 – the latter being a 38.2% retracement level of the 1996-2000 XAU decline. As such, gold stocks are best left alone for the moment. We remain gold bulls at heart, but flat in terms of our current position.

A Survivable Theme

But what of our title this month -- "In Search of Survivable Themes." One survivable theme we see is the growth of global Internet gambling—specifically sports betting. If the Internet has proven itself successful in one thing, it has been to bring diverse buyers and sellers of goods together. That old 1910 postcard found by someone in an attic may mean nothing to the person who finds it, but can become a cherished relic to someone else with family ties close to the vista pictured. Similarly, we all know that America loves betting on sports – particularly on college and pro Football – but up until now, one could only do so by one of three ways: travelling to Las Vegas, finding an illegal bookie, or casually betting against a personal friend.

And as markets continue to turn sour, the desire to find some relief from reality via gambling – dreams of instant wealth and interest in mega-lotteries -- tends to actually increase. As one textbook recounts when describing the Depression: "There was an unholy fascination that bred in casinos….[People] wanted to do something that would get their mind off of the events that surrounded them. They basically wanted to have fun despite the tragedies that were occurring. They felt in a way that they had to gamble in order to try to win a few dollars because they did not have much money. But at the end, they ended up losing more than they gained because the men began to see the realization of how many coins had recently taken their departure. They felt that gambling would help them forget about their problems, but in the end, people only left with more problems."

But unlike the 1930's, now there isn't even a need to visit a casino, let alone leave one's office chair. Instead, we have the Internet to bring sports betting – fully legalized in certain offshore countries – directly to America's homes. Surely this is a growth business – a survivable theme. It is also of course a dangerous space to consider any investment. Most web gambling companies are based in the Caribbean and often offer no address or phone number – only an e-mail address. Win a pot full of money, and it may be hard to collect that dough. Britain has been a historically more reputable place for sports wagering with many fine old bookmaking firms such as Ladbrooks and William Hill & Co., but the British government taxes sports winnings and British websites generally cater to a European clientele. There is enough action in European soccer and horse racing, that the British have generally been slow to offer any odds on day-to-day American baseball, basketball, hockey, or football.

But down in Australia, one small company seems to be doing it right. This company is called Canbet Limited. Canbet is the largest Australian bookmaker – a company that has actually been listed on the Australian Stock Exchange since April 2000 under the symbol CBT. Over the past several years it has developed a highly user-friendly and secure website (www.Canbet.com) where new users can fund their accounts either by bank wires or via Visa or Mastercard debits. (As one note here, Visa or Mastercard may initially decline the charge – deeming a foreign charge of some size made over the Internet as a potential fraud. A simple phone call to one's credit card company can easily correct this, however, and allow the charge to go through). Once a new client signs up, Canbet endeavors to offer fair and attractive odds.

Last year, Canbet faced a life-threatening vote by the Australian government on whether to allow Internet sports betting at all, and if so under what terms. But at the end of that legislative process, when the Interactive Gambling Act was passed by the Australian government, it left Canbet as a fully legal and licensed Internet sports betting operation capable of taking bets from any domestic or foreign customer. Indeed, in certain respects Canbet was grandfathered into an advantageous competitive position, because the new law places more stringent requirements on newer entrants into Internet sports gambling. The official regulation also put Canbet firmly within a regulatory environment that provides a better degree of credibility and reliability compared to similar businesses operating in less regulated jurisdictions. The only thing that the Australian government specifically prohibited was "on the fly" betting on sports events after a given event has already begun (such as offering odds on a game as of a half time) – not a particularly worrisome or onerous restriction. The Australian government also specifically left all sports gambling over the Internet as completely tax-free.

With 80% of its customer base currently sourced out of the U.S., Canbet still stands at some risk, of course, to possible U.S. legislative changes. One could certainly imagine laws either prohibiting U.S. citizens from using an offshore betting service such as Canbet, or requiring U.S. citizens to declare income derived from such activities. Alternatively, someday down the road, the U.S. might actually license Las Vegas-based companies to offer the same type of service (perhaps as a way to collect some sort of wagering tax thereon?). But for now, Canbet.com is the quality betting franchise on sports events globally, and is advantageously geared toward a sports hungry U.S. public. It's a company in the right place at the right time.

