

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

May 2009

Featured Companies:

iShares Dow Jones US Insurance (IAK) / Brown & Brown Inc. (BRO)
Vanguard Extended Duration Treasury Index ETF (EDV)
Market Vectors High-Yield Muni ETF (HYD) / (EDV)
Google Inc. (GOOG)

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Murray's Musings

The S&P 500 SPDRs as a Hedge in Equity Investing

Before embarking on the subject for this issue of the *Devil's Advocate Report Compendium*, which is the use of the S&P 500 SPDRs as a hedge in equity investing, it is worthwhile making a small detour to consider the use of language in financial writing. Though it may seem irrelevant to the subject at hand, the reason for including it will become apparent in due course.

If one wished to undertake a negative analysis of financial events, the range of synonyms at a writer's disposal is extraordinary. If I wished to discuss bad events, I could use the words catastrophe, tragedy, disaster, crisis, horror, calamity, misfortune and so on, whereas if I wished to argue the reverse, the array of appropriate words is more limited and less descriptive. Similarly, the adjectives available to a writer describing a negative scenario are more evocative than those for a positive scenario. One can use adjectives such as looming, to say that there is a looming crisis, a looming tragedy, or a looming catastrophe. It would be inappropriate to use that adjective when describing a good scenario.

Similarly, almost all of the symbolism that comes from Greek mythology is associated with terrible events: the sword of Damocles, the Sisyphean struggle, a Pyrrhic victory, the flight of Icarus. They all have negative connotations. There are no positive parallels to those examples of mythological symbolism. Therefore, the range of language available to the financial writer is skewed in a certain sense that I believe affects cognition which, in turn, affects financial behavior. The specific manifestation that we'll consider today is the use of the S&P 500 as a hedge.

Table 1 (on the next page) shows earnings and dividends for the S&P 500 as reported from 1997 to 2008. It also shows the S&P dividend yield based on the S&P prices at the end of the year. It might not have been expressed in the financial press, but it's rather astonishing that the S&P 500 reported dividends for 2008 rose relative to 2007 from \$27.73 per unit to \$28.05, which is a modest increase of 1.1%, but it's an increase nonetheless. This increase occurred despite the various dividend cuts that occurred in financial institutions, which were a not small component of the S&P dividends. It's not clear that this situation would be arithmetically repeatable in 2009. Based on my own analysis, it's likely that the S&P dividends on a reported basis will decline in 2009.

The S&P reported earnings in 2008 were \$65.39, which is a decline of 20.8% relative to the \$82.54 reported in 2007. In 2001, S&P earnings declined from the 2000 figure by 30.8%. Including all of the unprecedented write-offs experienced in 2008, the decline in earnings was less in 2008 than in 2007. The S&P earnings in 2009 would need to fall to a level of \$57.11 merely to match the percentage earnings decline in the 2001 year. Even if they did so (and it might actually happen), the resultant earnings of \$57.11 would still be slightly more than 47% above the 2001 reported earnings.

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Table 1: S&P 500 Dividends, Earnings and Dividend Yield

Year	Dividends	Earnings	Dividend Yield
1997	\$15.52	\$44.09	1.60%
1998	16.20	44.27	1.32%
1999	16.71	51.68	1.14%
2000	16.27	56.13	1.23%
2001	15.74	38.85	1.37%
2002	16.08	46.04	1.83%
2003	17.88	54.69	1.61%
2004	19.40	67.68	1.60%
2005	22.38	76.45	1.79%
2006	25.05	87.72	1.77%
2007	27.73	82.54	1.89%
2008	28.05	65.39	3.11%

In order to match the decline in percent terms of 2001 we “need” another 12.66% decline in earnings. In addition, to reach the 1997 earnings level from the current level, we “need” a 32.57% decline in earnings in 2009. At its low, the S&P 500 unit value declined to the 1996 levels; therefore, the earnings experience was not as dire as that of the unit value. On May 1, 2009, the unit value of the S&P closed at 877.52.

If one undertook to sell short the S&P 500 SPDRs (SPY) as a hedge on December 31, 2006, at a unit value of 1,418.30, it's obvious what the resultant profit would have been. Let's assume as an alternative that the individual interested in undertaking a hedge purchased the VIX Index on December 29, 2006 at 11.56.

Table 2: Closing Yearly S&P Levels

December 1996	740.74
December 1997	970.43
December 1998	1,229.23
December 1999	1,469.25
December 2000	1,320.28
December 2001	1,148.08
December 2002	879.82
December 2003	1,111.92
December 2004	1,211.92
December 2005	1,248.29
December 2006	1,418.30
December 2007	1,468.36
December 2008	903.25
May 1, 2009	877.52

On May 1, 2009, the VIX Index, which actually declined considerably from its high, was at 35.3. Therefore, the rate of return on that trade as a hedge, relative to the rate of return of shorting the S&P, was 205.3%, which is far in excess of the return that would have

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been achievable had one merely shorted the S&P. It's interesting to note that the VIX Index on November 20, 2008 reached a high of 80.86. Assuming that one would've been prescient enough to sell the VIX Index at that point in time, the rate of return for that period would have been several basis points shy of 600% which, again, would have been far in excess of the achievable return from shorting the S&P.

If one had shorted the VIX on November 20, 2008, the equivalent action would have been to buy the S&P Index, which was at 752.44 and is now at 877.52. Not counting dividend income, the rate of return would have been 16.6%. If one had sold short the VIX at 80.86 then, using the May 1, 2009 VIX value of 35.3, the return would have been 129%.

Nothing in these results should be surprising, because it's all discussed in theoretical terms in a book called *Market Volatility* by Professor Robert Shiller of Yale University. His basic thesis is that whatever the economic fundamentals, whether positive or negative, the market tends to overreact to them. As a measure of volatility, the VIX is more an expression of market psychology than the S&P 500 index itself, because the VIX measures risk, uncertainty and perhaps fear, which makes it arguably a more effective hedge than the S&P 500.

At low VIX levels and high S&P levels, going long the VIX is superior to going short the S&P. At low S&P valuations and high VIX levels, going short the VIX appears to be superior to being long the S&P. It turns out that the S&P SPDRs is, at the moment, the most popular hedging vehicle, with daily trading volume of 236.1 million units. Recently, iPath, a division of Barclays, introduced Exchange Traded Notes (ETNs) on the short-term and mid-term VIX futures, which didn't exist until several months ago. At the moment, the mid-term VIX futures ETN, measured in units, has a daily trading volume of 12,300. The short-term VIX futures ETN, measured in units, has a daily trading volume of 140,355.

My prediction is that ultimately the VIX ETNs, or other similarly constructed vehicles, will far supersede the volume of the S&P. It may be possible that those with more ingenious minds than I have will find actual trades for being simultaneously long and short the VIX and the S&P. There may be some interesting trading relationships to be undertaken in that sphere.

This situation is important for *Devil's Advocate*, because in the text of the recommendations for this issue we will look at some ETFs. The veritable explosion of ETFs opens up many possibilities for being short and long different variables that didn't exist several years ago.

Industry Thoughts

Master Limited Partnerships (MLPs)

In this issue I'll create yet another create another industry categorization. This one is the industry of Master Limited Partnerships, or MLPs. I'll compare MLPs in their limited partner (LP) incarnation to their general partners (GPs) that manage the LPs, and are publicly traded. The GP, in its publicly traded incarnation of an LP, makes an investment in the LP, and then manages the LP. The GP gets an LP return, and also earns management fees and incentive fees for managing the LP. Definitionally, the GP should do better than the LP.

