
THE DEVIL'S ADVOCATE REPORT

COMPENDIUM

January 2012

Featured Companies

McDonald's Corp. (MCD)
Procter & Gamble (PG)
DST Systems, Inc. (DST)
iShares Barclays TIPS Bond Fund (TIP)



*Exclusive Marketers of
The Devil's Advocate Report*

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Murray's Musings

INDEXATION AS A BUSINESS

Indices were originally invented to serve as a benchmark, or reference point, for measuring the ability of managers. The index is essentially a sample of the opportunity set of all securities available within an asset class. Therefore, a comparison of the returns of a manager with those of an index is entirely reasonable. Yet, what happens when the index becomes a business? That is to say, what happens when the reference point itself is marketed as an actual portfolio that competes with the managers being measured by that reference point? Is it still legitimate to use the index as a reference point if it's also being used as a business?

To explore those questions, let's consider the scientific method employed to conduct objective inquiry in the western world. One can divide the scientific method simplistically into two spheres: observation and experimentation. In observation, a classic example might be ancient astronomers observing the stars. The act of observing the stars in no way alters the reality; however, even in such a simple observation there can exist that which a statistician would call confounding variables. For instance, no modern astronomer would dare draw any conclusions from viewing the night sky in a large city, because of the distortions created by ambient light. In that case, ambient light is a confounding variable.

In experimentation, it's easy to see how a confounding variable might exist. For instance, if half a group of patients afflicted with a given disease are given a drug while the other half are given a placebo, some of the possible confounding variables would include differences in age, health, quality of medical care and so on. Any of those variables might possibly explain results achieved in the experiment. In fact, to achieve experimental results without the existence of confounding variables is one of the great problems of science.

In the case of indexation, the largest holders of virtually any company in the S&P 500 include Blackrock, State Street, Vanguard, TIAA-CREF, and Invesco PowerShares, which are all well-known indexation firms. There are over \$1 trillion worth of assets in ETFs which, after all, are merely indexes. The total amount of money invested in the many and various passive strategies, whether in separate account form or in structured product form, is clearly many times larger than that existing in ETFs. No one knows with any degree of precision how much money is actually indexed. Moreover, no one is in a position to know, since no small portion of indexation money is invested via derivatives, and no hard figures are readily available. Given that situation, one may ask if anything is proven by the fact that the passive strategies have outperformed the active strategies, except that investors have been convinced to purchase trillions of dollars' worth of passive strategies.

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If the issues at stake were merely those of measuring relative performance, this would be a trivial subject; however, the issue is much more profound. For example, the central concept of indexation is to hold the index portfolio for long periods of time since, in principle, there is no statistical advantage in attempting to time the ebb and flow of the market. Nevertheless, in the 11 months of 2011 through November, roughly \$1 trillion worth of ETFs produced a trading volume with notional value of \$18.9 trillion.¹

This year-to-date amount means that there's little basis to doubt that notional trading volume will comfortably exceed \$20 trillion by the end of 2011. Consequently, using the \$1 trillion of indexation strategies represented by ETFs as a proxy, these indexes turned over 20 times, or 2,000%. The U.S. equity long category had \$476 billion of ETF assets at the end of November 2011.² Its notional trading volume on a year-to-date basis through November 2011 was roughly \$12.3 trillion.¹ The U.S. indices' turnover was therefore 25.8 times, or 2,580%.

The long leveraged category of ETFs had \$10.2 billion of assets at the end of November 2011. The notional turnover, or trading volume, for this group was \$951 billion.¹ This amount equates to a turnover ratio of 93.2 times, or 9,320% in 11 months. However large these figures are, they dramatically understate the actual impact, since the leveraged funds are at least 2 times levered, and in many cases they are 3 times levered. Therefore, the turnover figure should be multiplied by a coefficient of somewhere between 2 and 3 times to arrive at a more realistic figure that would certainly exceed 20,000%.

Similarly, the leveraged short ETF category had roughly \$7 billion of assets. The notional trading volume for this group in the first 11 months of 2011 was approximately \$835 billion. This amount is equivalent to a turnover ratio of 119.3 times, or 11,930%. Of course, the leverage factor would imply that the gross turnover is well in excess of 2 times that amount, so the actual number is certainly in excess of 23,000% in 11 months.

In light of these figures, is there anyone willing to assert that the S&P 500 is only an abstract benchmark? Should an active manager really be faulted for being unwilling to build a portfolio comprised of the same constituents as these so-called indexes? Can an active manager really be expected to predict the ebb and flow of money that enters and then leaves these various index products on a daily basis? Is the manager being fairly compared to a benchmark, a random number generator, or a casino?