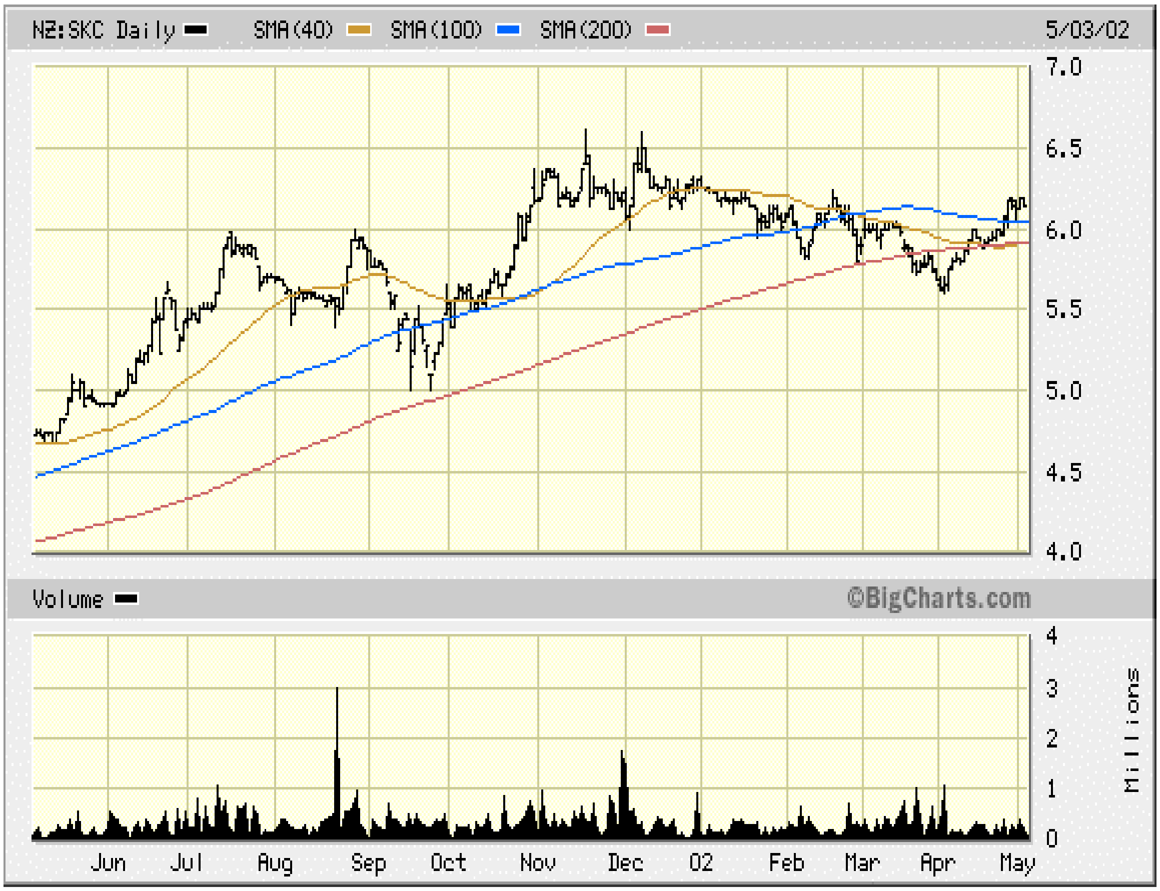
Be forewarned: The company is a small one, with a great number of authorized outstanding shares. Trading on the Australian Stock Exchange at approximately A$ 0.10 cents, but with 350 million shares outstanding, Canbet carries a market capitalization of just A$35 million, or approximately $18 million U.S. dollars. But despite its micro cap size, and great number of shares floated, the company also currently holds A$14 million in cash, has a well-functioning and fully paid-for website, no substantive debt, and a customer base that is growing by leaps and bounds. In 2001 its bookmaking total handle was A$284.7 million, a 320% rise over that achieved in 2000. The company has gone from running a gross bookmaking profit (before administration expenses) of approximately A$1.3 million in 1999, to A$2.9 million in 2001, to A$2.1 million in 2001 to A$4 million in the first four months of 2002. With total annual expenses of approximately A$3.2 million, this now means Canbet is already net profitable for the current year.

And while bookmaking profits are notoriously unpredictable and clumpy in nature, the more customers Canbet can add, and the lower its average bet size becomes, then the more scaleable and predictable its business revenues will become. Indeed, these are the current goals of Canbet's management -- goals that are increasingly being achieved.

But hold on a second – is Sand Spring really recommending a A$ 10 cent stock trading on a foreign exchange? Have we stooped so low as to be touting penny stocks? Well, we normally might have passed over such a company, particularly given its inherent liquidity risks and the possible added spread costs involved in trading such a security. But we were further intrigued by the fact that Canbet is 33% owned by Sky City Entertainment Group (www.SkyCity.co.nz) – a casino, hotel, and restaurant operator based in New Zealand. Sky City is itself the 11th largest company listed on the New Zealand Stock Exchange and is 5% owned by the California–based mutual fund managers Capital Research & Trading. To us there appears to be a stamp of institutional approval here – at least behind the scenes.

