THE FIXED INCOME CONTRARIAN COMPENDIUM

December 2011

Featured Companies

Standard Pacific (SPF)
Nuveen Investments (NUVINV, CUSIP 67090FAD8)
Vulcan Materials (VMC)
Jefferies Group (JEF)

Exclusive Marketers of
The Fixed Income Contrarian Report

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Murray's Musings

TAIL RISK AS AN ASSET CLASS

Conventional asset allocation is divided by security type: bonds and equities. Equities are further sorted according to market capitalization and, not infrequently, by geographic location. Major geographic subdivisions include domestic (U.S.), emerging markets, and Europe. In some cases, the latter two are further subdivided by nation. In the estimation of all, the emerging markets are considered inherently more risky than the developed markets. The contention of this brief essay is that this classification system is completely unworkable.

To illustrate, would anyone seriously suggest that purchasing the common stock of a company such as Bank of America would entail significantly less risk than purchasing the common stock of a company such as the United Overseas Bank of Singapore? I don't believe anyone would make that assertion.

Similarly, let us compare two bonds. First, consider the Bank of America 6.5% due August 1, 2016 and, second, the Republic of Lebanon Sovereign Debt 9% due March 20, 2017. The two bonds have comparable, though not identical maturities. As of December 2, 2011, the yield to maturity for the Bank of America bond was 7.33%, or a small discount to par. As of the same date, the Republic of Lebanon bond was priced to have a yield to maturity of 4.91%.

The market's risk assessment for those two pieces of paper does not correspond to the classification system currently embraced by asset allocators. The asset allocation building blocks cannot be utilized to assess risk, because the definitional categories completely ignore the market's risk assessment. How can definitional categories of risk be relevant when the market's own assessment of risk differs radically from those definitions, whether or not the market's evaluation is correct?

Let's say that an investor purchased shares of the iBoxx Investment Grade Corporate Bond Fund (LQD). It is reasonable to assume that this individual would not be seeking a very high risk profile. Nevertheless, that fund has a very high proportion of bonds floated by issuers such as Morgan Stanley, Bank of America, Citigroup, American International Group, et cetera. Most would agree those issuers do entail a certain degree of risk. LQD has a weighting of 35.79% in financial paper, mostly with issuers of that type. Its 30-day SEC yield is 4.01%, its yield to maturity is 4.33%, and its average maturity is 11.92 years.

The problem with LQD is that the issuers of the debt not only include the combination of those that probably entail very little risk and pay very little in terms of interest, but also

includes issuers that might entail somewhat more risk and pay somewhat more. The table below lists the yield to maturity and the yield to worst in the event that it is called, of some of the paper held in LQD. This combination explains much about how the yield to maturity is actually derived. Even though it's not proper to refer to this fund as barbell structured, in a loose manner of speaking that is an appropriate description. The ETF contains very high grade paper as well as some not so high grade paper, for a yield of roughly 4%.

In extreme circumstances, the buyer of LQD might actually be assuming much more risk than is suggested by the yield to maturity of the fund itself. However, the larger question is definitional. This ETF is a high grade corporate bond fund and, therefore, it is considered to be radically separate and distinct in terms of risk profile from an emerging market bond fund, but perhaps it should not be so considered.

iBoxx Investment Grade Corporate Bond Fund (LQD)
Top 8 Holdings as of 12/2/2011

Ticker	Issuer	Coupon	Maturity	YTM
WFC	Wells Fargo	5.625%	12/11/2017	3.38%
JPM	JP Morgan	6.30%	4/23/2019	4.68%
GE	General Electric	5.625%	5/1/2018	3.98%
C	Citigroup	8.50%	5/22/2019	5.88%
AIG	American Intl Group	5.85%	1/16/2018	6.53%
GS	Goldman Sachs	6.15%	4/1/2018	6.08%
MS	Morgan Stanley	6.00%	4/28/2015	6.88%
AXP	American Express	8.12%	5/20/2019	4.06%

Source: http://us.ishares.com/product_info/fund/holdings/LQD.htm

Ultimately, as the paper in this fund matures or is called for redemption in the next year or two, those assets will be redeployed into lower yielding paper. As those events unfold, the fund will probably yield less, even if its price doesn't change.

Another way of designing asset classes that, by definition, express their risk is to look at the section of the options market that speaks to tail risk. The following table shows options on the bond issuers listed in the table above. The exercise is to see what would happen if one were to sell options with January 18, 2013 expirations, which is slightly over a year. The object of this exercise is to see how the options market views these issuers in terms of tail risk.