The academic answer is that the comparison is fair, since the manager is certainly at liberty to buy and hold the S&P 500 issues. However, consider that Berkshire Hathaway has \$67 billion of its capital invested in S&P 500 issues, including Johnson & Johnson, Procter & Gamble, IBM, Coca-Cola, American Express, and Wells Fargo. Its mix of other businesses

¹ Source: National Stock Exchange <http://www.nsx.com/content/etf-notional-list>.

² Source: National Stock Exchange <http://www.nsx.com/content/etf-assets-list>.

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includes MidAmerican Energy, PacifiCorp, GEICO, Burlington Northern, See's Candies, Benjamin Moore Paint, and others, is well-diversified and not vastly different in character from the S&P 500. Yet, thus far in 2011, Berkshire Hathaway's shares have underperformed the S&P 500 by over 1,000 basis points. Is anyone willing to assert that the business prospects of Berkshire Hathaway are so vastly inferior to those of the S&P 500, despite the fact that a large proportion of Berkshire Hathaway's assets are invested in the S&P 500?

One is tempted to assert, but unable to prove, that there is more than a slight connection between the 1,000 basis point underperformance of Berkshire Hathaway stock and the fact that it is the largest member of the SPDR Financial Select ETF (XLF). In that index, Berkshire Hathaway has a weight of 9.12%. It is contained in the same portfolio as Bank of America, Citigroup, and Goldman Sachs. According to Bloomberg, there were 247 million shares short of XLF as of November 30, 2011.

As a practical matter, because of its weight in XLF, Berkshire Hathaway has become one of the most heavily shorted stocks in the United States. There are many companies that suffer the same fate by virtue of their inclusion in or exclusion from an index. It is clearly beyond the ability of any person or group of people to predict these changes. In fact, prior knowledge of such changes is considered insider information and anyone with access to that data is legally prohibited from making use of it.

The problem is not only limited to the use of indexes as benchmarks for active managers. Indexes are also the basic data implements used in making asset allocation decisions. Portfolios are constructed, in no small measure, based upon the correlation of these indices with one another. Due consideration is given to historical return characteristics of various indices; yet, how can anyone possibly expect that U.S. government bonds will produce anything remotely close to the historical level of return when the 10-year U.S. Treasury now yields 1.85%, and the 30-year Treasury yields 2.85%? Ultimately, if yields rise to historical levels, how is it possible that other asset classes will react in accordance to historical correlations when the S&P itself now yields more than either the 10-year or 30-year Treasury?

Let us consider the following figures: the iShares Barclays 20+ Year Treasury ETF (TLT) has a 30-day SEC yield of 2.79%; the iShares Barclays 7-10 Year Treasury ETF (IEF) has a 30-day SEC yield of 1.63%; the iShares Barclays Aggregate Bond Fund (AGG) has a 30-day SEC yield of 2.10%, and that's considered to be the proxy for the bond market at large; the Vanguard Barclays Total Bond Market has a 30-day SEC yield of 2.40%; and the iShares Barclays TIPS Bond Fund (TIP) (for Treasury Inflation Protected) has a 30-day SEC yield of negative 12 basis points.

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	<u>SEC Yield</u>
iShares Barclays 20+ Year Treasury ETF (TLT)	2.79%
iShares Barclays 7–10 Year Treasury ETF (IEF)	1.63%
iShares Barclays Aggregate Bond Fund (AGG)	2.10%
Vanguard Barclays Total Bond Market	2.40%

Source: ETF sponsors' websites as of 12/16/2011

It is extraordinary that the iShares Barclays TIPS Bond Fund has \$22 billion of assets under management given that the ETF has a negative yield. The March 2012 at-the-money put with a strike price of \$117 traded at \$2 on December 16, 2011. If one wished to be long TIPS, and if all else remains constant, one could sell the at-the-money puts every three months at \$2 to earn 6.84% plus a handful of basis points from placing the collateral for the trade in a money market account. It is possible to construct a portfolio that would be effectively long TIPS and would have a yield that is much higher.

That situation is not supposed to exist in a world of efficient markets, and it highlights the distortions created by indexation. Of course, as simple as this trade would be to construct, it will generally not be done for reasons that are relatively simple. In modern portfolio theory logic, constructing a TIPS portfolio via options would be an asset allocation move from bonds to options. Moreover, the trading account for the portfolio would require a Level 5 Options Trading Authority.

The same construction technique performed on the iBoxx High-Yield Corporate Bond ETF (HYG) using the March 2012 options, as they were priced on December 16, 2011, would produce a yield of 14.25%. As of the same date, the HYG yield was 7.86%.

It is certainly in accordance with the scientific method that managers should be quantitatively assessed against a standard or benchmark. However, the benchmark is no longer merely a standard; it is a competitor. Large-scale use of the benchmark as a product creates its own confounding variables such that measuring the accomplishments of managers against the benchmark is meaningless. The benchmark is merely another manager with a quantitative method of security selection. If it should ever lose popularity, the investment flows and performance characteristics will be dramatically reversed, with grievous consequences to the investors in the index.

The index is now, by far, effectively the largest manager. There do not exist sufficiently large pockets of liquidity to accommodate a large-scale outflow of funds from indices. The following table displays the current indexation circumstance:

<u>Institution</u>	<u>Assets Under Management</u> <i>(\$ in trillions)</i>
State Street	\$2.0
Vanguard	\$1.6
BlackRock	\$3.345

Source: Company websites as of 12/16/2011

State Street is largely an indexation company. Although BlackRock is not entirely an index fund, it is largely an index fund, because it owns iShares. If there should ever be a significant outflow from indexation into any other type of strategy, there exists no pool of capital sufficiently large to absorb the outflow of dollars from the index securities, an observation of which asset allocators should be reasonably cognizant.

Industry Thoughts

LOW PRICE-TO-BOOK VALUE STOCKS

This section offers an analysis of three low price-to-book value stocks. These three securities are very different from each other and include Bank of America, which trades at 0.23x book value; Overseas Shipholding, which trades at 0.18x book value; and Citigroup, which trades at 0.42x book value. If one constructed a portfolio that was equally weighted among those three securities, the average would result in a group that trades at 0.28x book value.

For illustrative purposes, let's say that an investor placed \$3,000 in this equally-weighted portfolio and held it for five years. At the end of that holding period, if Bank of America were to trade at 1.1x book value, without increasing its actual book value, and the other two companies had gone bankrupt and were worth zero, the portfolio itself would be worth \$4,783 for a 9.78% compound annual rate of return.

In addition, let us say that one created an index of 100 securities, each expected to grow at 10%. If they all did so, that portfolio would modestly outperform the three security portfolio described above. If, however, 20% of the securities in the index have a rate of return that is positive but is less than 10%. In that scenario, the return from the 100 security index would be inferior to that of the portfolio of three distressed securities. The only way the return of the index could be equivalent to the portfolio would be if an equivalent number of securities returned more than the assumed 10%, to balance out the 20% that would earn less than the assumed 10%. It's certainly asking a great deal of a portfolio of 100 securities to produce a 10% rate of return, when it's always possible to have one or more negative exogenous events.

In the three-security book-value portfolio, one could assume two horrendously negative exogenous events—in other words, two of those companies could become bankrupt and be worth nothing—and still the portfolio would earn a rate of return not different from what one might expect of an index. That scenario is an example of the equity yield curve in action. All that would be required is for one of the three securities to produce a high rate of return, since they're not expected to do so.

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The most important question in building portfolios is not what the fundamentals of the companies are, but what the prices suggest the fundamentals of the companies are, because that changes the odds. In the three-security portfolio, the required odds for earning a return comparable to an index are one out of three. We understand that the required odds in a generalized portfolio are much higher. Therefore, as volatile as a portfolio comprised of these three enterprises would be, I dare say it is superior to an index.

In principle, one could create a portfolio with 100 stocks that are trading at discounts to book value, but it would be extraordinarily difficult to raise money in it. That assertion is not based on mere supposition; the proof is in the iShares MSCI Europe Financials Sector Index Fund (EUFN), because that is comprised of all the leading European financial institutions, which are all under pressure.

Let us assume that only a handful of the companies survive the European debacle that everyone seems to expect. The companies that fail will effectively surrender their business to those companies that do not fail. In other words, the business of the failed companies will eventually be absorbed by the firms that remain solvent. The index itself will be very volatile, but it will not be worthless. As an index, it is likely to produce an above-average rate of return. Nevertheless, it has \$19.7 million in assets under management as of the most recent reckoning. It trades \$522,000 dollars' worth of volume per day. At that rate, it turns over 6.7 times a year, far less than other index funds, so it clearly has very little attention drawn to it.

Top Ten Holdings (EUFN) (As of 1/5/2012)

<u>Symbol</u>	<u>Name</u>	<u>% Net Assets</u>
HSBA	HSBC Holdings Plc	12.64%
SAN	Banco Santander SA	5.72%
STAN	Standard Chartered Plc	4.86%
ALV	Allianz SE-REG	4.05%
UBSN	UBS AG-REG	4.05%
BBVA	Banco Bilbao Vizcaya Argenta	3.56%
BNP	BNP Paribas	3.47%
DBK	Deutsch Bank AG-REG	3.23%
BARC	Barclays Plc	3.09%
ZURN	Zurich Financial Services AG	3.02%

Source: iShares website

Facts & Figures

FEDERAL DEPOSIT INSURANCE CORPORATION

The figures included in this section are all from the Federal Deposit Insurance Corporation (FDIC) Quarterly Banking Profile. One can observe in the table below that from the fourth quarter of 2009 to the second quarter of 2011, the Federal Deposit Insurance Fund had a negative balance.

FDIC Fund Balances (<i>\$ in billions</i>)		
<u>Period</u>	<u>Beginning Fund Balance</u>	<u>Number of Reporting Banks</u>
3Q2011	\$3.916	7,445
2Q2011	(1.023)	7,552
1Q2011	(7.352)	7,584
4Q2010	(8.009)	7,668
3Q2010	(15.247)	7,771
2Q2010	(20.717)	7,840
1Q2010	(20.862)	7,944
4Q2009	(8.243)	8,022
3Q2009	10.368	8,109
2Q2009	13.007	8,205
1Q2009	17.276	8,257
4Q2008	34.588	8,315
3Q2008	\$45.217	8,394

Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 16

Nevertheless, the FDIC was able to seize banks and pay deposits of failed banks, even though its insurance fund was more than exhausted during the credit crisis. The fund has only now begun to build. It wasn't until the third quarter of 2011 that it regained a positive balance. The conclusion readers should draw from this table is that the faculties of government are unique unto themselves. The government can operate with negative balances, because of its unique characteristics, something which many are likely to forget.

The next table presents the number of failed institutions and the number identified by the FDIC as "problem institutions" that require monitoring for quality issues. In recent times, both the number of problem institutions and the number of failed institutions have begun to decline. It's the first sign of improvement in the health of the banking industry.

As of September 30, 2011, there were 844 problem institutions out of the 7,445 banks reporting to the FDIC. Therefore, 11.34% are defined as problematic by the FDIC. In the third quarter of 2008, there were 8,394 reporting banks, so there's been enormous contraction in the number of banks. In order to have a banking crisis again, we would have

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to create more problematic banks, which would cause the ratio to be at a level that has no precedent in any period of history.

<u>Period</u>	FDIC	
	<u>Number of Problem Institutions</u>	<u>Number of Failed Institutions</u>
Through 9/30/2011	844	74
Through 9/30/2010	860	127
2010	884	157
2009	702	140
2008	252	25
2007	76	3
2006	50	0

Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 16

The next table shows that at the end of the third quarter of 2008, the banking system had \$13.573 trillion of assets on its balance sheets. In the same period of 2010, that figure was \$13.373 trillion. That contraction is unprecedented in the post-World War II era.

Total Assets of All FDIC Insured Institutions (<i>\$ in trillions</i>)	
<u>Prior First Three Quarters</u>	<u>Total Assets</u>
2011	\$13.808
2010	\$13.373
2008	\$13.573
2006	\$11.754

Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 7.

Comparing the \$11.754 trillion of total assets in the banking system at the end of the third quarter of 2006 with the 2008 figure of \$13.573, shows a gain of 15.47%. One would normally expect an asset expansion of that magnitude to generate inflation, but it didn't. One might also expect an asset contraction to generate deflation, but it didn't. Clearly, there are confounding variables at work, not the least of which is the action of the Federal Reserve.

It's worth remembering that there are only 106 banks in the United States that have balance sheet assets of more than \$10 billion. In other words, there are 7,730 banks, almost the entire total, that have less than \$10 billion of assets.³ Ultimately, one should anticipate that the government will enact rules to make it difficult for the large banks to gain market share, because they are systemically dangerous.

Future growth in banking will probably come from a set of small banks. However, the small banks are not represented in the index, nor can they be, because there are over 7,000

³ Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 6

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of them. This major sector of the U.S. economy will probably experience some period of growth once it recovers from the debacle of 2008 and its aftermath, but it's not likely to be represented in the index or, if it is, it's likely to be represented in very small measure.

According to the FDIC, 1,186 banks reported holding derivatives, as of the third quarter of 2011. The combined assets of those banks were \$11.3 trillion. Almost all the assets of the aggregate banking system are held by roughly one-seventh of the banks, and those institutions buy, sell, and trade in derivatives. Their total deposits were \$8.1 trillion, and the notional amount of their holdings in derivatives outstanding was \$250.5 trillion.⁴

If one assumes that banks with an aggregate balance sheet of \$11.3 trillion have combined equity ratios of 10%, which is a generous assumption and probably overstates it, that figure would imply that those banks have \$1.1 trillion. If the amount of net exposure at risk for the \$250 trillion notional value of the derivatives is as low as 0.44%, then these banks have collectively bet their entire shareholders equity on derivatives. If the net exposure is greater than that, then they have bet more.

The FDIC calculates exposure as follows: current exposure to Tier 1 capital, which is different from shareholders equity, is 52.5%. Potential future exposure to Tier 1 capital is calculated at 82.8%, and total exposure to Tier 1 capital at 135.3%. Given those figures, the aforementioned assumptions are not unreasonable. Nearly 87% of the derivatives held by these banks are of the interest rate variety. The banks are effectively betting on interest rates by having a balance sheet that acts in the positively sloping yield environment. They are trying to hedge their exposure, but the interesting question is with whom are they hedging it?

Derivatives, All FDIC-Insured Commercial Banks and State Chartered Banks
(dollar figures in trillions)

<u>All Derivative Holders</u>	<u>3rd Quarter 2011</u>
Number of institutions reporting derivatives	1,186
Total assets of institutions reporting derivatives	\$11.3
Total deposits of institutions reporting derivatives	\$8.1
Total derivatives	\$250.5
<u>Risk-Based Capital: Credit Equivalent Amount</u>	
Total current exposure to Tier 1 capital	52.5%
Total potential future exposure to Tier 1 capital	<u>82.8%</u>
Total exposure (credit equivalent amount) to Tier 1 capital	135.3%

Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 11

⁴ Source: <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>, p. 11.

Featured Companies

MCDONALD'S CORP. (MCD)

McDonald's is trading at its all-time high share price. Since everyone understands its business, this company requires no introduction. Analysts expect the company to earn \$5.72 a share; consequently, its P/E is 17.04x based on the 2012 estimates, and 18.67x based on the 2011 estimates, which have yet to materialize.

There is nothing wrong with McDonald's as a company—other than the possible high caloric content of its products. However, the company now has a 31.75% operating margin and a net profit margin of 21.03%. Looking at it from the point of view of an analyst, there are 33,144 McDonald's restaurants in the world, or one McDonald's for every 199,131 people on the planet. From that perspective, there seems to be room for the company to grow.

The total landmass of the world is 57,510,000 square miles. If one subtracts from that figure certain large areas of territory in which McDonald's is unlikely to expand, including Tibet, Antarctica, Chad, Somalia, Greenland, and the Northwest Territories, the resultant area available for McDonald's expansion is a mere 49,631,451 square miles. If one looks at the 33,144 existing McDonald's restaurants in the context of 49 million square miles, it would appear to have massive room for expansion. Although, to give a truer figure, some of the Siberian tundra, the Lapland in Scandinavia and other areas should be subtracted as well.

Looking at McDonald's another way, in the first nine months of 2011, it earned a little over \$4.1 billion. During that period of time, McDonald's repurchased \$2.993 billion worth of its common stock, and paid cash dividends of \$1.894 billion. In other words, the company expended, or returned to shareholders, more than its earnings. In the past year, the company's system-wide restaurants expanded by 2.1% from 32,461 to 33,144. At the end of 1999, the company had 26,806 restaurants. The compound annual growth rate in its restaurants during the past 11.75 years is 1.82%. In whatever manner McDonald's chooses to grow, it is certainly not generating double-digit gains in earnings by building new restaurants or by reinvesting its cash flow. It's effectively returning to shareholders more than its cash flow.

McDonald's has managed to grow its profit margin from 11.98% in 1989 to its current level of 21.05%. Over the past decade, the company has essentially raised its prices faster than its costs, including labor, commodities, rent, and others. It has simply managed to raise prices faster than inflation. The question is how long can that formula work?

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McDonald's Profit Margins

2011	21.05%
2006	13.70%
2001	11.00%
1998	14.69%
1995	14.57%
1989	11.98%

Source: Company Reports

The answer to that question might be found in what's known as the Big Mac Index, published by *The Economist* magazine. The latest version was released on July 28, 2011. This index lists the cost in U.S. dollars of a Big Mac in various countries.

Cost of Big Mac in USD in Various Countries

Brazil	\$6.16
Argentina	4.84
Sweden	7.64
Switzerland	8.06
Euro Area	4.93
Canada	5.00
South Korea	3.50
Mexico	2.74
Australia	4.94
Russia	2.70
Britain	3.89
Japan	4.08
China	2.27
USA	4.07
India	\$1.89

Source: <http://www.economist.com/blogs/dailychart/2011/07/big-mac-index>

The issue is McDonald's margin expansion: can the company continue to raise prices at the historical rate in order to produce the earnings gains that it has had in the past? There are very few companies in history that have ever sustained a 21% net profit margin. If McDonald's margins are to be restored to something more reasonable in a historical context, the actual margin might be something between 10% and 12%. Understand that, at these prices, double-digit gains require double-digit price increases, because the number of restaurants is not increasing at a very high rate. It's doubtful that the company can achieve those increases.

There will always be some type of inflation in wages, especially in emerging market countries and, as labor becomes more expensive, it's likely that these high margins will reverse themselves. Therefore, one could easily experience P/E degradation, as well as not a little earnings degradation. McDonald's is not a dangerous company. If one were to sell it short, the worst that could possibly happen is that it produces yet another low-double-digit earnings increase, which would make that short position a 10% greater liability one year from now than it is now. On a risk-reward basis, McDonald's is worthy of being sold short.

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PROCTER & GAMBLE (PG)

There is nothing wrong with Procter & Gamble, which makes excellent products that are in great demand now, and in the foreseeable future. The only problem comes essentially from the shareholders. As of the June fiscal year, this company trades at 15.4x its estimated fiscal earnings. Analysts generally estimate that Procter & Gamble will grow its earnings by an amount either in the high single digits or the low double digits.

In fairness to the analysts, this impression is obtained directly from page 3 of the most recent Procter & Gamble annual report, which outlines the goals of the company.⁵ These are:

1. Organic sales growth 1% to 2% above the global market rate; in other words, continued market share growth. Clearly, Procter & Gamble is a dominant market share company in these product lines.
2. Core earnings growth of high single digits to low double digits.
3. Free cash flow equal to 90% of earnings.

In the most recent quarter, Procter & Gamble earned slightly in excess of \$3 billion, paid dividends of slightly more than \$1.5 billion, and repurchased stock of slightly more than \$1.26 billion. Consequently, the company reinvested \$260 million in itself in one quarter. If the analysts are correct, it will earn \$12.5 billion.

If the company were to grow at 10% a year, it would have to increase its earnings by \$1.25 billion, or 10% of the \$12.5 billion the analysts project. If the company reinvests \$260 million in itself each quarter, by the end of the year it will have reinvested slightly in excess of \$1 billion, and it will have produced an increment of earnings of \$1.25 billion, thereby earning a marginal return on marginally invested capital of 120%. That figure is basically obtained by taking the increment of increase in the earnings, which is \$1.25 billion, and dividing by the amount of earnings reinvested, which is \$1.04 billion, resulting in 120%. That strategy does not seem sustainable.

According to page 8 of Procter & Gamble's annual report, the United States generates \$96 in sales per capita for the company each year. Mexico produces \$20 per capita, China \$4, and Indonesia \$1. Growing sales in the emerging markets to the American level could produce a tremendous amount of revenue and, therefore, a tremendous quantity of earnings. No reasonable person should doubt that such growth is possible. However, the question is not whether or not it's possible for Mexico and Indonesia to absorb more Procter & Gamble products; of course they can. The question is what magnitude of

⁵ The 2011 Annual Report for PG can be found at:
http://www.pg.com/en_US/downloads/investors/annual_reports/2011/PG_2011_AnnualReport.pdf

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reinvestment of profits is needed to generate those revenues? More importantly, what will be the resultant margin?

Procter & Gamble serves 4.2 billion consumers per year (from page 8 of the 2011 annual report). There are only 6.6 billion consumers on the planet, and the third of the world population who are not already served by the company includes, generally speaking, the poorest people on earth.

Procter & Gamble currently produces a net profit margin of 14%. In the year 2000, it produced a profit margin of 8.87%, in 1995 it was 7.9%, and in 1990, it was 6.65%. In fiscal 2011, the company had \$82.5 billion of revenue, and in 1990 it had slightly in excess of \$24 billion. The compound annual growth rate in revenues for the past 21 years is 6.05%. The revenue growth during those two decades was accomplished in an environment that witnessed much higher inflation rates than we currently have, because that 6% growth is nominal.

Procter & Gamble's Profit Margin

2011	14.00%
2000	8.87%
1995	7.90%
1990	6.65%

Source: Company Reports

How is the company to produce that level of earnings growth, unless it either improves margins by selling more of the same products to the poorest people on the planet, or it accelerates the rate of revenue growth in an environment that produces less inflation, all the while selling to people with the lowest incomes? It doesn't appear to be reasonable or possible; therefore, Procter & Gamble is recommended as a short sale.

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

DST SYSTEMS, INC. (DST)

DST Systems has a market cap of roughly \$2 billion, so it's much smaller than the previous two companies. DST Systems is a computer services company that was founded in 1969 as a division of Kansas City Railroad. It was a very successful computer services company, because it was prescient in its expansion in three areas that produced consistent growth for many decades.