Indeed, for those a little less willing to become involved with a 10 cent stock that could conceivably go puff on some legislative whim that arrives from out of the blue someday, Sky City

(Symbol: SKC on the New Zealand market) might be a less risky play on Canbet's ultimate success. You see, Sky City's 33% investment in Canbet represents just an A$11 million investment within a company that elsewhere is generating NZ$500 million in gross revenues and NZ$76 million in annual net profit. Better yet, at a NZ$1.1 billion capitalization, Sky City is a company that has delivered steady growth in its assets and an average annual return of 19.7% to shareholders over the past five years. It also has a strong ethic of proper corporate governance, maintaining a policy of paying out to shareholders dividends equal to 90% of annual after-tax earnings. The stock currently trades at a modest 9x trailing earnings and last year paid a handsome dividend that approximated a 11.4% yield (calculated off of the average 2001 SKC price). 39% of shareholders agreed to participate in a dividend reinvestment program. The company's net earnings grew at a 16% pace last year on a 48% increase in gross sales revenue.



A graphical summary of Sky City's past success, taken from its 2001 annual report, appears as follows:

From a balance sheet point of view, Sky City's ratio of current assets/current liabilities is an acceptable 1; the company trades at approximately 3x book value; and Sky City has a Debt/Equity Ratio of 1.5-1 – all certainly reasonable stats for a growth company of this sort.

Anecdotally, the company is also a fun one. In addition to its several casino operations across New Zealand, Sky City is taking advantage of the increasing trend toward adventure tourism via its Sky City Auckland "Sky Jump." This new attraction allows thrill seekers to jump off of its Sky Tower, and experience a 192 meter controlled free fall. Sky City controls the brand names for Planet Hollywood and Hard Rock Café themed restaurants in New Zealand, and Sky City also just took over the Force Corporation that has 73 movie theatres (including one IMAX theatre) located throughout New Zealand. The company's Sky City Hotel in Auckland achieved an 83% average occupancy rate in 2001. And in these relatively violent times of terrorism, we also feel in a strange way that New Zealand's relatively removed locale will on the margin make it a better destination for the global tourist as compared to more mainstream locations such as London, Paris, or Rome. Flying JFK to London will always hold more risk of an act of terrorism than LA to Auckland.

So there you have this month's bit of eclectic thinking from Sand Spring. Hedge fund investing is not a bubble (yet) – but instead a trend that may become abused at some later date. The U.S. markets remain in some trouble for now, with a chance to finally bounce between June and November, but not before – at least according to our cycle analysis. And lastly, Canbet and Sky City are two growth stocks in a growth industry. They likely represent a survivable investment theme regardless of how nasty U.S. markets become. Who knows, maybe more and more suddenly unemployed telecom workers will take to betting on football and baseball as they also try to find new jobs.

It is important to admit that Sky City in particular could be hurt by a global debt-deflation situation that cuts down on non-essential spending and tourism. That is why Canbet, while a smaller and riskier company, is also a purer play. And given that the Australian dollar is still at a modest .52 cents, 100,000 shares of Canbet can also be had for approximately $5,200. In an ideal world, this company just might grow and grow and grow. As one side note, its web architecture is well designed enough that Oracle has already chosen Canbet as the first such betting system for inclusion in its virtual private network.

Certainly, when compared to some still lofty corporate valuations elsewhere in the U.S., neither CBT nor SKC can be deemed to be trading on "air" and "hype" alone. And if governments were ever to change regulations regarded to Internet sports betting, one can more easily imagine some sort of tax surcharge as a revenue collection vehicle rather than the complete elimination of Internet sports betting. In the depression, the U.S. government resorted to imposing an inheritance tax to raise tax receipts (When all else is unpalatable, you can always tax the dead). In today's more modern environment, one can anticipate that politicians would not want to completely squash a potential revenue generator such as Internet sports gambling, but instead somehow benefit from it. Canbet certainly has an enviable position, and stands a wonderful chance to achieve more critical mass – at least until that day comes. It has an Amazon.com type of head start, but with no inventory costs at all (only correct odds provisioning), it also has the advantage of already being profitable.

By matter of disclosure, we are long both Canbet Ltd. and Sky City. We also attach here as a separate PDF file an added Australian brokerage company write-up on Canbet.

Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE