

27th November 2006

On the 24th, Americans sat down to dinner, bow their heads and give thanks. It was a holiday in the USA.

Yes, dear reader, we reckon 24th as an everyday we never stop working to achieve our goals. And what we see is a form of temporary insanity that takes over the multitudes from time to time. Sometimes it expresses itself in politics; sometimes in finances; sometimes in fashion and culture. We looked around on Friday morning and where do we see this collective insanity?

‘All of the above,’ is the answer.

Hedge fund managers bid millions for works of ‘art’ that would make a serious man choke himself laughing. No joke it’s a fact! This was featured on a BBC report I viewed last week. They commented that art market has never been flush in my opinion never more in need of flushing.

Today’s new art collectors are far more aggressive than previous generations, said the experts. They hire specialists to create multi-million dollar portfolios of what looks for the entire world like junk. Twisted bits of metal, Fabric samples, Paintings done with rollers for heavens sake or grotesque representations of the human form what next?

The Frieze in London brought in more than 60,000 gawkers when it put on a show of contemporary art recently. Sales of the stuff reached about \$65 million.

The so called expert continues by investing in artists at the beginning of their careers, explains an article in The Business, “it is possible to acquire a major work. There is also the warm glow of having given an artist crucial support before everyone else jumped on the bandwagon.”

How does the ‘hedge fund investor’ know there will be a bandwagon? What makes him think he can make money by buying bits of inanimate trash? What does this stuff yield?

“The art world has finely tuned antennae for those who put financial considerations before an interest in art. Any art buyer is expected to make a personal as well as a financial commitment; even the most hard-nosed dealer resents seeing artworks only appreciated in terms of accruing value Artists hate it when their works are sold like commodities.”

Here, I have to stop writing; due to laughing too hard. RIO’s Comment on the TV broadcast is that the presenter’s need to Getting a grip on them selves, what planet does they come from? Artists are delighted if anyone buys their stuff at all. “Appreciated only in terms of accruing value?” They should be overjoyed if it’s appreciated in anyway at all.

Agnes Gund, a famous collector, once noticed that her cat had appreciated a sculpture by Mary Frank, by using it as a litter box. Most contemporary artists would be lucky even to get that kind of attention. And as for financial appreciation - well, ha ha ha

Meanwhile, in the world of finance, we are spoiled for choice. Last week, we mentioned Google. The stock shot up over \$500. At that price, an investor has a choice. He can earn the ‘risk free rate of return’ from Treasuries - which, for the purpose of sticking with round numbers, we will say is 5%. Or he can buy a stock - Google - with an earnings yield of 1.8% and enough risk to satisfy a teenaged skydiver.

We also learned a few days ago that Sam Zell had sold out. It was the biggest, most important property transaction since the Louisiana Purchase, said the US press. Today, we discover a bit more about the terms and conditions of sale. The buyers, a subgroup of BlackRock, Inc., paid \$5.4 billion for a couple of big properties in New York City.

RIO's comments are that they have forgotten the old and golden rule of thumb which is that New York property costs its owners about 10% per year - in taxes, maintenance and operational expenses. So, at today's 'risk free rate of return' a buyer needs to get 10% to cover his cost and another 5% or so to come out even with Treasury bonds. But the BlackRock group didn't even come close. Five percent of \$5.7 billion is \$270,000 million. But the projects' estimated rental income is only about \$170,000 per year. **In other words, investors aren't even covering their interest cost - to say nothing of their operating expenses.** And with the property market about to take a pounding in the US, what are they thinking?

The same thing Google buyers are thinking and 'art' investors are thinking that bear markets may have existed in the past, but they won't exist in the future. Yes, property, stocks, the economy even bonds and the dollar may have fallen in the past, but never will they do so again. Everything only goes up, forever and ever ...Amen. This leaves me lost for words except that theirs a large herd of sheep out there ready to be lead straight to the slaughter.

But it was Thanksgiving and we are thankful to BlackRock, Google and all the others who make our world so entertaining.

But let's look at Google. Is it really a technology company? Maybe it is not? It earns its money from what looks like the publishing business - advertising. People go online and Google for something. Google knows what they are looking for. It can target its advertising, and focus readers' attention on new products and services just when they are most keen to buy - When they're looking.

The technology behind it is the computer program that connects seekers to the sought after. We don't know anything about it, but we can imagine that there are many other smart young people figuring out new and better computer programs to do this.

So, let's look at Google as a publishing business. Roughly, it has a market cap of more than \$150 billion, revenues of \$10 billion, and profits of \$2.8 billion. A very nice company but what is it worth? If you project recent rates of growth into the future, it could be worth \$500. If profits were to double and double again it would be trading at a reasonable multiple of earnings. But if earnings don't go up 300%, it is over-priced.

What's more, as a publishing business, Google has a major flaw - it has no firm connection with its readers. People do not think of themselves as 'Google customers,' the way they often identify themselves with a local paper, a newsletter, a magazine, or even a website. For example, many people are actually proud to be New York Times readers (if you can believe it). Google is largely invisible, like a pane of glass. It does not 'own' its customers. Instead, customers will desert it - as they did Yahoo - as soon as something newer, better, and faster comes along. Then, Google will be yesterday's news.

That may be happening already. From the second quarter to the third quarter, Google earnings grew 11% or only two-thirds the rate of the same period a year ago. Earnings growth is slowing down, in other words. Just like it always does with new technology companies. When investors realize what is happening they are likely to desert Google too - and buy into the next hot thing.

William Gray
Executive Chairman
The RIO Club