The first and largest area of expansion was mutual fund processing; the second was the software services related to the administration of healthcare; and the third was processing for cable TV and ancillary services, all of which witnessed a great expansion over the last several decades. Currently, all three of those areas are under great pressure. The biggest challenge is in mutual fund processing, the company's largest business. Mutual funds are gradually being displaced by ETFs which, because they trade like stocks, don't require the processing of individual accounts that mutual funds must provide.

According to DST Systems, the number of registered accounts in mutual fund processing in 2008 were 111 million, and they were 99.4 million at the end of 2010. Lest anyone think that this damage was done in 2009, it was not, as can be seen in the table below. The damage was done in the year 2010. The percent decline in processed accounts was roughly 10% in the year 2010, and it continues this year.

DST Systems Registered Accounts
(in millions)

Q3-2011	86.8
2010	99.4
2009	109.9
2008	111.2
2007	117.2
2006	105.8
2005	102.2

Source: Company Reports

There are also significant pressures in healthcare, and they will probably worsen, because there are major cost containment pressures afoot that will only accelerate. The telecommunications industry is not immune, since cable firms, which are large customers of billing software, gradually suffer erosion of subscribers to new wireless internet types of technologies.

DST Systems is not without its virtues. As of September 30, 2011, it had a sensibly arranged balance sheet with \$89 million of cash and \$945 million of investments mainly in publicly traded companies, including State Street, Computershare, and Euronet Worldwide. It has about \$220 million of private equity investments that could be valued at cost. It also has about 3.2 million square feet of office space, which is a fair amount of real estate. However, the company also has \$312 million of current debt, \$962 million of long-

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

term debt, and net current assets of negative \$201 million, so its assets are more than balanced by its liabilities.⁶

Recognizing that there is a problem in all of its business areas, the company was aggressively acquiring companies in 2011. In April, it acquired the firm known as Finix Business Strategies, and it acquired a firm known as Subserveo in June. Finix Business Strategies is involved in automation of brokerage, and Subserveo is an automated compliance system.

In July 2011, DST acquired IntelliSource Healthcare, which is involved in healthcare-related software. In May, it acquired Newkirk Products, a financial services company. In August, it acquired a British company known as Lateral Group, which is active in marketing communications.

The company reports the total cost of all these investments as \$114.8 million for \$259 million of annual revenue. However, the aggregate revenue of all those companies happens to be in decline. The features of those companies are not radically different from the features of the existing companies, although there may be economies of scale on merging them.

In October of 2011, the company purchased ALPS for \$250 million. Since ALPS is involved in the ETF business, it is DST System's first foray into the growth area of ETFs. Yet, ETF providers themselves are experiencing margin pressures, which is in no small measure due to the entry of Vanguard into that business. Vanguard is in the process of issuing many ETFs that have exceedingly low expense ratios. It is driving down the profitability and, therefore, the margins of virtually everything in the ETF space, with quite unpredictable consequences for the future of that industry.

The ALPS acquisition may not necessarily solve the problem; nevertheless, DST Systems paid \$250 million for it. To fund the acquisition, the company issued \$125 million in long-term debt and paid the rest from cash on hand. Since the balance sheet is deteriorating, as are the characteristics of all the businesses, and the margin is likely to be under pressure, DST Systems is recommended as a short sale candidate.

⁶ For more information see the 2010 Annual Report at:
http://www.dstsystems.com/ic/pdf_files/10k/022011/14001T06_CNb.PDF

iSHARES BARCLAYS TIPS BOND FUND (TIP)

The logic behind a short sale recommendation on the iShares Barclays TIPS Bond Fund (TIP) is that although this ETF has a distribution yield of 2.25%, it's only because the securities it holds have larger coupons than TIPS currently do, because they were purchased years ago. The 30-day SEC yield of this TIPS ETF is negative 12 basis points, and the average real yield-to-maturity is negative 29 basis points.⁷

The ETF must have a cash distribution, since the interest derived from the relatively high coupon TIPS are taxable, and the practice is that the fund pays out its taxable income. Since the real yield of the TIPS is negative, by definition, the unit value must decline.

The rate of return of this fund was positively impacted, as all Treasuries were, by the decline in interest rates. Since its December 4, 2003 inception, this fund's rate of return was 6.13% per annum. It has \$22 billion of assets. The average maturity of this fund is 9.53 years. One might well ask what would happen to the unit value of this fund if TIPS yielded 3%, which is nothing other than the presumptive inflation rate.

Amazingly, the fund continues to gather assets. Eventually, as the fund purchases more TIPS bonds, the higher coupon TIPS will be diluted by the lower coupon TIPS. Essentially, this situation creates a free put option on the normalization of interest rates because, effectively, there is a cash-carry, but no real carry. Interestingly enough, this security is also a free put option on deflation, because every TIP must mature at par value, but it need not pay off at its accreted value. If there were deflation, it would be possible to have negative accretion on TIPS.