The table below presents data on the options as of December 2, 2011. The strike prices of the puts are well below the current stock price, so these are way out of the money options. The indifference point is defined as the strike price less the option premium, and basically represents the amount of capital at risk. The last column is yield on capital at risk assuming that the indifference points are never reached. In principle, if one were to write a put option with a strike price of $15 and take in $1.15 in premium, the worst that could happen is that

the stock could go to zero. Since one keeps the option premium, in that instance the loss would be $13.85, which represents the capital at risk.

The indifference point is the point at which one starts losing money. If neither the indifference point nor the strike price is reached, one would earn the yield on capital at risk, as compared to the yields to maturity on the bonds. The yields to maturity on those issues range from a low of 3.38% in the case of Wells Fargo to a high of 6.88% in the case of Morgan Stanley. The yields on capital at risk for the put options on the same issuers range from a low of 5.78% in the case of American Express to a high of 21.8% in the case of Morgan Stanley. Therefore, the options market has a radically different approach to exogenous negative event risk.

Ticker	Issuer	Stock Price	Strike Price	Option Premium	Indifference Point	Yield on Capital at Risk
WFC	Wells Fargo	$26.07	$15.00	$1.15	$13.85	8.30%
JPM	JP Morgan	32.33	15.00	1.02	13.98	7.30%
GE	General Electric	16.09	12.50	1.10	11.40	9.65%
C	Citigroup	28.17	15.00	1.83	13.17	13.90%
AIG	American Intl Group	23.18	13.00	1.06	11.94	8.88%
GS	Goldman Sachs	97.15	60.00	5.80	54.20	10.70%
MS	Morgan Stanley	15.52	10.00	1.79	8.21	21.80%
AXP	American Express	48.23	30.00	1.64	28.36	5.78%

Source: Bloomberg data as of 12/2/2011; Horizon Kinetics Research

The next table represents the decline necessary in these individual stocks to merely reach the indifference points. In most of the cases it's well over 40%. In the case of JPMorgan it's 56.76%. To merely reach the indifference point, JPMorgan has to lose over 50% of its value. The smallest path to travel is 29.15% in the case of General Electric. Nevertheless, the yield on capital at risk for the General Electric puts is 9.65%.

Ticker	Issuer	Decline Required to Reach Indifference Point
WFC	Wells Fargo	46.87%
JPM	JP Morgan	56.76%
GE	General Electric	29.15%
C	Citigroup	53.25%
AIG	American Intl Group	48.47%
GS	Goldman Sachs	44.21%
MS	Morgan Stanley	47.10%
AXP	American Express	41.20%

Source: Horizon Kinetics Research

The point of this analysis is that it's much more logical to classify securities according the market's assessment and pricing of that risk, rather than by some definitional attribute. The reason is that the nature of risk entailed in certain securities is not constant; it fluctuates.

There are certain points in the lives of certain companies when their balance sheets are pristine and their market position is virtually impregnable and the security effectively entails no risk. However, there are other times when the security retains its categorical definition, but the company's balance sheet and market position has eroded. Perhaps it faces some legal liabilities or regulatory challenges and therefore it entails much more risk than is expressed in the price of the stock or other security as the case may be.

An interesting point about the use of options is that if one merely wrote out-of-the-money puts on the eight financial companies in question, odds are that most of the options would expire worthless. Ironically, if the prices of their common stocks were to decline sufficiently to reach the indifference points, it's fairly likely that there would also be substantial erosion in the market price of these bonds from those noted in the first table (page 4).

In summary, paying attention to the market assessment of risk as opposed to the definitional categorization of risk appears to be a reasonable undertaking.

Industry Thoughts

DIVIDEND-RELATED ETFS

Of the 44 dividend-related ETFs that I could identify, the table below lists the 29 that have over $100 million in assets under management. The largest is the Dow Jones Select Dividend Index Fund (DVY). How can there be so many dividend-related ETFs? Does the world need so many?

Ticker	ETF Name	AUM *($ in billions)*
DVY	iShares Dow Jones Select Dividend Index Fund	$8.8
VIG	Vanguard Dividend Appreciation ETF	8.5
SDY	SPDR S&P Dividend ETF	7.8
VYM	Vanguard High Dividend Yield Index Fund	2.2
DEM	WisdomTree Emerging Markets High-Yielding Equity Fund	2.0
DTN	WisdomTree Dividend Top 100 Fund	0.87
DLN	WisdomTree World ex-US Growth Fund	0.86
DGS	WisdomTree Emerging Markets Small Cap Dividend Fund	0.75
IDV	iShares Dow Jones EPAC Select Dividend Fund	0.67
HDV	iShares High Dividend Equity Fund	0.66
DWX	SPDR S&P International Dividend ETF	0.59
PID	PowerShares International Dividend Achievers Portfolio	0.56
DLS	WisdomTree International Small Cap Dividend Fund	0.37
FDL	First Trust Morningstar Dividend Leaders Index Fund	0.37
FVD	First Trust Value Line Dividend Fund	0.35
DWM	WisdomTree DEFA Fund	0.34
DHS	WisdomTree Equity Income	0.31
PEY	PowerShares High Yield Equity Dividend Achievers Portfolio	0.30
DON	WisdomTree Midcap Dividend Fund	0.27
PFM	PowerShares Dividend Achievers Portfolio	0.26
DOO	WisdomTree International Dividend ex Financials Fund	0.25
DES	WisdomTree Small Cap Dividend Fund	0.24
DTD	WisdomTree Total Dividend Fund	0.20
DFJ	WisdomTree Japan Small Cap Dividend Fund	0.19
DTH	WisdomTree DEFA High-Yielding Equity Fund	0.14
DOL	WisdomTree International Large Cap Dividend Fund	0.13
FGD	First Trust Dow Jones Global Select Dividend Index Fund	0.12
DIM	WisdomTree International Midcap Dividend Fund	0.12
EDIV	SPDR S&P Emerging Markets Dividend ETF	0.11

