The Continued Crisis in Europe

2 Eurozone: Integration or Dissolution
6 An Overview of the European Financial Crisis
8 Interrelation between Sovereign CDS and Bond Prices in Eurozone Countries
The Continued Crisis in Europe

Boston College Financial—a magazine written and managed by our graduate students—seeks to bridge the gap between financial research and practice, provide a platform for students to publish their work, and connect with the industry. Following last year’s issue focusing on the recovery of the U.S. financial industry, we take a more international perspective in the seventh issue of the magazine.

The 2012 edition begins with an overview of the origins of the European Debt Crisis and a thorough analysis of the complexities and challenges in the “Eurozone.” Our graduate student contributors provide insight into how this political and economic crisis is reflected in financial markets and consider possible outcomes. In addition, they explore some timely issues in both the political and technological spheres.

Our aim is to inspire and inform both the larger graduate school population and industry professionals alike. Similar to previous issues of Boston College Financial, this edition demonstrates a spirit of passion for finance that we hope will excite its readership. This magazine not only has an important impact on our students’ careers but also enhances the reputation of the Carroll School’s graduate programs and allows students to display their academic development to the Boston College community.

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Contents

2 EUROZONE: INTEGRATION OR DISSOLUTION
6 AN OVERVIEW OF THE EUROPEAN FINANCIAL CRISIS
8 INTERRELATION BETWEEN SOVEREIGN CDS AND BOND PRICES IN EUROZONE COUNTRIES
13 MAKING THE DECISION TO INVEST IN SPINOFFS
17 A LEGAL EXAMINATION OF SUPER PACS
19 THE FUTURE OF YOUR PHONE
23 MERGERS AND ACQUISITIONS IN LATIN AMERICA: THE EMERGING OPPORTUNITIES
26 BUCKING THE TREND OF THE PAST: THE SAN FRANCISCO 49ERS’ NEW HOME
28 2012 TRADING STRATEGIES
During the past 18 months, the recovery of the global economy has slowed down after an initial rebound driven by the inventory cycle and fiscal stimulus. In capital markets, the debt issues of peripheral euro countries have initiated an unprecedented weakening of confidence in sovereign debts and have deeply affected global equity and foreign exchange markets as well. Concerns about government overspending and sovereign bond credit risk spread not only within Europe but also to the United States, which lost its top-tier credit rating from S&P in August 2011. The European debt crisis has also triggered political unrest and social instability as a result of turnover of heads of government and high unemployment rates.

Who are the victims?

In 2001, Greece became the 12th nation to join the Economic and Monetary Union (EMU) after its first attempt to join in 1999 failed due to high inflation and public sector borrowing. By the end of 2007, Greece’s real GDP growth rate exceeded the eurozone area average by more than 2% a year. However, in late 2009, the Greek government admitted that its deficit would be 12.7% of its gross domestic product, not the 3.7% the previous government had forecast. In spite of the higher government spending in the past years, Greece was unable to rebound as quickly from the 2008-2009 global economic downturn as other EMU member countries did. Its real GDP growth rate fell to -3.3% in 2010, lowest among all 17 eurozone countries, whose growth rate averaged 1.9% for the same year.

Compared to Greece, Italy appeared to be a much bigger problem for the EMU. Its public deficit soared to 118% of its GDP in 2010 (Figure 1), and debt outstanding accounted for nearly a quarter of the total eurozone nations’ debts (Figure 2). Unlike Greece, however, Italy’s deficit was only 4.6% of GDP in 2010, close to that of Germany. At the same time, its economic growth rate has been lower than the EMU average for over a decade owing to low investment in education and R&D. Italian government bond yields rose sharply to more than 7% in November 2011, almost triple the yields on German government bonds. With €300 billion in debt principal coming due in 2012, Italy cannot sustain the entire amount at refinance rates in excess of 7%. Other eurozone countries that have suffered from high bond yields...
include Spain, Portugal, Ireland, and Belgium. The most affected five countries (Portugal, Ireland, Italy, Greece, and Spain) are known as “PIIGS” from their country initials.

Even Europe’s second largest economy, France, has been busy defending its government bonds’ creditworthiness. A risk of being downgraded from AAA could happen sooner or later if it is not able to narrow the gap with Germany in terms of public debt, budgetary deficit, and trade deficit. France can barely fend for itself. S&P has already downgraded French bonds to AA+ in January 2012 while Moody’s and Fitch still keep France on their Aaa/AAA watch list.

While Greece’s problems have spilled over into high perceived default risks of other countries, Germany has had a robust performance in its domestic economy with record employment and an estimated growth rate of 3.6% for 2011. Moreover, Germany’s six-month bills were dramatically auctioned at a negative yield (-0.0122%), making it a “safe haven” amid the eurozone debt crisis.

Although arguments have appeared domestically that Germany’s taxpayers should not undertake the burden of financing or guaranteeing the debt of weaker countries, German leaders finally chose to keep Greece in the eurozone and to alleviate financial system instability. The rationale was that if the market saw the EMU’s inability to keep Greece and solve its problem, it would end up losing other PIIGS nations in succession and the eurozone would collapse without doubt.

According to the Bank for International Settlement (BIS), French and German lenders were the biggest foreign owners of Greek government bonds with €55.7 and 21.3 billion, respectively, of Greece’s total €340 billion in debt (Figure 3). Greek domestic banks, European Central Bank (ECB)
and EMU/IMF loans accounted for around €50 billion.\textsuperscript{16} The restructuring plan drawn up by the EMU in October 2011 required Greek bond holders to accept not just a delay in repayment but a 50% write-down in their investment.\textsuperscript{11}

The situation has prompted many big lenders in Europe and the U.S. to rapidly sell down their holdings, which they accumulated in an era when the high-yielding bonds were viewed as virtually risk free.\textsuperscript{19} However, for Italy and Portugal, about one-fifth of their government bonds are held by domestic banks. The deep financial links between European governments and domestic banks have played a part in fueling the debt crisis. In spite of the arrangement of interest rate cuts, or “haircuts,” on Greek bonds, these banks were under pressure by local government to hold the bonds or even buy more.

**CAUSES OF THE SOVEREIGN DEBT CRISIS**

It is generally believed that the EMU’s debt crisis has resulted from forging a monetary union without a fiscal union.\textsuperscript{9} The monetary union protects member states from high inflation, lowers transaction cost of trade and investment, and maintains financial system stability. The EMU member states are asked to respect the Stability and Growth Pact (SGP), which mandated deficit ceilings of 3% of GDP and national debt less than 60% of GDP for member countries when it was adopted in 1997. However, France and Germany both broke the rule in 2003, but no penalties were imposed on them in view of the severity of their economic problems.\textsuperscript{14} Later in 2005, the Pact was amended to allow more “exceptional and temporary” considerations, resulting in even more lax enforcement.\textsuperscript{15} Apparently, thanks to these exceptions and a lot of disputes about the Pact’s one-size-fits-all rule, the influence of the SGP has been undermined.

On the other hand, such economic fundamentals as productivity and competitiveness differ widely among member states. Germany’s labor cost growth has been 20-30% lower than other eurozone countries since 2000, while Greece and Spain have the highest inflation rates.\textsuperscript{16} Normally, a weak economy fights back a recession by employing a mix of three tools: monetary policy, fiscal policy, and foreign exchange policy. Membership in the eurozone has simply closed the door for two of these escape hatches, leaving only fiscal policy.\textsuperscript{17} Fiscal policy, through either tax cutting or increasing government spending, can pile up public debt.

When the euro area economy was booming, it seemed that Greece leveraged its budgetary deficit to facilitate economic growth, so the Greek economy outperformed the eurozone average by more than 2%. In fact, by 2008, eurozone nations, including Greece, were able to take advantage of low borrowing costs to support their deficits with very little yield spread relative to German or French bonds. However, the global financial crisis has turned out to be more than Greece can bear. The government has had to provide extra support to its banks to keep them from bankruptcy; meanwhile, Greece suffered a severe decline in tourism revenue, seen as a main pillar of its economy. In 2010, when the Greek government deficit skyrocketed to 15.5% of its GDP,\textsuperscript{18} it was found to have inappropriately reported its financial statistics\textsuperscript{19} in order to live up to the monetary union guidelines.

Conversely, Italy had a moderate fiscal deficit for years, but the contagion from Greece ultimately spread to the world’s third largest bond issuer in 2011. First, Greece’s public deficit and sovereign debt default risk has risen since early 2010. The EMU’s bailout program was not decisive enough, and member states spent too much time in passing it. This gradually led to market turmoil and a negative outlook on the eurozone area as a whole. Second, the EMU’s inability to keep the Greece problem under control in time finally evolved into the 50% haircut on the private sector, which further eroded trust on eurozone bonds. Third, an expectation of a potential “bailout” plan, enabling Italy to sustain its debt, was expected to be imposed by the EMU. If Italy accepted it, austerity and recession would have to be under way for years.

**CURRENT SOLUTIONS**

Restructuring Greece’s government bonds is what the EMU has been trying to resolve since 2010. The Greek government would have already gone bankrupt if not for the €110 billion bailout package from other EMU nations and the IMF.\textsuperscript{20} About $52 billion of that has been used to repay bonds that came due between May 2010 and September 2011, according to a review of the bailout program done for European leaders to address financial problems in the 17 nations of the euro area (EA17).\textsuperscript{21} However, restructuring the debt alone cannot rescue Greece from bankruptcy. The bailout program would barely substitute public debt supported by taxpayers from other European nations for private investment of banks and pension funds if total debt amounts were not reduced. In this sense, the negotiation is centered on to what extent private sector investors should be protected. If the EMU pushed too hard on the investors, it would undermine trust in the European bonds and could even end up evolving into a European banking crisis due to liquidity or undercapitalized risks; conversely, if the EMU took full responsibility for Greek debt coming due, moral hazard could lead other countries to follow risky strategies, and the EMU’s unity and financial strength would be further threatened. For Greece, the best part of the restructuring is that debt coming due could be rolled over under an agreement and at a negotiable rate superior to what the market would offer.

On the other hand, the key condition for full installments of bailout money is for PIIGS to implement austerity measures on their public spending. Despite such measures, Greece seems to be unable to reach the targeted deficit level set by the EMU and the IMF
for 2012. Greece’s GDP fell by 6.9% in 2011 and is expected to contract by a further 2.5% in 2012, and interest payments for refinancing its debts will make the government budget deficit even worse. Moreover, Greece will remain stuck in an inflationary depression as it is forced to import inflation from the ECB’s monetary policy while at the same time its economy stagnates in nominal terms and deflates in real terms. Even if the bailout plan worked, assuming Greece tightens its belt and finally reaches the goal by reducing its debt to 120% of its GDP by 2020, its debt ratio would still be too high to avoid new default risk. It wouldn’t be surprising to see Greece with an even weaker and more debt-burdened economy a decade from now.

Another effort the EMU is making now is to pump up liquidity into the market, especially European banks, to shore up bond market confidence. The ECB is using a mix of monetary policies to increase currency supply. It lowered the key interest rate twice from 1.5% to 1.0% by the end of 2011. In December, ECB President Mario Draghi further agreed to offer an unlimited supply of cash to European banks for the next three years to replace the medium-term funding that private investors are unwilling to extend, and also loosen collateral rules for refinancing operations. The new cheap lending provided by the ECB can have an impact on the banks in two ways: one is to offer liquidity to those banks that are short of funds in order to mitigate some of the pressure to dump risky government bonds on the markets; the second is to induce the banks to buy up European sovereign debts and profit from the yield differentials. European banks can turn in those bonds to the ECB as collateral for low-interest loans. However, it seems that this measure is unlikely to avert a nasty credit crunch because banks are inclined to shed assets rather than make new loans as they strive to comply with a higher 9% core capital reserve after writing down their holdings of sovereign debt. Although the ECB should not be regarded as the lender of last resort under the EMU’s current framework, maybe it should step in more aggressively to address the crisis through quantitative easing (QE). Essentially, it could print more money to purchase bonds from Italy and other eurozone governments to stabilize the market.