A positive real carry, which is a free put option on deflation, is worth being shorted. It appears that there is very little upside potential in TIPS to have a negative real yield, so sale is recommended.

⁷ Source: http://us.ishares.com/product_info/fund/overview/TIP.htm

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

Money Manager Index

From Jan 1983 to December 2011

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	Annualized return (since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.22	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49	85.67	90.79	99.97	101.69	107.32	107.36	110.94	115.01	2009	115.01	69.4%	19.7%
2010	106.84	110.32	118.13	114.91	100.18	88.17	97.65	89.64	103.59	108.29	108.64	119.58	2010	119.58	4.0%	19.1%
2011	122.80	128.28	127.94	127.97	126.06	121.03	115.49	104.25	91.32	102.44	103.79	103.98	2011	103.98	(13.1)%	17.8%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	AMG us equity	Affiliated Manager	\$22,947	1377	11/30/1997	132,105
2	ALNC us equity	Alliance	\$7,633	491	4/30/1994	15,304
3	BLK us equity	BlackRock	\$23,205	1658	9/30/1999	297,714
4	WDR us equity	Waddell & Reed	\$27,513	1587	3/31/1998	39,714
5	EV us equity	Eaton Vance	\$2,641	3998	1/31/1986	94,522
6	TROW us equity	T. Rowe Price	\$2,423	2014	4/30/1986	115,313
7	BEN us equity	Franklin Resources	\$908	1263	4/30/1985	124,204
8	LM us equity	Legg Mason	\$1,000	462	8/31/1983	11,153
9	FII us equity	Federated Inv	\$26,381	2206	5/31/1998	33,422
10	FIG us equity	Fortress Investment Group	\$102,249	3389	2/28/2007	11,455
11	PZN us equity	Pzena Investment Management	\$122,426	6317	10/31/2007	27,353

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Index Constituent Changes: 1. Everest Financial Group Limited (EFG AU) was delisted from the Australian Security Exchange effective 7/19/2011 and has been removed from the index. The divisor has been adjusted accordingly. 2. RAB Capital Plc (RAB LN) was delisted from the London Security Exchange effective 9/2/2011 and has been removed from the index. The divisor has been adjusted accordingly.

International Money Manager Index

From Jan 1983 to Dec 2011

Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	Annualized return
																(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63	22.82	23.73	26.14	27.05	28.41	28.53	28.69	29.83	2009	29.83	89.0%	15.8%
2010	28.50	27.58	29.90	29.58	25.53	24.72	27.82	26.74	30.36	33.68	31.85	34.52	2010	34.52	15.7%	15.8%
2011	34.91	36.17	36.51	39.63	37.86	35.31	35.83	32.76	29.28	32.04	31.23	30.59	2011	30.59	(11.4)%	14.7%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	IGM CN Equity	IGM Financial Inc	\$1,000	73	31/11/1986	3,234
2	FCAM LN Equity	F&C Asset Management Plc	\$1,203	485	5/31/1989	492
3	IVZ US Equity	Invesco Plc (Previously Amvescap)	\$1,357	1,153	1/31/1991	11,577
4	SDR LN Equity	Schroders Plc	\$1,208	505	3/31/1991	10,289
5	RAT LN Equity	Rathbone Brothers Plc	\$1,208	736	3/31/1991	12,094
6	ADN LN Equity	Aberdeen Asset Mgmt Plc	\$1,208	1,827	3/31/1991	6,172
7	CIX CN Equity	CI Financial Corp.	\$2,585	3,224	6/30/1994	67,147
8	EMG LN Equity	Man Group Plc	\$2,862	6,344	10/31/1994	9,401
9	AGF/B CN Equity	AGF Management Ltd-CI B	\$3,343	1,346	1/31/1996	20,942
10	8739 JP Equity	Sparx Group Co Ltd	\$11,762	108	12/31/2001	7,542
11	HGG LN Equity	Henderson Group Plc	\$14,447	8,666	12/31/2003	11,010
13	AZM IM Equity	Azimat Holding Spa	\$21,908	4,977	7/31/2004	39,961
15	CCAP LN Equity	Charlemagne Capital Ltd	\$36,848	22,300	3/31/2006	3,891
16	PGHN SW Equity	Partners Group-Reg	\$36,848	578	3/31/2006	100,975
17	INRE LN Equity	Invista Real Estate Inv Mngt	\$36,589	21,540	9/30/2006	3,165
18	ASHM LN Equity	Ashmore Group Plc.	\$36,688	9,873	10/31/2006	51,141