Source: www.etfdb.comp*; AUM as of 12/2/2011*

The iShares Dow Jones Select Dividend Index Fund (DVY) has 101 holdings, the top 10 of which represent 21.32% of assets. Ironically, it's actually a concentrated portfolio. Below is a list of its top 10 holdings as of December 2, 2011.

iShares Dow Jones Select Dividend Index Fund (DVY)
Top Ten Holdings as of 12/2/2011

Ticker	Company
LO	Lorillard, Inc.
VF	VF Corporation
CVX	Chevron
ETR	Entergy Corp
KMB	Kimberly-Clark Corporation
TEG	Integrys Energy Group
MCD	McDonald's Corporation
FE	FirstEnergy Corp
OKE	ONEOK, Inc.
DTE	DTE Energy Company

Source: www.ishares.com

Net of fees, the dividend yield for this ETF is 3.5%, and the fund has a 34% weight in utilities. By comparison, the S&P yields roughly 2.1%, and it has a weight in utilities of 3.62%. Therefore, this ETF has nearly ten times the S&P weight in utilities, which is risk of a sort, all for the purpose of obtaining a dividend yield that is higher by a little more than 100 basis points. Do the purchasers of this fund understand the mechanism by which those basis points are earned?

Another ETF on the list is the WisdomTree Total Dividend Fund (DTD), which has 822 holdings, of which the top 10 represent 25.89% of assets. Even though this fund has eight times as many holdings as DVY, DTD's top 10 holdings represent a larger percentage of its assets. This observation brings up the subject of the capture rate, which will be discussed in more detail at the end of this report. The capture rate is generally absent in discussions on indexation, yet it is very important. It is basically the probability that a group of companies will be included in (i.e., captured by) an index.

The table below lists the top ten holdings in the WisdomTree Total Dividend Fund. That list looks very similar to the top 10 names in the S&P 500, with the exception that this ETF excludes companies that pay no dividends, like Apple Computer and Google. Those non-dividend paying securities are replaced by several hundred much smaller securities to provide a balance and to generate a yield for this portfolio of 2.93%. In other words, this portfolio removes the non-dividend paying stocks and replaces them with hundreds of dividend paying mini cap stocks. It hasn't been a bad strategy because, even though Apple has provided excess return relative to the index, this portfolio was able to avoid non-dividend paying disasters like Netflix. The WisdomTree approach is actually more sensible, but the potential issue is that in exchange for some dozen basis points of extra yield, the index is excluding very large companies that may provide substantial outperformance (or may not). It all comes down to the issue of the capture rate, and whether or not one is willing to exclude a certain number of securities with given characteristics that might provide a substantial amount of return.

WisdomTree Total Dividend Fund (DTD)
Top 10 Holdings (*as of 12/2/2011)*

Ticker	Company
T	AT&T Inc
XOM	Exxon Mobil Corporation
CVX	Chevron Corp
PFE	Pfizer Inc
JNJ	Johnson & Johnson
VZ	Verizon Communications Inc
PM	Philip Morris International, Inc
PG	The Procter & Gamble Co
MSFT	Microsoft Corporation
GE	General Electric Co

Source: www.wisdomtree.com

Historically, DTD has outperformed DVY as can be seen in the table below. Year-to-date, however, DVY has outperformed. With rates as low as they are, the utilities have done reasonably well. The point of this discussion is that it is very hard to isolate the dividend variable of a group of stocks without inadvertently incorporating some other type of risk, which may or may not be desirable. In the case of DVY, the fund incorporates a utility concentration risk.

Year	DVY Return	DTD Return
2011 YTD*	(0.54)	(3.41)
2010	17.69%	17.31%
2009	10.99%	20.46%
2008	(32.99%)	(34.85%)
2007	(5.38%)	1.95%

Source: DVY: iShares website; DTD: WisdomTree website
**As of 9/30/2011*

The difference between DTD and DVY illustrates another issue in indexation and the creation of ETFs, which we will call for the purposes of this paper the tilt approach versus the categorization approach.

Most ETFs have rigorous inclusion criteria and, because the underlying indexes include certain types of securities and exclude others, they inadvertently incorporate a certain type of risk. The WisdomTree approach is more akin to the tilt approach. It slightly alters an existing index to overweight one characteristic and underweight another. It appears that virtually everything that has happened thus far in the world of ETFs has been based on the categorization approach, but it seems to me that the future of indexation is in the tilt approach. I believe that the categorization approach is very dangerous for reasons that will be addressed in the following section.

Facts and Figures

TOBACCO AND THE S&P 500 COMPANIES

The following table is adapted from Jeremy Siegel's book *The Future for Investors*[1]. This very important table has enormous relevance for indexation. It shows the best performing S&P 500 firms, by which we mean the firms that were included in the S&P 500 from 1957 to 2003. The table shows the rank of the company by market capitalization in 1957, tracks the evolution of the company through acquisitions, and gives the annualized rate of return from 1957 to 2003.

Twenty Best-Performing Firms in total Descendants Portfolio

Rank Return	Rank Market Cap 1957	Original Name — 2003 Name (—*Merger; > Name Change)*	Annual Return
1	215	Philip Morris > Altria (2003)	19.75%
2	473	Thatcher Glass — Rexall Drug (1966) > Dart Industries (1969) — Dart & Kraft (1980) > Kraft (1986) — Philip Morris (1988) > Altria (2003)	18.42%
3	447	National Can — Triangle Industries (1985) — Pechiney SA (1989)	18.31%
4	485	Dr Pepper — Private (1984) — Dr Pepper 7-Up (1993) — Cadbury Schweppes (1995)	18.07%
5	458	Lane Bryant — Limited Stores (1982) > Limited Inc. (1982)	17.62%
6	259	Celanese Corp. — Private (1987) — Celanese AG (1999)	16.93%
7	65	General Foods — Philip Morris (1985) > Altria (2003)	16.85%
8	197	Abbott Labs	16.51%
9	234	Warner-Lambert — Pfizer (2000)	16.40%
10	299	Bristol-Myers > Bristol-Myers Squibb (1989)	16.36%
11	433	Columbia Pictures — Coca-Cola (1982)	16.25%
12	487	Sweets Co. > Tootsie Roll Industries (1966)	16.11%
13	274	American Chicle — Warner-Lambert (1962) — Pfizer (2000)	16.06%
14	143	Pfizer	16.03%
15	83	Coca-Cola	16.02%
16	267	California Packing Corp — Del Monte (1978) — R.J. Reynolds Industries (1979) — Private (1989) — RJR Nabisco Holdings (1991) — Philip Morris (2000) > Altria (2003)	16.01%
17	348	Lorillard — Loew's Theatres (1968) > Loew's (1971)	15.96%
18	66	National Dairy Products — Dart & Kraft (1980) > Kraft (1986) — Philip Morris (1988) > Altria (2003)	15.92%
19	117	Merck	15.90%
20	218	Standard Brands — Nabisco Brands (1981) — R.J. Reynolds Industries (1985) > RJR Nabisco (1986) — Private (1989) — RJR Nabisco Holdings (1991) — Philip Morris (2000) > Altria (2003)	15.90%

Adapted from: Jeremy Siegel, *The Future for Investors*, 258.[1]

[1] Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Business, 2005), 258

The best performing stock during that period was Philip Morris (now Altria), with an annualized rate of return of 19.75%. Interestingly, Philip Morris was the 215th largest company in 1957, but it inadvertently acquired the successor company to Thatcher Glass. Thatcher Glass, which in 1957 was the 473rd largest company, merged with Rexall Drug in 1966, which in turn merged with Dart Industries in 1969, which became Dart & Kraft in 1980, was acquired by Philip Morris in 1988, and then became part of Altria in 2003. Subsequent to that date, other transactions happened that are not germane. That chain of securities returned 18.42%.

Similarly, Philip Morris made its appearance in National Dairy Products, which was the 66th largest company in the S&P500 in 1957. Ultimately, National Dairy Products found its way into Kraft and, therefore, into Altria. That security, had it been held throughout the series of transactions, provided a rate of return of 15.92%. California Packing, which was the 267th largest company in 1957, was acquired by Del Monte, which in turn was acquired by RJ Reynolds, which went private and then came public again. Some of those businesses were acquired by Philip Morris, and then became part of Altria. That investment returned 16.1% for the relevant period. Interestingly enough, many of the 20 best performing companies are somehow related to tobacco. For example, Standard Brands became Nabisco Brands, which was acquired by RJ Reynolds, and eventually ended up in Altria. Lorillard was acquired by Loew's Theatres, which transformed itself into Loew's, and provided a 15.96% rate of return for the period.

Measuring numerically rather than by market capitalization weight, about 25% of the best performing firms between 1957 and 2003 had something to do with tobacco. Had there been no tobacco companies included in the S&P 500, it is fairly evident that the S&P 500 would have had a meaningfully lower rate of return. The conclusion from of all of this is that it's a mere accident of history that tobacco stocks were included in the S&P 500, which brings us again to the capture rate. In this instance, tobacco companies were captured by the index, but they need not have been. The probability of a given company being captured is not constant throughout history. This observation raises some issues about indexation design, as will be discussed in more depth at the end of this report.

One other point is that if one studies all the companies in the S&P 500, it is fairly evident that the returns of the index are normally distributed by company, which means that on the positive tail, a relatively small group of companies provided a very high proportion of the returns. Therefore, the capture rate, meaning the probability that this small group of companies is included in the index, is critical to indexation design.

BASIC PRINCIPLE OF THE SOCIOLOGY OF INDUSTRY

Companies that ultimately provide a large rate of return are usually not widely held because, if they were, they would have a tendency to be efficiently priced. To explore that observation, I looked for a book on investing that was published prior to the inception of the S&P 500. The one I chose was *Technical Analysis of Stock Trends* by Robert Edwards and John Magee. [2] I referenced a 2008 edition, but the book was originally published in 1948. It is considered one of the classics of technical analysis. Its purpose was to educate readers on how to analyze various performance trends of leading companies, and it is replete with examples. Below is the list I made of the companies featured in the chapters on reversal patterns, which are illustrated with charts and constitute about 50% of the book.

In viewing the table, readers should keep in mind that the list was effectively created in 1948. Therefore, not all of the names will be familiar. These may or may not have been desirable investments to hold from 1948 until today. However, this list represents what someone who was very active in financial markets in 1948 found very important about common stocks.

American Power and Light	American Locomotive	Hudson Motors
Chicago, Milwaukee & St. Paul Railroad	Baltimore and Ohio Preferred	American Rolling Mills
Westinghouse Electric	Creole Petroleum	Goodrich
Republic Steel	General Bronze	Schenley Distillers
Mack Trucks	Lone Star Cement	U.S. Steel
DuPont	Public Service of New Jersey	American Bosch
Consolidated Edison	National Supply	Shell Union Oil
Republic Aviation	Phillips Petroleum	NY Central
American and Foreign Power Pfd	Graham Paige	National Cash Register
Transcontinental and Western Airlines	American Safety Razor	Armour and Company
Union Carbide	J.I. Case	Socony Vacuum Oil
Lockheed	Gamewell	Bath Iron Works
Dome Mines	Inland Steel	Revere Copper & Brass
Newport Industries	Gabriel Company	International Paper
Marshall Field	Vanadium	Associated Dry Goods
Budd Manufacturing	Hudson Bay Mines	Paramount Pictures
Sears Roebuck	Nash Kelvinator	Allied Stores
Johns Manville	Lima Locomotive	Celanese
Delaware and Hudson	Loew's	Briggs Manufacturing
Cuban-American Sugar	Youngstown Steel	Southern Railway Preferred
National Gypsum	American Zinc Lead & Smelting	Publicker Industries
North American Corporation	Bell Aircraft	Crane
Vertientes-Camaguey Sugar	Kennecott Copper	Air Reduction
Eastern Airlines	United Aircraft	American Bank Note
U.S. Industrial Chemicals	American Airlines	Great Northern Preferred
	Continental Corp.	Greyhound

Source: Robert Edwards and John Magee. Technical Analysis of Stock Trends

It is beyond my ability to perform a study of the performance of these companies, and I have no way of accessing the relevant data. However, I would guess that this list, had it

[2] Robert Edwards and John Magee. *Technical Analysis of Stock Trends* (BN Publishing, 2008), 53-166.

been an index, would have demonstrably underperformed the S&P 500 had that index been created in 1948. Even though there are some instances in this list of very successful companies, there don't appear to be many that ultimately became one of the 20 best performing in the S&P 500. In fact, many of these companies ultimately became worthless. It may be that the companies on which people focus are not necessarily the critical ones that deserve the attention.

Featured Companies

STANDARD PACIFIC (SPF)

(Data as of 12/27/2011)

The Standard Pacific 8.375% due May 15, 2018 is priced with a yield to maturity of 8.88%, and is rated B3 by Moody's and B by S&P. This is a $581 million issue. Total debt for the company, which is essentially all senior notes, is $1.273 billion. This issue represents nearly half of the company's debt. The bonds yield nearly 9% because this company is a home builder, and that industry is enormously depressed. While there are those who would assert that the bottom may have been reached, it's not entirely clear that it has been.

This company has over $1 billion of debt, $604 million of shareholders' equity, and $420 million of cash, so the balance sheet is able to withstand the current conditions for a very long period of time. On a GAAP basis this company loses about $6 million per quarter. However, on a cash flow basis it's more like $3.5 million a quarter, if one gives due consideration to the amortization of stock-based compensation.

In terms of risk, Standard Pacific's finance subsidiary, which was at one time a serious risk, has been more or less dismantled. Therefore, the success or failure of this company is really a function of the housing industry. It's possible that the company could cut its expenses further, but it's an uncertain possibility. The only development that could really help this company is an improvement in the housing industry, but that's unlikely to occur in the next several quarters. As a result, the bond yields almost 9%.

If current conditions persist for several years, the balance sheet is not likely to be severely eroded and one would be earning nearly 9% per year, which is about as well as one will do in the high yield market of today, given the risk this company entails. It doesn't have solvency risk; it merely has the risk of a credit in the absence of meaningful cash flow. However, if in 2018 the housing industry conditions are much as they are today, it's not unlikely the company could refinance its debt. Of course, its debt refinancing is not an

issue at the moment, and this appears to be a reasonable but not outstanding investment in the world of high yield.

NUVEEN INVESTMENTS (NUVINV, CUSIP 67090 FAD8)

(Data as of 12/27/2011)

Another interesting investment in the world of high yield is the Nuveen Investments 10.5% bonds due November 15, 2015. This security was recommended in these pages about one year ago. This bond is priced to have a yield to maturity of 10.65%, so it trades almost at par. It is rated CAA2 by Moody's and CCC by S&P.

Nuveen is a money manager and, even though it manages $207 billion of assets, it really has no tangible assets. Therefore, there is nothing that a bond holder could claim in a liquidation. About 45% of that $207 billion is equity, about 46% is municipal bonds (Nuveen is famous for its municipal bonds), and about 9% is taxable income. This is a publicly traded leveraged buyout and it is about 8x leveraged. It has copious earnings and copious cash flow, and its business is growing.

One of its several problems is that the financial services industry is clearly the wrong one to be in at the moment. The second is that it doesn't have any meaningful balance sheet assets that are attachable, even though it has $237 million of cash on the balance sheet. These notes stand behind a very large amount of bank debt. At the moment there is no problem, but in the world of investment management, problems can develop rapidly. If there were difficulties, this bond could potentially be problematic.

To make matters more interesting, Nuveen is in the process of making yet another acquisition. It is acquiring an asset manager called Gresham Asset Management, which would round out its business. Its business right now consists of Nuveen Asset Management, with $103 billion of assets under management; Tradewinds, which is a global equities manager managing $37 billion; Winslow Capital, which is a growth equity manager managing about $28 billion; Santa Barbara Asset Management, which is a growth equity manager managing $4 billion; Symphony Asset Management, which is a manager in alternatives managing $8 billion; and NWQ, which is a value-based company in equities managing $19 billion.

If Nuveen investments chose to become a publicly traded company and have equity, there's very little doubt that it could have a sensibly arranged balance sheet, with the proviso that it would be issuing equity at a very low valuation in the current environment. The management is properly loathe to do that. As a consequence, it retains its current balance sheet structure and, therefore, the yield is available to all who choose to invest in it. It is recommended for purchase.

VULCAN MATERIALS (VMC)

(Data as of 12/27/2011)

Vulcan Materials has issued 7.5% bonds maturing on June 15, 2021 that are rated Ba2 by Moody's, BB by S&P, and are priced to have a yield to maturity of 6.29%. There are also the Vulcan Materials 7.0% bonds due 6/15/2018 that are priced to have a yield to maturity of 6.23%.

Vulcan Materials is the largest producer in the United States of construction aggregates like crushed stone, gravel, and sand. Since it's related to the construction and housing industry, it's share price is depressed. Unlike some of the housing companies, Vulcan Materials has a pretty good balance sheet. It has $152 million in cash, $2.8 billion in debt, and $3.9 billion in shareholders' equity. However, the equity is the result of many years of acquisitions of competitor companies. The acquisitions gave the company its strong competitive position, but also made its equity intangible. This is not to say that if these bonds were to default, there wouldn't be assets that could be attached, but for book purposes there is no tangible equity.

Nevertheless, this company is consistently profitable. It made $19 million in the last quarter and there is every reason to believe that it can service its debt. There is only $285 million in bank debt; the rest is in notes, of which these are two examples. This is a relatively safe, relatively high yielding security that, in principle, could aspire to be a higher-rated corporate bond if the company could improve its balance sheet in any meaningful way. Perhaps the time will come when it can do so, or perhaps the time will come when the fundamentals, and therefore the cash flows, will improve and the bonds would get a ratings upgrade. If it gets a ratings upgrade, it would not be yielding just over 6%; it would be yielding considerably less. The investment rationale is to wait for an improvement in the cycle such that these securities are upgraded and the bonds trade at a higher price. It is recommended for that reason.

JEFFERIES GROUP (JEF)

(Data as of 12/27/2011)

The Jefferies 3.875% convertible maturing on November 1, 2029 is convertible into 26.2251 shares at $38.13. This bond, with the common shares at $13.67, has a very large conversion premium. The price is volatile, but as of December 27, 2011, it was trading at $76.00.

Jefferies is an investment bank not dissimilar to its larger brethren except that it operates with a much more conservative balance sheet and on a much smaller scale. Recently, Jefferies was downgraded by Egan-Jones Ratings because, according to the rating agency, the company was exposed to $2.7 billion of European sovereign debt. The fact that this sum represented approximately 75% of shareholder equity appeared rather alarming. Jefferies maintained that its positions in European sovereign debt were hedged, and not with credit default swaps.

To quell fears that could seriously affect Jefferies in a funding sense, on November 4, 2011, the company released its gross and net exposures as of that day. As can be seen in the table below, Jefferies had over $2 billion in long positions in Italian government bonds, but it also had $2 billion of short positions in Italian government bonds. The total net position was negative $25 million. The total net position on all of the sovereign debt exposure on that date was negative $9 million. On a net basis the company had no exposure; however, the release of that information did little or nothing to quell the market fears.

Country	Long *($ in millions)*	Short *($ in millions)*	Net *($ in millions)*	Futures *($ in millions)*	Total Net *($ in millions)*
Italy	2,086	(2,011)	75	(100)	(25)
Spain	191	(209)	(18)	-	(18)
Ireland	110	(80)	30	-	30
Portugal	20	(16)	4	-	4
Greece	-	-	-	-	-
Total	**2,407**	**(2,316)**	**91**	**(100)**	**(9)**

Source: Company report

Although Jefferies essentially had no net exposure, it subsequently cut what it had in half, but this action did little or nothing to alter the market's sentiment. During the last several quarters of the crisis, Jefferies has been consistently profitable, and it maintains an 11x leverage ratio. There's no evidence that it is in any way stressed other than the fact that it's obviously going to have to shrink its balance sheet to get more desirable financing terms.

Its largest investor, Leucadia National, actually bought more stock, as did the principals of Leucadia National, who bought stock personally for their own accounts. Jefferies is

moving to fill the vacuum left in various areas by the large investment banks as they have withdrawn from various types of businesses.

This bond is really an equity investment in Jefferies. If the market assessment of the company is correct, this bond will have little or no value. Therefore, the thrust behind this recommendation is that the market assessment of Jefferies does not appear to be correct, because it is based on the issue of exposure to European sovereign debt.

The market, whether rightly or wrongly, has chosen not to accept that the Jefferies sovereign debt holdings are hedged, so the issue is really the credibility of its management and its balance sheet. If one believes that Jefferies is sensibly managed and is hedged against the risks of owning these various securities then, in the fullness of time, Jefferies stock and these bonds should appreciate, and a certain return will build. If Jefferies management proves to be unreliable, then this would be a very unfortunate investment indeed.

Based on my own scrutiny, I'm much more inclined to accept the evidence offered by the Jefferies management than to reject it. However, time will tell whether this investment is successful or not. In any event, it's recommended.

Miscellaneous Remarks

CAPTURE RATE

It's very important to understand that the S&P 500 of today is very different in character and construction than the S&P 500 as it existed in 1957. Although there was an over the counter market in 1957, from an index creation standpoint that market didn't provide reliable pricing data. As a practical consideration, the creators of the index in that era had to rely on the securities that traded on the New York Stock Exchange.

In 1957, there were 1,098 companies that traded on the New York Stock Exchange, so the S&P 500 captured nearly half of the companies of note that were available to be traded. Today, 3,245 companies trade on the New York Stock Exchange and 2,790 companies trade on the NASDAQ, so the S&P 500 represents less than 10% of what is tradable.

As noted in the *Facts and Figures* section, according to Siegel's study, a disproportionately large part of the S&P 500 returns from 1957 to 2003 came from industries that were small in 1957. Specifically, they came from a handful of companies in the tobacco industry, which no one could have predicted. Philip Morris, which was the best performing company in the S&P 500 for that period, was the 215th largest company in the index in 1957, or the 215th out of the universe of over 1,000. It was included only because the index was capturing almost 50% of the companies trading on the NYSE at the time. But had the index been capturing only the 8% or so that it does now, a strong case can be made that Philip Morris might not have been included in the S&P 500 and neither would RJR Nabisco or Lorillard. As a matter of definition, the S&P return would have been lower.

The S&P 500 return cannot be considered an immutable feature of the return characteristics of equities, but rather as a statistical/historical accident. However, there is a secondary problem beyond the capture rate, which is the dilution rate of a company when it is captured. Dilution in equities usually refers to dilution by share issuance, but in the context of indexation it refers to dilution by size. Today, there are companies that have giant market capitalizations, so even when a smaller company is captured, it's likely to have a very small weight. By definition, the larger the mega-capitalizations, the smaller the weights of the other companies that are captured. Therefore, it is reasonable to suppose that the S&P 500 rate of return in the future will be much more a function of the rate of return of the giant mega-capitalization companies than it will be of the characteristics that the S&P 500 had in 1957.

The S&P 500 index is now calculated differently than it was in 1957. Today, the weight of a company in the S&P is a function of its market capitalization, adjusted for its float. In

1957, it was a market capitalization weighted index with no adjustment for float. Accordingly, one of the problems the S&P 500 will have in the future will occur in those instances where the managements are aggressively buying back shares for their own accounts, or for the corporate accounts. The float will correspondingly shrink, resulting in the company having a lower weight than it would otherwise.

For example, when the management owns a great quantity of stock, the market capitalization doesn't change, but the float is reduced. When a company buys back the stock, both the market capitalization and the float are reduced. When the management is buying back stock and is doing so aggressively, an argument might be made that it makes the company worthy of inclusion in a portfolio. In the reverse situation, if the management were to sell all its shares in the marketplace, the float would be equal to the market capitalization and the company would be at full weight.

Clearly, one of the mechanisms present in the S&P is the incentive to do exactly the opposite of what everyone knows is the sensible thing to do. The index will increase a company's weight when management is selling, and it will decrease the weight when management is buying. As a result of these factors, the index, as it exists today, is very different than it was in 1957.

Money Manager Index

From Jan 1983 to November 2011 — **Annualized return**

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly 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	13.32	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	104.250	91.32	102.440	103.790		2011	103.79	(13.2)%	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	130,205
2	ALNC us equity	Alliance	$7,633	491	4/30/1994	14,544
3	BLK us equity	BlackRock	$23,205	1658	9/30/1999	285,159
4	WDR us equity	Waddell & Reed	$27,513	1587	3/31/1998	43,143
5	EV us equity	Eaton Vance	$2,641	3998	1/31/1986	96,081
6	TROW us equity	T. Rowe Price	$2,423	2014	4/30/1986	114,306
7	BEN us equity	Franklin Resources	$908	1263	4/30/1985	127,349
8	LM us equity	Legg Mason	$1,000	462	8/31/1983	12,262
9	FII us equity	Federated Inv	$26,381	2206	5/31/1998	35,540
10	FIG us equity	Fortress Investment Group	$102,249	3389	2/28/2007	11,523
11	PZN us equity	Pzena Investment Management	$122,426	6317	10/31/2007	31,270

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 Nov 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		2011	31.23	(9.5)%	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	3,122
2	FCAM LN Equity	F&C Asset Management Plc	$1,203	485	5/31/1989	526
3	IVZ US Equity	Invesco Plc (Previously Amvescap)	$1,357	1,153	1/31/1991	11,740
4	SDR LN Equity	Schroders Plc	$1,208	505	3/31/1991	10,654
5	RAT LN Equity	Rathbone Brothers Plc	$1,208	736	3/31/1991	12,934
6	ADN LN Equity	Aberdeen Asset Mgmt Plc	$1,208	1,827	3/31/1991	5,763
7	CIX CN Equity	CI Financial Corp.	$2,585	3,224	6/30/1994	65,108
8	EMG LN Equity	Man Group Plc	$2,862	6,344	10/31/1994	11,247
9	AGF/B CN Equity	AGF Management Ltd-Cl B	$3,343	1,346	1/31/1996	20,741
10	8739 JP Equity	Sparx Group Co Ltd	$11,762	108	12/31/2001	6,312
11	HGG LN Equity	Henderson Group Plc	$14,447	8,666	12/31/2003	12,668
13	AZM IM Equity	Azimut Holding Spa	$21,908	4,977	7/31/2004	39,658
15	CCAP LN Equity	Charlemagne Capital Ltd	$36,848	22,300	3/31/2006	3,767
16	PGHN SW Equity	Partners Group-Reg	$36,848	578	3/31/2006	109,982
17	INRE LN Equity	Invista Real Estate Inv Mngt	$36,589	21,540	9/30/2006	3,807
18	ASHM LN Equity	Ashmore Group Plc.	$36,688	9,873	10/31/2006	54,100