In contrast to Greece, which received bailout money directly from other European nations and the IMF, Ireland and Portugal received their bailout money from the European Financial Stability Facility (EFSF), which was mainly guaranteed by Germany, France, the Netherlands, Luxembourg, Austria and Finland, the AAA-rated club of the EA17. The EFSF has plans to boost the current €440 billion rescue fund initially to €780 billion, and ultimately to €1 trillion to help contain the region’s sovereign debt crisis. However, even though the EFSF still qualifies for an AAA rating (S&P downgraded EFSF to AA+ on Jan. 16, 2012), it is not easy for it to find buyers of its bonds at this time, especially after France and Austria have recently been stripped of their AAA ratings by S&P. Disappointment in the euro bond market has caused international investors to switch to the U.S. Treasury market and other healthy markets. During 2011, the EUR/USD exchange rate depreciated by 3.3%, and is expected to fall further in 2012. Despite the strong dollar’s unfavorable impact on the U.S. economy, the Federal Reserve claimed to have no plans to give money to the IMF to bolster the European bailout fund. Britain also refused to give an extra contribution to the IMF to save the euro. It seems that the EMU has to go further with a feasible plan before it can restore the confidence of the international community and raise money from outside. For now, it has to fix the liquidity problem on its own and can only work out plans with the IMF for limited bailout funds.

DEEP REFORMATION
To keep the eurozone intact, it is urgent for the EMU to reach a consensus on a comprehensive fiscal integration, including budget surveillance. The EMU should make radical changes to accelerate the decision-making process. As European Parliament President Jerzy Buzek put it, the key problem is that the leaders of various countries are not promoting the interest of Europe as a whole, because as national players they lack the mandate to do so. Therefore, the EMU leaders should propel the shift of power from national governments to the core of the EMU, including fiscal power. In the December 2011 meeting, the EMU put the following three measures on their agenda: 1) monitoring and assessment of member states’ budgetary plans by the EMU, 2) budgetary surveillance of member states experiencing or threatened with serious difficulties and 3) economic strengthening of member states to meet the common economic goals of the EMU.

Even though the EMU leaders have decided to keep Greece as a eurozone member and the German foreign minister also stated publicly that Greece and Europe belong together, the final vote for further integration as a fiscal union will have to be passed on national levels. For the past two decades, politicians have been hoping the single currency would bind the whole of Europe, but they may have overlooked the fact that what holds an economic union together “has less to do with fiscal and monetary institutions and more with the desire of its people for closer political cohesion.” If Europe can build up enough cohesion in dealing with the crisis, it would be a huge step ahead toward the EMU’s integration. The future of the EMU could be in the hands of EMU citizens.
AN OVERVIEW OF THE
EUROPEAN FINANCIAL CRISIS

By Fernando Alvarado Blohm

Recently, the financial crisis in the European Union (EU) has been prominently featured in the news. But what exactly is meant by a financial crisis? Financial analyst Cory Janssen, creator of the Investopedia website, defines financial crisis as a situation triggered by panic in which investors sell off assets, or withdraw their savings from financial institutions, because they fear that the value of their assets will drop abruptly. Since assets’ prices are determined by the market and thus by supply and demand, when many investors sell their assets they are abruptly increasing supply. If there is no corresponding demand to meet the increased supply, the market value of those assets must fall; thus, the fear of a financial crisis can actually cause the crisis itself.

How do investors determine what they are willing to pay for an asset? There are a number of valuation techniques, but they are all based on investors’ intuition and expectations for the future. For example, investors using the discounted cash flow (DCF) valuation method make forecasts of the future cash flows they expect to receive from a security or other asset and then discount these cash flows back to the present, using a discount rate that reflects the perceived uncertainty surrounding the cash flows. Alternatively, investors may price one asset by observing how comparable assets are priced in the market (the market approach). However, the prices of those comparable assets must in turn ultimately be based on future expectations and perceptions of risk. Thus, while any tradable asset can be sold in the market for an objective quantity of cash, the amount of cash received at any given time depends on highly subjective expectations. Furthermore, anything that causes investors to be more pessimistic or less certain about the future can cause a sudden drop in any asset’s price. This pricing principle helps us understand the notion that widespread investor fear of a financial crisis can help bring on that crisis. With this key concept in mind, let’s start examining the background that preceded the current financial crisis in the EU.

In the years before 2006, financial institutions were characterized by rapid credit growth, low-risk premiums, abundant liquidity, increased leverage, and soaring asset prices, especially in real estate. The problem with a rapid credit growth,
also referred to as a credit boom, is that investors may consider making large investments in a certain market, typically using loans from banks. At the same time, the practice of “securitization” grew substantially during this period. Instead of keeping the original loans on their books, many banks and other financial institutions began pooling mortgages and other loans and using them as collateral for securities, which could then be sold in the bond markets. Financial institutions could then use the proceeds from these bond sales to fund more loans.

As the credit boom and economic activity grew, the stock market and other markets rose in value, creating an illusion of low risk and financial health. As we have seen, however, such illusions can be shattered abruptly if anything happens to weaken investors’ confidence. Banks and other financial institutions fund a good deal of their lending through short-term instruments, such as deposits and repurchase agreements, and if there is a sudden increase in demand for liquidity from investors, banks are forced to ask other banks (or the government) for loans to sell their securities or to take other drastic measures to meet that liquidity demand. The entire process results in a sudden drop in security prices—a financial crisis. This is the principle behind what happened with Lehman Brothers and the collapse of the real estate bubble in the United States in 2008.

Lehman Brothers, affected by the quickly spreading fear about the real estate bubble bursting, had massive losses on mortgage-related securities that it had kept in its own portfolio during 2007 and 2008. Lehman Brothers was one of the biggest, most respected, and highly trusted financial entities in the world, and when it was forced to file for bankruptcy in September 2008, this had direct and catastrophic consequences for investor confidence and for financial markets worldwide. For example, the official European Commission’s publication on the economic crisis states: “The proximate cause of the financial crisis [in the EU] is the bursting of the property bubble in the United States and the ensuing contamination of balance sheets of financial institutions around the world.” To alleviate the turmoil caused by the sudden drop in market valuations, many European investors ran to sovereign bonds, switching their trust from the corporate sector to governments.

To preserve their own liquidity, banks around the globe reacted to the financial crisis by limiting credit and raising interest rates on loans, including loans to other banks, even though this credit limitation reduced the banks’ own sources of income. Credit limitation also affected general business, because as trade credit became scarce and expensive, credit-dependent customers began to limit their spending and business inventories began piling up.

European governments reacted by injecting capital into banks. They bought toxic assets—mainly loans and bonds with high default risk—from financial institutions in exchange for more stable assets like cash or sovereign bonds. This alleviated the situation and cushioned the fall relative to what it could have been. However, the biggest challenge that the European governments currently face is how to stop the cycle and stop issuing sovereign debt to further relieve financial institutions of their risky loans.

Some people say that the current crisis can be summarized as a crisis of trust. Let’s contrast it with two earlier events that had the potential to develop into crises of trust but did not.

Prior to the start of the 21st century, the economic outlook was promising. Multiple companies in the Internet, real estate, banking, and service industries were being funded and valuations and economic growth appeared robust. Nonetheless, right at the beginning of the century, we feared a massive electronic holocaust as a consequence of the famous Y2K bug, and a year afterwards fear struck once again with the terrible events of 9/11. While both these events had the potential to spread financial panic across the world, however, they had only a transient effect on the U.S. economy. How did this happen?

In the years immediately prior to 2000, U.S. companies spent about $30 billion per year to prevent electronic system failures; and, even though there was a latent fear of service disruptions, U.S. firms, along with major trading partners from Canada, Mexico, Europe, and Japan, firmly believed that their strategies for avoiding technical problems would work. Thanks to these preventive actions and to the confidence that disastrous technical failures were highly unlikely, the fear of a major electronic collapse proved to be inconsequential and activities remained normal through the entire period.

In 2001, the U.S. stock market dropped sharply in the wake of the attacks of 9/11, inflicting a deep wound on the financial system. However, the Federal Reserve acted promptly to inject added liquidity into the system, preventing the spread of the financial panic, and foreign central banks shored up the dollar in world markets. These preventive measures cushioned international trade from the threat of a financial crisis.

These two events suggest that effective policy responses and maintenance of trust are key elements in the prevention of financial crises. Currently, Europe is suffering from a crisis of trust. Beginning with the collapse of the real estate bubble in the U.S., European financial institutions have struggled to maintain trust among investors. Historically, financial institutions have resorted to governments in moments of distress to help secure liquidity and thus maintain investor trust. This is exactly the position of Europe right now. Questions remain about for how long, to what extent, and how effectively European governments can continue to support financial institutions. The answers to those questions are yet to come.
Abstract: This paper attempts to study the relationship between sovereign credit default swap (CDS) spreads and sovereign bond yields against the backdrop of the European debt crisis. I have investigated the pricing of credit risk in two different markets—CDS and bond—and studied the impact of the crisis on their relationship. I have analyzed the daily last-price CDS and bond-yield data for nine eurozone countries. My analysis confirms the existence of a long-term stochastic trend between prices in the two markets—i.e., both markets move together. For most of the countries, there is cointegration between these two prices at a 95 percent confidence.
90 percent. The probability of default as greater than last month, Thomas Reuters estimated spread was hovering around 2000 bps payment. In fact, when Greece's CDS happening that would trigger CDS an increased chance of a credit event tries is becoming more expensive. In relation from the default of those coun-
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tries is becoming more expensive. In other words, investors are pricing in an increased chance of a credit event happening that would trigger CDS payment. In fact, when Greece's CDS spread was hovering around 2000 bps last month, Thomas Reuters estimated the probability of default as greater than 90 percent.6

At the same time, the global sov-
ereign debt crisis does not seem to be abating. Even the United States is struggling to contain its debt. Several finance professionals are already calling it “the end of risk-free security.” Indeed, present stratospheric CDS prices do manage to reflect tumultuous times in global sovereign debt markets. This is understandable, since a CDS spread represents the cost of protection against the default of an underlying debt instrument. Thus, although many factors independently affect CDS prices, in efficient markets they should move in tandem with the yields on the underlying bonds. In other words, in a perfectly efficient and frictionless market, derivative securities and cash securities should not provide any arbitrage opportunities. However, there are many reasons why deviations occur. CDS contracts are not traded on exchanges like most options are, and thus they lack transparency. Moreover, they have been loosely regulated, if not totally unregulated, rendering them susceptible to in-
sider trading and manipulation by a few players. Thus, from a supervisory point of view as well as an academic perspective, it is important to study CDS prices and their interaction with, as well as their impact on, bond prices.

CDS: A credit default swap is a type of derivative instrument. It is simply a contract that provides protection against a default by a particular company or sovereign entity. The company is known as the “reference entity” and a default by the company is known as a “credit event.” The buyer of the CDS obtains the right to sell bonds issued by the company at their face value, and the seller of the CDS agrees to buy the bonds at their face value if a credit event occurs. The total face value of the bond that can be sold is known as the credit default swap’s “notional principle.”

The buyer of the CDS makes periodic payments to the seller until the end of the life of the CDS or until a credit event occurs. The rate of payments made per year by the buyer is known as the CDS spread. The periodic payments—such as quarterly, half yearly, or yearly—are made in advance.

Consider, for instance, that Greece's sovereign CDS spread was trading at 2185.53 basis points on June 24, 2011, one of the highest spreads in recent times, for a five-year contract on Greece’s five-year sovereign bond. This means that the buyer pays $21.85 million per year and obtains the right to sell $100 million face value of Greek government bonds for $100 million in the event of default.3

Earlier Research: My work builds on earlier work done in this area. Haibin Zhu (2004) studied the data of 24 corporate entities in the United States and Europe. He analyzed the daily price data from the sample period January 1, 1999, to December 31, 2002. He confirmed the theoretical prediction that the two prices should, on average, be equal; however, in the short run there are quite significant pricing discrepancies between the two markets. His work further suggests that the derivatives market tends to move ahead of the bond market, and that the liquidity factor matters for the adjustment dynamics for U.S. entities.4

John Hull, Mirela Predescu, and Alan White (2004) worked with a much more comprehensive data set, covering the period from January 5, 1998, to May 24, 2002, and containing 233,620 individual CDS quotes. They also confirmed that the theoretical relationship between credit default swap spreads and bond yield spreads holds up fairly well.5

Alessandro Fontana1 and Martin Scheicher (2010) have done a study similar to mine. Their data included weekly prices for a sample period—January 2006 to June 2010. The weekly frequency of their data set, in my opinion, may not be suitable to capture the short-term dynamic interactions. Hence, I choose daily prices instead for my research. They supported the conclusion of Zhu: the no-arbitrage relation between CDS and bonds can break in the short term. However, they are unable to provide a conclusive direction of feedback as, for half of the countries, price discovery happens in the CDS market, whereas for the other half it takes place in the cash market. My paper, based on the VECM (Vector Error Correction Model) analysis, shows that bond markets move ahead of CDS markets.

The Data Set: Both sovereign CDS spreads and sovereign bond yields have been collected by Bloomberg for Greece, Portugal, Spain, Austria, Belgium, Finland, Italy, France, and Germany. The sample covers data from July 2007 to June 2011. The interval chosen is daily. A daily interval is particularly important because it provides a more accurate analysis of short-term dynamics between the two markets. Longer intervals would not be able to capture short-term deviations from the co-integration of derivative and cash markets. The most liquid CDS maturities are five-year contracts. Hence, all CDS
prices represent the last traded daily spreads of five-year maturities. Correspondingly, last-traded daily yields of five-year sovereign bonds have been chosen as the other variable.

**Analysis:** I have employed the following econometric tests for my analysis: the Augmented Dickey-Fuller Test to check the non-stationarity of the data; the Engle-Granger Cointegration Test to check if there exists a stochastic trend between the two variables; and the Granger Causality and Vector Error Correction Mechanism to find out which variable can antecedently predict changes in the other.

**Test of Stationarity:** The first basic step of any econometric analysis is to check the data for a unit root. A unit root test tests whether a time series variable is non-stationary using an autoregressive model. I use a popular test called Augmented Dickey-Fuller (ADF), which is appropriate for a large data sample such as mine.

The ADF tests the null hypothesis of the existence of a unit root, Ho: $\gamma = 0$, against the alternative hypothesis of $\gamma < 0$, in the following equation no. 1. The intuition of the test is that if $\gamma = 0$, then the change in preceding periods has no effect on the change in the present period, and the series follows a random walk.

**Equation (1)**

$$\Delta y_t = \alpha + \beta t + \gamma y_{t-1} + \delta_1 \Delta y_{t-1} + \cdots + \delta_{p-1} \Delta y_{t-p+1} + \varepsilon_t$$

Table 1 shows that for every country, the test statistic is greater than the critical value, and hence the test fails to reject the null. Thus, the results confirm the presence of a unit root and in turn non-stationarity for all countries, as predicted by the theory. It is imperative to transform the data to stationary data because, when a data set shows non-stationarity, the use of ordinary least squares (OLS) regression can generate spurious results: high $R^2$ values and high $t$-ratios with no economic meaning. The next step is to check for the order of integration, denoted as $I(p)$. I determined that the order of integration is $I(1)$, which implies that taking a first difference yields a stationary process (Table 2).

**Long-term Equilibrium between the Two Prices:** To show a long-run equilibrium between the two prices, I needed to prove that the two prices move together, even though each follows a random walk. This special econometric relationship is called cointegration. I used the Engle-Granger Cointegration Test to see if there exists a cointegration, and in turn a long-run consistency, between the two prices. First, in order to test whether the series are cointegrated, I used OLS to estimate the regression:

**Equation (2)**

$$BY_t = \alpha + \beta \ CDSS_t + Z_t$$

In Equation (2), $BY =$ Bond Yields, $CDSS =$ CDS Spread, and $Z$ is the regression error term. I then tested the order of integration of the estimated residuals, defined by:

**Equation (3)**

$$\hat{Z}_t = \hat{\alpha} - \hat{\beta} \hat{CDSS}_t$$

In Equation (3), $\hat{\alpha}$ denotes regression estimates. I determined that the order of integration is $I(1)$. To do this, I performed a Dickey-Fuller test on the residual sequence to determine whether it has a unit root, using the autoregression of the residuals:

**Equation (4)**

$$\Delta \hat{Z}_{t-1} = \rho \hat{Z}_{t-1} + \varepsilon_t$$

No intercept term is included in Equation (4), since the residuals are from a regression equation with a constant term and thus have zero mean. If we can reject the null hypothesis that $\rho = 0$ against the alternative $\rho < 0$ at a given significance level, we can conclude that the residual sequence produces a stationary process and therefore that $CDSS$ and $BY$ are cointegrated. Here, it is important to be mindful that for carrying out this test it is not possible to use the Dickey-Fuller tables themselves since $\hat{Z}$ is a generated series of residuals from fitting a regression. MacKinnon (1991) provides values appropriate for such tests. As shown in Table 3, cointegration between bond and CDS prices is present for all countries at a 90 percent confidence interval. This confirms that the two markets price the credit risk fairly equally in the long run. The results are quite in line with expectations. Since these are the prices that measure the same underlying risk, one would expect the arbitragers to take away price discrepancies eventually.

**SHORT TERM LINKAGES:**

**Granger Causality Test:** Cointegration proves that there are no arbitrage opportunities in the long term. However, does this relationship hold steady even in the short term? Which market is a leader in price discovery? To investigate these questions, I used the Granger Causality Test and the VECM technique.

A general equation of Granger Causality is given by:

**Equation (5)**

$$x_t = \alpha + \sum_{i=1}^{p} \gamma_i x_{t-i} + \sum_{j=1}^{p} \beta_j y_{t-j} + \mu_t$$

When I check effect of CDS spreads (CDSS) on bond yields (BY), $x = BY, \ y = CDSS$, and $H_0: \ \beta = 0$ i.e. CDSS does not
Granger Cause BY. Similarly, when I check if BY moves ahead of CDSS, \( x = \text{CDSS}, \ y = \text{BYS} \), and \( H_0 : \beta = 0 \) i.e. BY does not Granger Cause CDSS.

The results show that there is a two-way information flow from either side (Table 4). The test fails to provide a definitive answer, however, as to which market is more efficient in price discovery.

**Vector Error Correction Model:** The vector autoregressive model (VAR) is generally used to describe the dynamic relationship among stationary variables. When the time series are not stationary, as in our study, then the VAR framework needs to be modified to allow consistent estimation of the relationships among the series. Thus, the vector error correction model (VECM) is just a special case of the VAR for variables that are stationary in their differences. The VECM framework I use here can be represented with two equations:

\[
\Delta BY_t = \alpha_1 + \sum_{t=1}^{p} \beta_1 t \Delta BY_{t-1} + \sum_{t=1}^{p} \gamma_1 t \Delta CDSS_{t-1} + \lambda_1 Z_{1(t-1)} + \varepsilon_1
\]

Equation (6)

\[
\Delta CDSS_t = \alpha_2 + \sum_{t=1}^{p} \beta_2 t \Delta BY_{t-1} + \sum_{t=1}^{p} \gamma_2 t \Delta CDSS_{t-1} + \lambda_2 Z_{2(t-1)} + \varepsilon_2
\]

Equation (7)

In (6) and (7), \( Z_{1(t-1)} \) and \( Z_{2(t-1)} \) are residual values from regressing BY over CDSS and vice versa, respectively, in period \((t-1)\). Here notably the magnitude of \( \lambda_1 \) and \( \lambda_2 \) are critical determinants of how fast two markets react to the news. For instance, if \( \text{Abs}(\lambda_1) > \text{Abs}(\lambda_2) \), that means the CDS market leads over the bond market. In other words, if the ratio \( \text{Abs}(\lambda_1) / \text{Abs}(\lambda_2) \) is larger than 1, then the CDS market moves faster to correct the disequilibrium. Table 4 displays the \( \lambda \) values. The bond market beats the CDS market in six out of nine countries chosen for the study. Surprisingly, three countries where the CDS market trumps the bond market—Portugal, Spain, and Greece—are facing the worst sovereign debt crisis. For Finland, both markets are almost equally efficient.

**Conclusion:** This paper has investigated the impact of sovereign CDS and bond prices for nine eurozone nations during the latest debt crisis. The econometric analysis proves that the CDS spreads share comovements with the bond yields. That is, the two spreads, though meandering individually, track each other quite closely—understandably, due to the underlying common factor. This phenomenon, described as cointegration by econometricians, shows that there are no arbitrage opportunities in the long run between the two prices. However, VECM analysis shows that there could be temporary deviations from this equilibrium relationship. Also, the two markets do not react equally efficiently to the changes in credit risk. The cash market trumps the derivatives markets as a leading market for price discovery in six out of nine countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>CDSS</th>
<th>BY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lags (SIC-Schwarz’ Bayesian Information Criterion)</td>
<td>Critical Val</td>
</tr>
<tr>
<td>Greece</td>
<td>7</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Portugal</td>
<td>4</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Spain</td>
<td>4</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Italy</td>
<td>3</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Germany</td>
<td>1</td>
<td>-1.9411</td>
</tr>
<tr>
<td>France</td>
<td>1</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Finland</td>
<td>1</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Belgium</td>
<td>4</td>
<td>-1.9411</td>
</tr>
<tr>
<td>Austria</td>
<td>1</td>
<td>-1.9411</td>
</tr>
</tbody>
</table>

Table 1. Estimated values of Augmented Dickey-Fuller Test. A T-Stat greater than Critical Value fails to reject the null and hence indicates the presence of non-stationarity.
<table>
<thead>
<tr>
<th>Country</th>
<th>Lags (SIC)</th>
<th>Critical Val</th>
<th>T-Stat</th>
<th>Result</th>
<th>Lags (SIC)</th>
<th>Critical Val</th>
<th>T-Stat</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>6</td>
<td>-1.941128</td>
<td>-9.69749</td>
<td>1 (1)</td>
<td>3</td>
<td>-3.414148</td>
<td>-19.15911</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Portugal</td>
<td>3</td>
<td>-3.414148</td>
<td>-20.29908</td>
<td>1 (1)</td>
<td>1</td>
<td>-3.414136</td>
<td>-26.41847</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Spain</td>
<td>3</td>
<td>-3.414148</td>
<td>-20.8329</td>
<td>1 (1)</td>
<td>1</td>
<td>-3.41414</td>
<td>-22.86851</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Italy</td>
<td>2</td>
<td>-1.941128</td>
<td>-20.17961</td>
<td>1 (1)</td>
<td>1</td>
<td>-3.436413</td>
<td>-28.17382</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Germany</td>
<td>1</td>
<td>-1.941128</td>
<td>-31.71525</td>
<td>1 (1)</td>
<td>1</td>
<td>-2.864106</td>
<td>-30.55612</td>
<td>1 (1)</td>
</tr>
<tr>
<td>France</td>
<td>1</td>
<td>-3.414136</td>
<td>-31.18489</td>
<td>1 (1)</td>
<td>1</td>
<td>-3.414136</td>
<td>-31.63431</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Finland</td>
<td>1</td>
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<td>-28.23385</td>
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<td>1</td>
<td>-3.414136</td>
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<td>0</td>
<td>-1.941129</td>
<td>-29.61944</td>
<td>1 (1)</td>
</tr>
<tr>
<td>Austria</td>
<td>0</td>
<td>-1.941128</td>
<td>-34.57345</td>
<td>1 (1)</td>
<td>3</td>
<td>-1.941129</td>
<td>-30.25309</td>
<td>1 (1)</td>
</tr>
</tbody>
</table>

Table 2. Estimated values of Augmented Dickey-Fuller Test after first difference. A T-Stat less than Critical Value rejects the null and hence indicates the presence of non-stationarity.

<table>
<thead>
<tr>
<th>Country</th>
<th>McKin Prob. Of Unit Root Residual Series</th>
<th>Result (90% CI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>0.0011</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Greece</td>
<td>0.0123</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Germany</td>
<td>0.014</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Italy</td>
<td>0.028</td>
<td>Cointegration</td>
</tr>
<tr>
<td>France</td>
<td>0.0305</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Spain</td>
<td>0.0492</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Austria</td>
<td>0.0513</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.0691</td>
<td>Cointegration</td>
</tr>
<tr>
<td>Finland</td>
<td>0.081</td>
<td>Cointegration</td>
</tr>
</tbody>
</table>

Table 3. Estimated values of MacKinnon Probability of Unit Root in Residual Series. Less than 10% probability of unit root shows that the residual series is stationary and bond and CDS prices are cointegrated.

<table>
<thead>
<tr>
<th>Country</th>
<th>$\lambda_1$</th>
<th>$\lambda_2$</th>
<th>Abs($\lambda_1$)/Abs($\lambda_2$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>-0.0002</td>
<td>-0.000624</td>
<td>3.8141026</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.0055</td>
<td>-0.00251</td>
<td>2.2011952</td>
</tr>
<tr>
<td>Greece</td>
<td>-0.0101</td>
<td>-0.0084</td>
<td>1.2014046</td>
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<tr>
<td>Finland</td>
<td>-0.0046</td>
<td>-0.00446</td>
<td>1.0313901</td>
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<tr>
<td>Italy</td>
<td>-0.0060</td>
<td>-0.01041</td>
<td>0.5793315</td>
</tr>
<tr>
<td>Austria</td>
<td>-0.0042</td>
<td>-0.00965</td>
<td>0.4316793</td>
</tr>
<tr>
<td>France</td>
<td>-0.0029</td>
<td>-0.0089</td>
<td>0.3259942</td>
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<tr>
<td>Belgium</td>
<td>-0.0025</td>
<td>-0.00763</td>
<td>0.3235410</td>
</tr>
<tr>
<td>Germany</td>
<td>-0.0039</td>
<td>-0.01345</td>
<td>0.2871265</td>
</tr>
</tbody>
</table>

Table 4. Estimated values of $\lambda_1$ and $\lambda_2$ from the Vector Error Correction Model, Equations (6) and (7), and results of the test for which market reacts more quickly to new information.
MAKING THE DECISION TO INVEST IN SPINOFFS

By Micah Plevyak

INTRODUCTION

In the fall of 1993, a study conducted at Penn State appeared in the *Journal of Financial Economics* and sparked a sudden and significant interest in spinoffs as an investment strategy. The study concluded that investing in spinoffs presented the opportunity for consistent and significant excess returns. However, mixed findings from subsequent research studies, combined with criticism of the statistical methods used to calculate long-term spinoff returns, placed doubt on the efficacy of the strategy and the possibility for outsized returns. As such, inquisitive investors considering investing in spinoffs will likely encounter inconclusive and conflicting research on the topic that casts doubt on the viability of the strategy.

The goals of this article are to evaluate the existing research from the perspective of an individual investor, to offer an opinion on the merits of pursuing a spinoff investment strategy, and to recommend a method for evaluating investment candidates. Toward these aims, the article will begin by discussing corporate motives for divesting through spinoff transactions and the rationale for long-term investment in spinoffs as presented by three renowned professional investors. Further, it will review research on the performance of long-term investment in spinoff transactions, including a discussion of historical returns, statistical significance, and common factors influencing the results. Finally, it will conclude in support of spinoff investing and include a recommended set of criteria for selecting spinoff candidates.

DEFINITION

When a firm executes a spinoff, it divests a subsidiary—which may hold a division or other assets of the company—and distributes shares in the subsidiary to its current investors. After the transaction, shareholders possess separate ownership stakes in the stand-alone operations of both the surviving “parent” firm and the newly independent “subsidiary” or “spinoff” firm. The newly spun-off firm operates as an independent entity, often retaining existing management.
CORPORATE MOTIVES FOR SPINOFF

Corporations pursue spinoffs in order to create value for shareholders by increasing the value of either the parent, the spun-off subsidiary, or both, so that the sum of the parts is more valuable than the current whole.1

For example, a corporation might spin off a business that no longer fits into the firm’s strategic plans and is diverting managerial focus from the company’s core assets and operations. Similarly, the spun-off business might be faring poorly and draining corporate resources. Alternatively, the parent firm might spin off a business because it experiences volatile earnings, thereby prompting a valuation discount in the market, or because it is heavily regulated, involved in costly litigation, or difficult to understand due to a complex financial structure. Finally, the parent might choose to spin off a business because it has a poor reputation. In each case, the parent firm benefits by divesting itself of a business that is believed to adversely influence investors’ perceptions of the combined firm’s value.

Separation from the parent firm can also increase the value of the subsidiary. Academicians and practitioners generally agree upon three sources of value creation for spun-off subsidiaries.2
First, management of the newly independent company is able to direct strategy and resources more efficiently, improving operating results. Second, new compensation plans improve incentives for management and employees and align their interests more effectively with those of shareholders. And third, the stand-alone firm attracts greater interest from investors who prefer more concentrated businesses and are better able to value the firm as a result of more detailed financial reporting.

RATIONALE FOR SPINOFF INVESTING

Peter Lynch in 1989, Seth Klarman in 1991, and Joel Greenblatt in 1997 each published books in which they addressed the investment potential inherent in spinoffs. These renowned investors identified a similar set of characteristics unique to spinoff transactions that create an exceptional investment opportunity. These characteristics extend beyond corporate motivations to include fundamental inefficiencies in the spinoff transaction, the seemingly irrational behavior of shareholders and company managers, indifference among stock analysts, and constraints inhibiting purchase by institutional investors. These unique circumstances mostly concern the spun-off subsidiary, making it the focus of this discussion.

In his book You Can Be a Stock Market Genius, Greenblatt notes that the spinoff process “is a fundamentally inefficient method for distributing stock to the wrong people.”3 Indeed, the recipients of shares in the spinoff are usually interested in investing in the parent company, not a subsidiary that may represent a fraction of the parent’s value and operate in a different industry. In response to receiving shares in this “castoff,” retail and institutional investors alike sell them indiscriminately—that is, without regard to price or underlying value.4 Investors faced with the challenge of understanding and valuing the spun-off company often determine that the path of least resistance is to sell their shares instead.5 Institutional investors may also sell because the position is too small to warrant continued ownership or because the institution’s investment mandates restrict it from owning shares based on the industry in which the subsidiary operates, its market capitalization, its dividend policy, or any number of other constraints.6 Similar restrictions also prevent other institutions, mutual funds, and index funds from purchasing shares. As a result, the indiscriminate selling depresses the price of the spinoff’s shares, but, as Greenblatt emphasizes, for reasons that do not necessarily involve its investment merits.7 Thus, an astute investor is presented with the opportunity to take advantage of investors’ irrationality and the resulting temporary mispricing by purchasing shares at a discount.

Equity research analysts and even the spinoff’s own management can also contribute to the unique share price pattern common to spinoffs. Analysts play an important role in directing the attention of potential buyers to a company’s stock by performing and distributing research on the company and expressing an opinion regarding its purchase. Research performed in 2009 revealed that analysts following the parent company, and who therefore hold a comparative advantage relative to most investors in understanding the transaction and forecasting future financial performance, in fact share relatively little information about the impending spinoff in research reports. The study’s authors refer to this phenomenon as “the forgotten child effect.”8 Seth Klarman, in his book Margin of Safety, suggests that this lack of analyst coverage contributes to investors’ ignorance and their participation in the indiscriminate selling suggested by Greenblatt.9 Klarman also explains management’s interest in seeing the spun-off firm’s share price languish. Management often receives stock options with exercise prices that are based on initial trading prices. Therefore, it is in managers’ best interests to allow the stock to trade initially at depressed prices.10 Once their options are granted, management incentives align with those of investors, as both will be rewarded by higher future share prices.11 The lesson: paying attention to the motives of management and insiders can transform an insider’s advantage into an advantage for the individual investor.12

SUMMARY OF CORPORATE AND INVESTMENT RATIONALE

The value creation opportunities that arise from a corporation’s decision to spin off a subsidiary, combined with the typical response of indiscriminate selling by recipient investors, indifference among analysts, and management incentive to temporarily depress the share price, create a unique opportunity for enterprising individual investors. Three
of history’s best investors recognize the opportunity in spinoffs, and it behooves the individual investor to pay attention.

**LITERATURE REVIEW**

In 1993, Patrick Cusatis and a team from Penn State published a study examining the operational and stock market performance of 146 spinoffs and their corporate parents over a 25-year period. From this study, and an expanded study published a year later, Cusatis et al. concluded that, over a 36-month period, spun-off firms outperformed industry peers and market indexes by an average of 10 percent per year. The study also reported raw cumulative stock market returns of 19.9 percent, 52.0 percent, and 76.0 percent over 12-, 24-, and 36-month periods, respectively, for the spun-off firms. Additionally, among spun-off firms, 58 percent, 64 percent, and 64 percent of firms achieved positive raw cumulative returns over 12-, 24-, and 36-month periods, suggesting two characteristics of a representative spinoff portfolio. First, the outsized returns among spinoffs are not dependent on a few fortunate outliers. Second, an individual invested equally across a representative portfolio of spinoffs could expect the portfolio to consistently generate positive returns.

Cusatis et al. emphasized that spun-off firms experience abnormally high takeover activity—five times greater than in non-spinoff firms. This finding is frequently cited as a caveat to investors considering investing in spinoffs. What is not cited is the authors’ conclusion that even non-acquired spinoffs achieve significant stock market returns for shareholders. In their expanded follow-up study, Cusatis et al. presented two additional concluding observations of particular interest. First, spun-off companies’ stock market gains are strongly correlated with improved operating performance. And second, this outperformance appears strongly related to improvements in corporate focus as a result of separating unrelated businesses.

Two subsequent studies, published in the *Journal of Financial Economics* and the *Journal of Investment Management*, found evidence to support the claims of Cusatis et al., while adding to the research on long-term excess returns of spinoffs. The first, published in 1999 by Desai et al., reported statistically significant excess returns of spun-off firms greater than those reported by Cusatis et al., as well as higher proportions of spun-off firms generating positive annual returns. Desai et al. contributed to the research by studying the performance differentials of “focus-increasing” versus “non-focus-increasing” spinoffs. Focus-increasing spinoffs referred to those transactions that reduced the diversity of the parent’s assets or operations, thereby improving managerial focus. The authors reported statistically significant excess stock market returns greater than 20 percent per year for focus-increasing spinoffs, touting the returns of non-focus-increasing spinoffs. Unlike Cusatis et al., Desai et al. concluded that the long-term returns were not dependent on takeover activity, as results were similar when acquired firms were excluded.

Desai et al. also reported direct evidence of an association between an increase in focus and operating performance and an increase in focus and stock market performance. Similar analysis of non-focus-increasing spinoffs presented a new finding: parent firms undertaking non-focus-increasing spinoff transactions are likely doing so to separate themselves from an underperforming subsidiary. The implication for spinoff investors is to avoid non-focus-increasing spinoffs to avoid potentially poor performers.

The second study, published in 2004 by McConnell et al. in an attempt to resolve contradictions present in the existing empirical evidence regarding excess long-term spinoff returns, performed a comprehensive analysis of 311 spinoffs across the 36 years from 1965 to 2000. Their research provides broad evidence of an association between an increase in focus and operating performance. However, the authors conceded that average raw stock market returns of both parent and subsidiary firms were consistently positive and substantial across all periods and that the spun-off firms consistently provided superior raw and excess returns calculated using the Fama (1998) method.
McConnell’s own comprehensive study in 2004 concluded that a strategy of investing in recently spun-off firms did produce statistically significant and substantial excess returns.

**LITERATURE TAKEWAYS FOR THE INDIVIDUAL INVESTOR**

Criticisms for a strategy of investing in spinoffs emerge exclusively from inconsistencies found in the excess returns achieved relative to the benchmark, which fluctuate depending on the benchmarking method used to measure returns, the calendar time period studied, the holding period analyzed, and whether the investment is in parent or subsidiary firms. However, within this morass, individual investors should understand two consistent findings. First, average raw stock market returns for spun-off firms over 12-, 24-, and 36-month periods are repeatedly found to be positive and substantial, indicating a strategy with the potential to provide consistent positive returns to the investor. Second, spun-off firms are repeatedly found to provide superior returns against established benchmarks, across various calendar periods, for all considered holding periods (but especially the 21- to 24-month holding period), when including and excluding takeover premiums and correcting for outliers.

**CONCLUSION**

Deciding to invest in spinoffs can be difficult for an individual investor. Certainly, the reasoning behind the corporate decision to spin off a subsidiary makes sense; the unique circumstances that make spinoffs especially appealing are intuitive to most investors; several very successful professional investors, known for their acumen in identifying lucrative opportunities, find spinoffs to be an attractive hunting ground; and numerous academic studies have concluded that spinoffs—particularly the spun-off subsidiaries—achieve consistent positive excess stock market returns. However, the existing research includes just enough contradiction and criticism to introduce doubt into the decision process. It is hoped that the discussion thus far has resolved many of the contradictions and explained the basis for the criticisms surrounding the effectiveness of a spinoff investment strategy.

Should an individual investor decide to pursue a strategy of investing in spinoffs, the following criteria can assist in choosing a promising candidate:

1. **Focus on the Spun-off Subsidiary.** The academic and empirical evidence suggests spun-off firms are likely to produce larger, more consistent positive returns over the long term than their corporate parents.

2. **Choose Spun-off Firms Involved in “Focus-increasing” Transactions.** In such a transaction, the spun-off subsidiary will generally operate in a different line of business than the parent.

3. **Implement Joel Greenblatt’s “Best of the Best” Criteria:**
   - **Institutions Don’t Want It.** There are numerous reasons why institutions, and many other recipients of the spun-off company’s shares, will indiscriminately sell or not purchase shares, which are not indicative of the firm’s potential. This selling pressure can spell opportunity.
   - **Insiders Want It.** Does management have incentives to make the spinoff succeed? For Greenblatt, insider participation is the most important consideration when researching a spinoff opportunity. Look for significant insider ownership or a plan for management to acquire significant ownership; management incentives that are aligned with the interests of shareholders by way of compensation in stock, restricted stock, or options; and a percentage of the company’s stock reserved for management and employee incentives. Be cognizant of other forms of insider commitment as well. For example, have high-performing executives from the parent company left to join and lead the spun-off firm? Commitments such as these demonstrate confidence in the new company.

4. **A Previously Hidden Investment Opportunity Is Created or Revealed.** A great, undervalued business might be revealed and made available for direct investment through separation from the parent firm. The pro-forma financial statements and management discussion might disclose opportunities for the new company not yet realized by investors. There are countless ways in which special investment opportunities can arise in spinoff transactions. With practice, the individual investor will be able to identify and take advantage of them.

5. **Pay Special Attention to Motives.** Does the spinoff transaction seem unduly complex, labyrinthine, or generally unappealing? Does it seem management of the to-be-spun-off subsidiary has little to say on the merits of the company? Remember that sometimes management is motivated to keep investor interest low for its own financial benefit. The intelligent investor can identify this insider advantage and use it to his own advantage as well.

41 **Buy at Initial Listing and Prepare to Hold the Investment for 21 Months.** Research shows this to be the optimal purchase strategy and holding period. Optimal performance within 21 months could result from operational improvements and increased focus, effectiveness of management incentives, or acquisition interest—most takeovers occur in years two and three. Whatever the reason, mark your calendar to check in by this point.
A LEGAL EXAMINATION OF SUPER PACS

By Ryan Fletcher

It has been two years since the Supreme Court’s landmark and controversial decision in Citizens United v. Federal Election Commission, which, citing First Amendment free speech protection, lifted campaign finance restrictions on corporations, unions, and other independent entities. While companies are still prohibited from contributing directly to or campaigning on behalf of a candidate, the Court’s ruling has paved the way for the “super” political action committees (“super PACs”) that have dominated advertising during the Republican primary election campaign. As election season heats up, and as the primaries lead into this fall’s presidential election, the monitoring of the influence of these super PACs will be increasingly important.

LEGISLATIVE HISTORY

Amid fears of bribery and quid pro quo arrangements, Congress banned direct corporate contributions to federal political candidates in 1907 with the passing of the Tillman Act. Restrictions were tightened throughout the 20th century, and with the 2002 passing of the Bipartisan Campaign Reform Act (BCRA), corporations were barred from using general treasury funds to bankroll PACs or engage in “electioneering communications” 30 days prior to a primary election and 60 days prior to a general election.

CITIZENS UNITED V. FEC

In 2008, the non-profit group Citizens United, while not the type of group the BCRA intended to limit, challenged the longstanding practice in an effort to more widely distribute a film critical of then-Democratic presidential candidate Hillary Clinton. Writing the majority opinion, Justice Anthony Kennedy stated that “[g]overnment may not suppress political speech on the basis of the speaker’s corporate identity.” The Court’s decision invalidated one act of Congress, severely limited another, and invalidated 24 state laws.

Predictably, the 5-4 decision was both partisan and controversial. Justice Kennedy further stated that “[n]o sufficient governmental interest justifies limits on the political speech
of non-profit or for-profit corporations,” while Justice John Paul Stevens wrote a 90-page dissenting opinion. President Obama voiced his displeasure, declaring the Court’s decision “a major victory for big oil, Wall Street banks, health insurance companies, and the other powerful interests that marshal their power every day in Washington to drown out the voices of everyday Americans.”

Not all predictions were as dire as President Obama’s. Nathaniel Persily, a professor of law and political science at Columbia Law School, described the decision this way:

...before Citizens United, a company or a union could pay for ads that said, “Tell Senator Smith to stop ruining America”. After Citizens United, they can add the magic words: “and by the way, don’t vote for Senator Smith.” That’s not much of a difference.

2012 REPUBLICAN PRIMARY

The decision’s effect on the election thus far falls somewhere in between Mr. Persily’s and President Obama’s predictions. The early primaries in Iowa, New Hampshire, South Carolina, and Florida were characterized by intensely negative super PAC-funded advertising campaigns. Spending on television ads by independent groups is already five times what it was during the 2008 primary. While the rules still prevent PACs from coordinating with candidates, in some instances that is only a nominal distinction. Mitt Romney’s super PAC Restore Our Future is run by his former chief campaign fundraiser and $1 million of the group’s initial funding was provided by his former partner at Bain Capital. Newt Gingrich’s PAC Winning Our Future is run by several of his former aides.

PACs are also not subject to the 2002 campaign finance reforms, which require all candidates to state approval of their advertisements. Nor must they disclose their donors; many of the PACs have nonprofit arms, which are exempt from disclosure requirements. The end result of this has been ads linking Gingrich to “China’s brutal one-child policy” and “taxpayer funding of some abortions.” Romney, meanwhile, has been derided as a “greedy corporate raider who slashed American jobs in his heartless chase after profits.”

The pro-Romney Restore Our Future has collected more than $30 million for the campaign and was credited with Romney’s victories in New Hampshire and Florida (both crucial early primaries), his near victory in Iowa (Rick Santorum was declared the winner, but the close race allowed Romney to capture much of the momentum), and Gingrich’s fourth-place finish in Iowa (their ads helped thwart a surging Gingrich). Romney himself has remained positive on the campaign trail, allowing him to avoid the criticism associated with running a negative campaign while reaping the benefits of the negative campaign run by his PAC.

A contemptuous early primary season led many to anticipate a protracted primary campaign. With an increasing number of states changing to proportional delegate allocation (allowing more candidates to stay in the race longer) and the California primary scheduled for June 5 (the nation’s largest state and primary awards 172 delegates in its primary), it would not have been surprising if a Republican candidate failed to emerge until this summer. However, Romney’s campaign gained momentum throughout the spring and with the suspension of Rick Santorum’s campaign. Romney has all but sewn up the Republican nomination. His super PAC has been credited with his defeat of Rick Santorum, contributing over $20 million in anti-Santorum ads alone.

POSSIBLE EFFECTS ON THE PRESIDENTIAL ELECTION

The same strategy that has fueled Mitt Romney’s push in the Republican campaign could potentially harm the Republican nominee come November. While President Obama was able to recover from his prolonged battle with Hillary Clinton in 2008, the Republican Party may not be able to duplicate that success. A primary season characterized by infighting, attack ads, and broad promises may provide the Democrats with fodder during the general election, and, most importantly, Republican super PACs have had to spend money on the primaries that otherwise would have been reserved for the general election. Analysts are also unsure as to what the super PACs of ousted candidates will do with their remaining cash. The one major restriction is they can’t give their money to another campaign. Aside from that, super PACs that outlast their candidates’ campaigns are free to do what they want.

The extent to which President Obama and his supporters have used the new campaign finance regulations to their advantage has been debated. The pro-Obama super PAC Priorities USA Action, headed by former Obama aide Bill Burton, has already begun fundraising and hopes to raise more than $100 million for his reelection bid. Republicans estimate that the President and the entirety of his supporters will contribute between $750 million and $1 billion in support of his campaign. However, Priorities USA Action has struggled with fundraising thus far. Though the President’s campaign has begun airing ads, there are some who believe he is moving too early and that he should allow the internecine fighting in the Republican Party to run its course. The early attacks on Romney may have inadvertently elevated him above the rest of the Republican field.

The economy stands to be a focal point in the general election. A positive Obama advertising campaign may be a tough sell. A more effective strategy may be a negative ad campaign discrediting the economic credentials of the Republican nominee, particularly if Romney, who has been championing his business background, prevails in the primaries. If that is the case, we can expect another ferocious super PAC-funded election season.

THE FUTURE

What this means for future elections
is uncertain. There are some who believe the country is headed back to the pre-Watergate days of organized crime and bagmen.44 This will usher in an era of “legalized bribery” in which the donors of these huge, unlimited contributions are essentially buying influence in the election.45 While that view may be extreme, the new campaign finance regulations may open the door to further political corruption and even more distorted ad campaigns. With their long history, distorted advertising is less worrisome to both Congress and the Supreme Court than corruption, which is a murkier issue. While direct political contributions from corporations are still prohibited, the association between super PACs, politicians, and their campaigns suggests this will be difficult to enforce and even more difficult to prove.46

There are some who believe the new regulations are a welcome development. Rick Santorum and Newt Gingrich may have had difficulty sustaining their campaigns without super PAC contributions.47 Foster Friess, a wealthy mutual fund manager and contributor to the pro-Santorum PAC Red, White and Blue Fund, believes that his contributions have exposed the country to a candidate they otherwise would not have been aware of.48

These positive effects have not tempered further reform efforts. Grassroots activists have been lobbying for support for a constitutional amendment that would overturn the Citizens United decision, and the House has passed the DISCLOSE Act, which would impose tougher disclosure restrictions on campaign contributors. However, amending the Constitution is painfully difficult, requiring a two-thirds majority in Congress for proposal and ratification from three-fourths of the states, while the DISCLOSE Act stalled in the Senate.29,30

CONCLUSION

In the infancy of the 2012 election, the effect of the Citizens United decision is already being felt. The Republican primary campaigns in Iowa, New Hampshire, South Carolina, and Florida have been characterized by intensely negative advertising funded by the super PACs now permitted by the Court’s decision. As election season heats up, the influence of super PACs will intensify and, absent legislative or judicial action, the effects of the Citizens United decision will reverberate throughout future election cycles.

THE FUTURE OF YOUR PHONE

By Andrew Maher

Here’s a quick perspective: imagine walking home past an advertisement, waving your cell phone near an ad to receive a promotional discount, and then heading off to the business to finalize the purchase via your mobile device. Or imagine receiving a discount simply for walking into a McDonald’s, paying with a QR code on your phone, and then instantly receiving your receipt via e-mail. Seamless, easy, and engaging. While these scenarios might seem foreign to you, they are happening right now with the increasing adoption of smartphones—devices that can act as digital wallets—and will only continue to increase with the mass adoption of mobile commerce.

Mobile commerce is a term that can be applied to a variety of digital transactions. John Caron of Forbes.com breaks down the term as mobile e-commerce versus mobile payment and commerce (generally known as m-commerce). E-commerce (the buying and selling of products or services over the Internet and other computer networks) and mobile e-commerce are essentially the same thing; the latter is merely allowing consumers to use Internet-enabled devices to make purchases on device-optimized websites. Sure, customers can make these purchases anywhere, but they are not technically mobile commerce transactions.

Whereas e-commerce attempts to replace brick and mortar stores, m-commerce moves the transaction from online to inside the store, aiming to improve the in-store experience. M-commerce applications that provide payment methods and in-store discounts offer retailers an unprecedented ability to connect with shoppers.1 M-commerce bridges the gap between the physical store and customers, providing a customized experience that influences brand engagement and spending behavior. The idea is to provide a holistic shopping experience by leveraging mechanics such as mobile couponing, offers, check-ins, payment, etc., so that shoppers have a unique experience based on who they are, where they are, and what they want to purchase.1 The mobile medium is an incredibly personal channel by which retailers can directly engage with their customers based on the context of the shopper’s needs, preferences, and location.

While m-commerce seems to be a relatively new buzzword, the concept of paying with a mobile device has been around for the past decade and longer. It was first seen in 1997 in Sweden when a limited number of Coca-Cola machines could receive payment via SMS text from a cell phone.2 This was soon followed by KLM Airlines allowing air travelers to confirm travel plans from cellular devices and the development of
Domino’s “Pizzacast,” which provided a mobile payment system for ordering and purchasing takeout pizza. By 2001, more than $2.4 billion worth of transactions flowed over mobile devices globally, a growth spurred primarily by mobile payment platforms in Japan, the Philippines, and even Africa. By 2008, both iPhone and Android smartphones had been released, and consumers were soon scrambling to purchase smartphones. Just a year later, the entire mobile e-commerce and m-commerce market was worth an estimated $69 billion, and by 2011 smartphone penetration in the U.S. had surpassed 40 percent, with over 33 million users having made a purchase using their mobile devices. According to Peter Crocker, an analyst at GigaOM, digital payments are expected to reach more than $750 billion worldwide by 2015.

The goal of the mobile commerce movement—much like the introduction of modern credit cards back in the 1970s—is to tap into the transaction space and help foster a cashless economy. Credit cards began to be widely used during the 1960s and ‘70s; they provided a quicker form of payment, allowing users the option of not carrying cash. Additionally, credit cards facilitated an easier payment method for both customer and merchant, one that resulted in customers ultimately buying more. Mobile commerce looks to provide these same benefits but aims to take them a step further, with direct marketing to mobile users, robust loyalty constructs, the tracking of purchasing behavior to provide merchants with line item data, and a lower interchange fee (the fee a merchant pays for credit card transactions). All these services hope to shake up the traditional payment industry by creating an easier flow of money, one that is driven by purchase data and has access to millions of mobile screens.

At the heart of this transition is the purchase data. While the concept of mobile commerce provides deep engagement for both consumers and merchants, what it really provides is an unprecedented amount of data about consumers’ purchasing behavior. Mobile commerce, similar to e-commerce, provides a platform that can track both unique users and their purchases. While this might sound Orwellian, data has been the essence of blue-chip giants for years. Google makes billions of dollars each year by tracking your search entries and utilizing them to send you personalized ads, news, and content. Facebook uses profile data to serve ads that are relevant to your expressed interests and likes. Amazon has been using your online purchase behavior to offer you complementary goods and discounts for over a decade. Mobile commerce provides merchants with data that will allow them to customize your in-store experience, whether with relevant discounts, a more compelling loyalty program, directed marketing, or simply an easier purchasing process. M-commerce provides the robust data that e-commerce has created and brings it back into the physical store.

According to the New York Times, this trend of utilizing data is only expected to grow. “Big Data,” as it is referred to, will continue to spread to other mediums and business models. Thousands of data analysts are being hired to make sense of this new-world data explosion and to help big retailers analyze sales, pricing, and demographic data to tailor product selections and marketing efforts. Even corporations outside the retail industry are utilizing this data capture, such as shipping companies tracking delivery times and traffic patterns for more efficient routing. A report by the World Economic Forum, “Big Data, Big Impact,” has declared data to be “a new class of economic asset, like currency or gold.” This will continue to hold true as data further directs vital business decisions.

Many companies, from giants like Google and Starbucks to startups like SCVNGR and Square, are looking to provide mobile payment solutions. However, not all mobile payment systems necessarily work in the same way. Both Google Wallet and Isis—a joint venture between major cellular carriers and credit card processors—use near-field communication (NFC) technology. NFC allows a smartphone to communicate instantly with a sales register by “tapping” on a receiving chip located in the register. Through this “tap” your credit card is immediately charged for the product being purchased. But this requires phones
with embedded NFC chips and merchants with NFC sales terminals. Currently, just a handful of smartphones offer an NFC chip, and only a handful of major chains, such as Subway, Bloomingdale’s, and Coke vending machines, have begun to install NFC technology, so it is still a long way off from ubiquity. The technology has the potential to provide some amazing mechanics beyond payment, like tapping an advertisement and receiving a discount or exclusive content.

Google Wallet is Google’s entrance into the mobile payment space. Utilizing NFC technology, Google has partnered with MasterCard and Citi Bank to provide users with a single form of payment that incorporates loyalty cards, coupons and credit cards all through a single “tap” of a phone that communicates with sales registers. Google was the first firm to launch a product in the m-commerce space but adoption has been limited due to its restricted availability on the Nexus S Android smartphone on Sprint. Additionally, phone carriers such as Verizon Wireless have fought back against preloading Google Wallet on devices with embedded chips, supporting instead their own soon-to-launch system, Isis.

Isis is a joint venture between AT&T, T-Mobile, and Verizon Wireless that is partnered with Visa, MasterCard, Discover, and American Express to develop a comprehensive mobile payment app utilizing NFC technology. Notably, Sprint is not part of the partnership given its affiliation with Google Wallet, yet MasterCard is. According to Bloomberg BusinessWeek, the coalition hopes to use its vast reach to allow Isis to be offered nationally at merchants and retailers as well as come preloaded on AT&T, T-Mobile, and Verizon Wireless smartphones, by committing $100 million to the endeavor. Aside from payment, Isis would also let consumers redeem coupons via their mobile devices once the service is live in mid-2012.

A similar technology, Quick Response Code (commonly known as QR code), is already widely used within the retail, consumer goods, and entertainment industries. That small, odd-looking, black-and-white geometric square found on the back of your Heinz ketchup bottle is actually a type of barcode, one that can store product information, digital coupons, or even, in the case of LevelUp, be linked to a credit or loyalty card. LevelUp, a mobile application created by SCVNGR, provides users with a unique QR code that is linked to their card of choice. When using LevelUp to purchase an item, a user simply presents his or her phone with the QR code on the screen, has the code scanned via a 2D barcode scanner, and receives a digital receipt via e-mail. The service has been live since last summer and is now seeing over $1 million in transactions a month. LevelUp users are offered discounts for first-time and subsequent visits, while merchants are offered a lower interchange fee (2.00 percent per transaction) and comprehensive data analytics tracking customer life-cycle value.

PayPal is pursuing a very different strategy, focusing on storing customers’ cards in the digital “cloud” and allowing them to be accessible from any computer or phone. With more than 103 million account holders, PayPal will have a vast reach in the payment space. PayPal is aiming to create an app that is an all-inclusive mobile wallet, one that is linked to all the user’s credit cards, gift cards, and frequent flier miles, all in one location. PayPal is actively working with retailers to build loyalty card constructs and coupons into the app. Users will check out by entering a phone number and a PIN number, and then swiping a PayPal payment card that is linked to the app. A key function—unique to PayPal—is payment flexibility. For up to five days after the sale, users will be able to choose how they want to pay for purchases. Since the app is linked to all the user’s payment methods, purchases can be split among credit cards, debit cards, PayPal accounts, and gift cards.

Another startup, Square, is breaking into the mobile payment space by focusing on merchants and their POS systems. Square is a small card reader that attaches to a smartphone or iPad device and allows small businesses and individuals to accept credit card payments over the cellular network without the need for a traditional POS system or card reader. In conjunction with the Square app, Square lets a business use its mobile device as a “supercharged” cash register and inventory system. The goal is to provide small businesses or even individuals with a low-cost POS system that can run on a device as small as a smartphone; like LevelUp, it boasts lower interchange rates than traditional credit card transactions. For the customer, Square’s recently launched “Card Case” feature allows customers to open a “tab” at a favorite spot and then pay by simply giving a name associated with the account, resulting in a receipt e-mailed to the patron.

Other industry giants, like Starbucks, have begun to enter the mobile payment space. The Starbucks application is a method of payment that is linked to a user’s Starbucks Rewards Card, allowing customers to scan their phones to pay for a cup of coffee at over 9,000 locations. While the card must be preloaded with credit, the wildly successful app has been used more than 26 million times. Other industry leaders have yet to officially announce plans but have already started to take initiatives toward building a mobile wallet. Apple recently launched the “EasyPay” app within all Apple retail stores. The app lets users purchase accessories at Apple stores by scanning in a barcode and completing the transaction on their own personal Apple iOS device, allowing them to skip the checkout line entirely while the payment is processed through their iTunes account. Although this is not quite a universal mobile wallet, it is expected that Apple will announce plans to launch a mobile wallet in the near future, possibly integrating NFC chips into the iPhone 5.

Given the vast adoption of e-commerce through online retail, “Consumers [now] expect to use one click to buy
just about anything,” explains Osama Bedier, vice president of payments at Google. Mobile commerce will be no
different, as consumers will utilize mobile coupons retrieved via store signage or elsewhere, stored within a digital
wallet and automatically applied at pur-
chase. Reliance on mobile devices for
financial services has already seen vast
adoption with more than 32 million
users managing their bank accounts
on cellular devices, a figure that leads
some to believe consumers are ready
to ditch paper and plastic all together.

“Twenty years ago, we had zero need
for digital payments,” says Bedier. “But
today you can’t buy a song or a game
for digital payments,” says Bedier. “But
to the hearts and phones of the general public. The great-
est challenge for the industry is con-
sumer adoption. It’s a complex prob-
lem: consumers can use the service
only if it is available at retailers, and
retailers will opt for the service only if
there are enough users to drive sales
and reduce processing costs. Therein
lies the problem of establishing the net-
work effect. With each new customer
or business adopter, the system itself
is enriched. An example of this is Face-
buch with every new user added to the
etwork, the Facebook brand is further
stretched and extended, an aspect
that has left marketers salivating.

So where is the real incentive for cus-
tomers to use a mobile app over cash or
or credit card? While there exists a value
for retailers to adopt mobile payment sys-
tems, firms must establish a strong
value-add for the customer as well. This
will depend on how firms implement
mobile payments from the customer’s
viewpoint. If mobile payments can
solve the small problems like storing
digital coupons, offering loyalty pro-
grams, or allowing customers to skip
the checkout line altogether, while at
the same time saving them money and
providing product and service reviews,
payment flexibility, and simplicity, the
result could be rampant adoption. Mc-
kinsey’s Philip Bruno says, “The con-
sumer will save money, in part through
deals that are based on past purchases,
not just random offers. And they’ll get
better financial control.” So, one day,
mobile just might become king. Al-
though we should not expect the U.S.
Mint to stop printing money anytime
soon, and according to Ed McLaugh-
lin, the head of emerging payments at
MasterCard, cash may become like “the
postage stamp. If you aren’t used to us-
ing it, it won’t make a whole lot of sense
why one would.”

Another challenge the industry must
overcome is consumers’ perception
surrounding security issues. A report
by KPMG’s Global Consumer & Con-
vergence Survey found that over 56
percent of consumers trusted their fi-
nancial services institution to handle
mobile commerce financial data, with
90 percent of consumers wary about
data privacy and security when it comes
to mobile transactions. It will be cru-
ical for firms to broadcast security ini-
tiatives surrounding their systems to
the everyday user. As m-commerce
becomes more commonplace, partici-
pants on both ends of the transaction
will need to be assured that paying with
a smartphone is as safe as paying with
a credit card.

According to ABI Research, the mo-
bile wallet is predicted to be worth $12.5
billion this year. This value is not just
based on the cost of transaction pro-
cessing, where traditional fees arise
from fraud management and legacy IT; rather, it’s created by helping mer-
chants operate more effectively. That’s
where the mechanics of a mobile pay-
ment system kick in; it gives merchants
the ability to track customers from ad-
vertisement to checkout and then use
that data to implement better pricing,
sales campaigns, and loyalty constructs,
and to take advantage of lower process-
ning fees. Ultimately, the usefulness of
the data generated through a mobile
payment system—data collection that
is non-existent in current credit card
processing—dictates the true value of
a processing fee. This brings into ques-
tion the entire concept of traditional
processing fees and where the value of
the fee actually originates. If the idea of
interchange fee origin switches from
the current model to one that is based
off of data, then we might one day hear
a new phrase uttered at the register:

“Will that be cash or mobile?”
Latin America has experienced a bullish market in merger and acquisition (M&A) activity over the last few years. As we can see from Exhibit 1, over the last five years, South America has been experiencing a steady increase in deals, reaching almost 1600 transactions in 2011 with a total value of around $140 billion, according to the Institute of Mergers, Acquisitions, and Alliances. The financial services, energy, and natural resources sectors have captured a significant amount of interest from foreign investors, especially those from Asia. Recognizing the importance of expansion opportunities in Latin America, multinational companies have established offices in the region, with notable interest coming from Russia, India, and China.

One factor responsible for increased interest in Latin America from outside investors has been the global financial crisis. From the first signs of a downturn at the end of 2007, investors have been looking for alternative ways to not only protect their capital, but also place some long-term bets in safer environments with greater growth prospects. This is why Latin America in the last few years has been gaining momentum. Running away from the U.S. mortgage collapse, from low interest rates and instability, and from contact with the epidemic chain that is still unpredictable in Europe, investors have found new opportunities in South and Central America.

Other factors spurring cross-border M&A activity include the current low cost of capital, the need for companies to consolidate due to intense competition, investment and financial reforms, and currency fluctuations. A number of Latin American countries have also tried to encourage foreign investment through tax incentives that range from tax holidays and credits to reduced tax rates.

Where has the inflow of foreign investment in Latin America come from? A good deal of outside interest in M&A has come from Asian countries seeking raw materials and com-
modities to propel their growth. For example, in 2008, the Japanese trading and investment company Mitsui increased its investment in Valepar, the controlling shareholder of Vale, the Brazilian mining group. This year, Sumitomo paid $1.9 billion for 30 percent of Mineração Usiminas, another Brazilian mining company. Other large deals include the Chinese oil giant Sinopec’s acquisitions of both the Brazilian assets of Spain’s Repsol for $7.1 billion and U.S.-based Occidental’s Argentina E&P assets for $2.5 billion as well as three Indian companies’ purchase of a $2.2 billion stake in Venezuela’s Carabobo Oil.

At the same time, economic growth and the inflow of foreign capital has increased the number of wealthy individuals and large corporations within Latin America. The increased desire for expansion on the part of these individuals and corporations clearly indicates the “emergence of strong Latin American players with regional and global ambitions.” In Colombia, for example, Bancolombia teamed with conglomerate Gruposura in a multi-billion dollar purchase of the Latin American pensions, insurance, and fund management operations of ING Group; and in a south-north purchase, 3G Capital, a Brazilian private equity firm, purchased ailing Burger King for $4 billion.

As can be seen in the examples above, M&A deals have brought new capital to Brazil, and even Argentina, despite the latter country’s continued political and financial problems. Only Venezuela, despite its wealth of resources, is being largely ignored by corporate suitors and is the only country with near zero GDP growth prospects for 2012 as we can see in Exhibit 2. This is the result of perceived political risk as the country moves ahead with its “21st century socialism” in the midst of growing capitalist activity in surrounding countries.

Such differences across countries, coupled with increased investment interest in Latin America, highlight the need and the hunger for greater knowledge. In investment banking circles, Mr. Margulies of Barclays has noted that “We’ve seen a lot of clients saying, ‘we need to grow via M&A in this region, and we need to get educated.’” Similarly, Antonio Pereira, the head of M&A and corporate finance for Goldman Sachs in Brazil, characterizes his country’s profile within the bank as “as high as it has ever been.”

In-depth knowledge is needed, for example, to take advantage of tax incentives for investment that have been offered in the different countries. Such incentives vary drastically based on regional and industry considerations. Fiscal regulations and probable incentives may impact the macro and micro factors of a deal, so it is essential that industry-leading tax professionals,
both local and international, structure the transaction in detail to ensure that it’s handled efficiently.

In addition to taking advantage of tax shields through careful due diligence, deal structuring, and post-deal administration, investors need to understand the region’s business culture outright. At the time of deal-making, it should be understood that in Latin America, the political and regulatory landscape is ever-changing, and it would be a mistake to believe that the rules of engagement will maintain uniformity in different jurisdictions. With dictatorships and left-wing governments becoming increasingly popular with the region’s citizens, the risk factor of investing in Latin America is not to be downplayed.

The flow of capital, as we can see in Exhibit 3, and the level of M&A activity in Latin America show no sign of letting up. Because of the risk factors that need to be considered, potential outside investors need to enlist regional expertise. Hiring local experts, particularly those that the buy-side firm feels comfortable with in a team environment and that can establish a clear-cut communication channel, is a key factor in achieving success through M&A in Latin American deals. From the perspective of the bankers, the game has changed; in order to be considered a primary and reliable source of M&A services, banks now need to have a local presence, as well as teams that are fluent in Spanish and Portuguese. The old business model, which had bankers constantly traveling back and forth to the region from New York City, is no longer effective, according to Pedro Chomnalez.⁴

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**Exhibit 2**

**LATIN AMERICA AND THE CARIBBEAN; AVERAGE PROJECTED REAL GDP GROWTH DURING 2011-2012 (PERCENT)**

Source: International Monetary Fund

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**Exhibit 3**

**PRIVATE CAPITAL INFLOWS, NET INTO EMERGING MARKETS 1980-2012**

Source: The Institute of International Finance, Inc.
BUCKING THE TREND OF THE PAST: THE SAN FRANCISCO 49ERS’ NEW HOME

By Nick Burrows

INTRODUCTION

In today’s society, everyone wants the latest and greatest gadgets. Everyone has to have the newest iPad, iPhone, etc. NFL franchises are no different than the rest of us. Owners are always looking to build the biggest, best, most technologically advanced stadium possible. The New York Giants and the New York Jets recently knocked down the old Giants Stadium in favor of the new MetLife Stadium. The Indianapolis Colts replaced the RCA Dome with Lucas Oil Stadium. And of course we all know that Jerry Jones outdid everyone with the new Cowboys Stadium in Arlington, Texas. But the question is: Is it fiscally responsible to build these lavish stadiums?

PRIOR FUNDING OF STADIUMS

Given the current economic situation, along with the taxpayers’ money needed to fund most of these projects, such outlandish and expensive stadiums seem fiscally and morally irresponsible. In the past, not only were stadiums funded by the sports franchises building them, but the costs were far cheaper, even when adjusted for inflation. Projects such as Fenway Park, Wrigley Field, and Ebbets Field would have cost about $15 million if built today. This obviously omits any renditions and add-ons, but the point still remains that stadium construction costs are spiraling to heights that are bordering on unprofitable. In the past, the bridge to publicly funded stadiums came as a way for cities to lure sports teams for the economic benefit the franchises would provide. While that may have been true in the mid-1900s, it’s not the case now, and, given the increase in the percentage of public funding used to build these stadiums, that is a problem. Recent trends show that the public is funding a large portion of the cost of today’s new stadiums. In 2004, the Philadelphia Eagles built Lincoln Financial Field, 40 percent of which was funded by the public. In 2007, the Arizona Cardinals built a University of Phoenix Stadium, 67.7 percent of which was funded by the public. The largest public funding of a stadium in recent memory was Lucas Oil Field, with 86 percent funded with public money.

1

2
CURRENT SITUATION

The San Francisco 49ers and current owner and president Jed York are in the process of building a new stadium in the city of Santa Clara, California, planned to be completed by 2015. This will be a multi-purpose stadium housing the San Francisco 49ers and possibly the Oakland Raiders; it will also host numerous other events such as international soccer games, concerts, and other live shows. The stadium will cost an estimated $1.02b, $850m of which will be financed by a loan from three banks: Goldman Sachs, Bank of America/Merrill Lynch, and U.S. Bank (hereinafter referred to as the “banking syndicate”). The $850m will be distributed to an entity called Stadium Financing Trust. The remaining $170m will come from loans from the National Football League (NFL), totaling $150m, and from the city of Santa Clara, specifically its Redevelopment Agency (RDA), totaling $20m. The RDA has stated that they have $10m to be distributed right away, with up to $35m available should it be needed.

The San Francisco 49ers, per the terms of the signed lease with the Stadium Authority—legal owner of the stadium—are contractually obliged to pay $30m in yearly rent. Also, any overruns in cost fall squarely back on the taxpayers’ money needed to fund most of these projects, such outlandish and expensive stadiums seem fiscally and morally irresponsible.

ECONOMIC IMPACT ON SANTA CLARA

A study done by John E. Connaughton and Alain A. Krapl for the San Jose Convention and Visitors Bureau and the Santa Clara Chamber of Commerce shows that the total economic impact of the stadium will be $650,864,140. This figure is based on the estimated 2,230 jobs it will create in Santa Clara County resulting in an annual economic output of $249m. This would result in a $12.3m annual tax income benefit, along with an additional $30m aggregate tax benefit for the construction of the project.

Looking at the project’s overall net economic impact, however, it is largely believed that the new stadium will not benefit Santa Clara. “There has never been a [professional] football stadium with a positive economic impact,” says Roger Noll, an emeritus professor of economics at Stanford University. The Santa Clara project, he predicts, could range “from pretty close to break-even to a catastrophe.”

“Given the current economic situation, along with the taxpayers’ money needed to fund most of these projects, such outlandish and expensive stadiums seem fiscally and morally irresponsible.”

FINANCIAL EXPOSURE

In a breakdown of the financial exposure of the parties involved, the city of Santa Clara seems to be fairly well protected. This is in contrast to many of the previous stadium deals in which the city took on a lot of financial risk. The creation of the Stadium Authority, the legal owner of the stadium, allows Santa Clara to avoid having to provide collateral out of its general funds for any of the loans. The entity with the most financial exposure is the team itself; Forbes estimates the 49ers’ worth at just under a billion dollars. The 49ers look to assume most of the risk, as they are backing the $850m loan as well as the $30m annually in rent, which is intended to cover the debt from the $400m loan as well as the operating costs for NFL-related events.

What it boils down to is this: the San Francisco 49ers seem to be the underwriting asset that will serve as collateral for all debt repayments. The city would be on the hook for up to $35m in taxpayer funds that would be fed through the RDA via increased hotel taxes—deemed a TOT (transient occupancy tax). On top of that, the 49ers are receiving zero equity stakes in the stadium.

CONCLUSION

Bucking the trend of recent stadium projects, the stadium in Santa Clara will be backed largely by the San Francisco 49ers themselves. Aside from MetLife Stadium in New York/New Jersey—funded with zero public money—every stadium built for an NFL team in the last 12 years has been funded by at least 28.6 percent of public money, with most above 67.7 percent. Most publicly funded stadiums take far longer than originally planned to pay off, laying a heavy burden on the city. If successful, Santa Clara and the San Francisco 49ers could start a trend that could help change the way stadiums are funded.
At the beginning of the year, Goldman Sachs expected 2012 global GDP growth to be 3.2 percent. Europe was on the brink of a recession, and U.S. GDP growth was expected to be less than 2 percent. Growth was expected to be found in emerging markets. In early 2012, China’s GDP growth was predicted to be 8.5 percent, with Russia expected to produce 3.5 percent GDP growth.

This article covers good opportunities to profit, including domestic and global opportunities, fixed income, commodities, and dividend paying stocks. You’ll find explanations and ETFs you can use to easily get the exposure you’re looking for.

Legal Disclaimer: I am not an investment professional. My trading ideas are merely suggestions and do not constitute investment advice.

2012 TRADING STRATEGIES
By Peter LeBrun

GLOBAL OPPORTUNITIES
Recommendation One: Bullish on China

As of this writing, China is the fastest growing segment of the globe. 2011 annualized GDP growth in China was 8.9 percent. At the beginning of 2012, growth expectations for the year ranged from JP Morgan’s estimate of 7.2 percent to Goldman Sachs’s more aggressive 8.5 percent. The Conference Board’s estimate was right in the middle at an increase of eight percent.

Our global economy is dependent on China for growth. China is one of the world’s leading engines for investment, and is now the second largest economy in the world.

China has several areas for positive economic performance. Early in 2012, it began easing monetary policy, which should lead to more loans in the future.
They have invested heavily in infrastructure through lending and stimulus packages, leading to newly developed roads, railways, and bridges. Incentives should spur domestic spending on consumer durable goods, and most importantly, increased domestic wages should translate well into increased domestic spending.

However, no trade is without risk. Global demand for Chinese exports has softened. China’s largest trading partner is the European Union, whose recession could spell trouble for the Chinese economy. A tepid economic recovery in the United States will also mean lower Chinese imports.

The Chinese property market could also be an issue. There are currently government policies in place to discourage the speculative activity that has wreaked havoc in many other countries. There are massive efforts underway to build low-cost “social housing” for low-income people to help keep the real estate sector afloat.

ETF Recommendation: MCHI, the MSCI China Index Fund

Recommendation Two: In Europe, Look to Poland

Germany has been in arguably the best shape of any country within the euro zone. In Q1 2012, the country cut its 2012 growth forecast to 0.7 percent, expecting unemployment to decline from 7.1 percent in 2011 to 6.8 percent in 2012 and for private consumption to grow by 1.2 percent.³

Early in the year, Goldman Sachs expected a decline in real GDP of 2 percent in Europe in 2012. Areas outside the euro zone, such as the United Kingdom, Scandinavia, and Eastern Europe, should be less significantly affected by the pending recession.¹ At this writing, unemployment is in the high teens in Greece, and the low twenties in Spain. Interest payments in Spain, Italy, France, and Portugal are enormous. The continued lack of fiscal discipline in the euro zone ensures that the best thing to do here is to stay out.

The decade in Europe has also dragged down others parts of the world that export to Europe, mainly China and the United States. In February, Moody’s suggested looking to Poland and Russia for growth in Europe.⁴

Amidst the euro zone’s troubles, Poland has managed to grow. Growth in domestic spending has been fueled by a nearly 4.4 percent increase in the country’s average wage over 2011. While neighbors such as Hungary and the Czech Republic have contracted, Poland was expected to perform better than the rest of Europe.³ The Organization for Economic Cooperation and Development has expected this growth to slow to 2.5 percent in 2012.

ETF Recommendation: PLND, Market Vectors Poland ETF

Recommendation Three: Russia

Russian industrial production slowed in 2011. At the beginning of 2012, the International Monetary Fund said that Russia’s 2012 growth would slow to 3.5 percent, compared to 4.1 percent in 2011. Any significant changes to oil prices would severely disturb Russia’s growth.⁶ Depending on your view of oil, purchasing an ETF such as RSX, which allocates about 33 percent to Russian oil companies, could be a good trade.

ETF Recommendation: RSX, Market Vectors TR Russia

Author’s Note: This trade looked good as of initial writing (early 2012). When going to print (May 2012), the trade no longer looks quite as good due mainly to volatility in the oil market. Holding January to March would have resulted in a net gain, but January to May would have resulted in a net loss.

DOMESTIC OPPORTUNITIES

Recommendation Four: Go Long on the S&P 500

Sam Stovall, chief investment strategist at Standard & Poor’s, said in January that the S&P will end 2012 at 1400—an increase of about 13.5 percent for the year. As we go to print, this forecast still looks reasonable.

Stovall’s historical analysis suggests such a result based upon 2012 being the fourth year in a bull market, improving macroeconomic statistics, projected growth in S&P 500 operating earnings, and historically low valuations. Kiplinger has projected S&P 500 earnings to increase 6 to 7 percent.

Major risks include excess fallout from Europe and a political meltdown in the United States.

ETF Recommendation: Buy IVV, the iShares S&P 500 Index Fund

Recommendation Five: Follow the Best Sectors

With an eye to more domestic markets, we evaluated a number of S&P sectors to identify areas that could make for good trades. Keep in mind that throughout 2012, the U.S. has been (and will be) in a reasonably low-growth environment. Figures released in Q1 of 2012 from the Bureau of Economic Analysis show that Q3 2011 GDP growth in the United States was 1.8 percent on an annualized basis. At the same time, Goldman Sachs expected 2012 U.S. GDP growth to be less than 2.5 percent, with unemployment hovering around 9 percent.⁷ S&P has recommended going long on the Consumer Discretionary, Consumer Staples, Information Technology, and Industrials sectors.⁸

Consumer Discretionary⁹

S&P has expected consumer spending to increase 2.2 percent in 2012, driven by technological innovation, international expansion (especially into emerging markets), improved market targeting, and changes in consumer behavior (shifting to more online spending). This also takes into account above-average EPS growth from this sector in 2012.

ETF Recommendation: XLY, the Consumer Discretionary Select Sector SPDR
Dividends

Recommendation Six: Collect Industrials ETF
ETF Recommendation: VIS, the Van- set European issues.

solid growth in Asia, which should off - due to gradual growth in the U.S. and in this sector. Opportunities may open measures seen over the last few years come from the aggressive cost-cutting some concerns. Additional value could come from the aggressive cost-cutting measures seen over the last few years in this sector. Opportunities may open due to gradual growth in the U.S. and solid growth in Asia, which should off-set European issues.
ETF Recommendation: VIS, the Van- guard Industrials ETF

Recommendation Six: Collect Dividends
Buying dividend stocks has historically offered opportunities for growth through both capital gains and divi- dend income. With bond yields re- maining low, choosing dividend-pay- ing large cap stocks will offer more certain regular payments and extra safety not offered by small caps. Corporations have been sitting on piles of cash, so they will be safe even in the event of another recession.9
ETF Recommendation: VIG, the Van- guard Dividend Appreciation ETF

FIXED INCOME OPPORTUNITIES
Recommendation Seven: Go long on Municipal and Corporate Debt, and Short on Treasury Bills
With short-term rates effectively at zero percent, good domestic bond op- portunities are few and far between. Ten-year T-bills are near 2 percent. My recommendation is to short the treas-ury, as forecasts predict 10-year T-bill yields to reach three percent. If you’re looking for income, look to municipal bonds, high-grade corporate debt, and mortgage-backed securities.
Good bond opportunities:
ETF Recommendation: MBB, the iShares Mortgage Backed Securities
ETF Recommendation: MUB, the iShares Municipal Bond ETF
ETF Recommendation: CSJ, the iShares Corporate Debt
ETF Recommendation: PST, the ProShares UltraShort 7-10 Year Treasury. (Full disclosure: I am long PST.)

Author’s Note: As we go to print, PST has been losing money. Worries over pro- longed recessions in the U.S. and Europe have kept interest rate forecasts and expec- tations low. However, I maintain my outlook on a long-term basis.

COMMODITY OPPORTUNITIES
Recommendation Eight: Go long on Oil and Livestock
In early 2012, the U.S. Energy In- formation Administration expects oil prices to continue to rise into the fore- seeable future.4

Goldman Sachs increased its 2012 outlook for oil prices early in the year, based on potential sanctions to be taken against Iran from both the EU and the U.S.. Additionally, Iran had threatened to close the Strait of Hormuz, through which 35 percent of all crude oil shipped overseas travels.13
ETF Recommendation: OIL, the iPath S&P GSCI Crude Oil Total Return

Author’s note: As of this writing (early 2012), oil appeared to be a good trade. Oil purchased in January and sold in March would have yielded net gains, but if it were held through printing (May 2012), it would have yielded significant net losses.

Where will the other great opportu- nities in commodities be? Look to live-stock.16
In Q1 2012, the USDA expected that beef and poultry prices would rise this year, due to droughts in the southern United States and high feed prices, as well as strong beef exports. Similarly, lower-than-usual supplies of chickens and turkey have been expected to in- crease poultry prices.97
ETF Recommendation: COW, the iPath DJ Livestock ETN

CONCLUSION
2012 offers many opportunities for great trades, depending on your risks and preferences. Going long on the S&P 500 Index may offer satisfactory returns in 2012; going short on the Treasury offers the opportunity for greater returns looking out further into the future. For the truly risk seeking, move into Eastern Europe.
So what is the best trade for 2012? Go for the currency trade. Take advantage of the depressed EUR to USD exchange rate by exchanging your dollars for euros and going on a vacation. Just don’t take any Italian cruises.
ENDNOTES