Depending upon the GP itself, the incentive fees, like all incentive fees, have certain hurdles that need to be crossed before substantial amounts of money can be earned. Most of the MLPs in question are involved in the energy business. The energy business has been under pressure during the last year due to the decline of energy prices; therefore, as energy prices declined, the prospect of earning the incentive fee became increasingly more remote. As a result, several months ago, the publicly traded GP units and LP units traded at very similar yields; yet, they are not similar vehicles.

In recent months, as energy prices have begun a modest increase, and the prospect of earning an incentive fee is somewhat less remote, the GP units have begun to trade at slight yield discounts, or slightly lower yields, than those of the LP units. Taking Buckeye Partners LP (BPL) and Buckeye GP Holdings (BGH) as examples, the LP interest yields 8.92% at the moment, and the GP interest yields 7.63% for a spread of 129 basis points. As noted previously, the spread was less in prior years.

Similarly, Penn Virginia is unusual in this industry because, in addition to the general partner (PVR) and the limited partner (PVG), this company also has the corporate form (PVA). Penn Virginia has very extensive reserves of both coal and natural gas, both of which have yet to stage meaningful recoveries from the price drops that occurred over the past year. The Penn Virginia LP yields 14.52% and the GP yields 13.16% for a spread of 136 basis points.

If one held the view that energy assets will be more valuable in the future rather than less valuable, the reasonable course of action would be to sell short the LP for a small negative carry, and to go long the GP. The small negative carry represents the optionality that's involved in controlling the GP incentive structure, if that ever proves to have economic value. As noted at the outset, the prospect of earning substantial incentive fees, given the evaluation of securities, appears to market participants to be rather remote. This approach is functionally equivalent to making an investment in energy assets, but it appears to be a much more risk averse manner. To control the assets in this way requires much less risk and much lower levels of capital.

Featured Companies

iShares Dow Jones US Insurance (IAK)/Brown & Brown Inc. (BRO)

The first recommendation in this section is the short sale of the Exchange Traded Fund called the iShares Dow Jones US Insurance (IAK) and, on a dollar equivalent basis, this trade should be paired against a long position in the insurance broker known as Brown & Brown (BRO). The IAK has as constituent members the largest insurance companies in America. The top ten positions are Travelers, Chubb, MetLife, Allstate Prudential, AFLAC, Loews, Progressive, UNUM, and Principal Financial. The insurance business in the United States is more or less saturated. It's clearly correlated with economic growth; it's also correlated with the value of real assets that need to be insured. For the last decade, it's been very hard for the insurance companies to grow tremendously, even for the better managed companies.

A good example is Chubb, which is one of the better managed insurance companies. The Chubb stock price has not manifested very much progress in the last five years. It has repurchased 10% of its shares, which to a certain extent is a statement about low valuation, but it's also a statement about its inability to profitably employ earnings in the enterprise. Total assets at Chubb Corp. were \$44.3 billion in 2004, while at the end of 2008 they were \$48.4 billion. Chubb, at least as an enterprise, is growing more or less like the economy, and it's reasonable to assume that will continue to do so.

The government plays a role in this situation, because it has recently undertaken to reverse years, perhaps decades, of financial services concentrations. The regulators apparently agree that they do not wish to permit the existence of another American International Group. They want to avoid the evolution of more companies that are systemically crucial to the U.S. financial system. Returns on capital for these companies are going to be lower. A contributory factor to low returns is that the insurance companies invested their capital largely in fixed income securities, for which the rates are very low. In addition, these companies have the prospect of reduced financial leverage.

The insurance business is saturated, but the insurance brokerage business appears to be much more vibrant. The insurance solutions that clients need usually involve spreading risk among an increasing variety of insurance providers, which requires the services of brokers in ever-increasing measure. There's also the further variable that the insurance brokerage business is going through a period of consolidation, which is really not possible to be emulated by the insurance business itself. The earnings of an insurance broker like Brown & Brown are growing more rapidly than the collective earnings of the insurance industry itself.

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Table 3: BRO Net Income History

Year	(\$ in millions)
2008	\$166.1
2007	190.9
2006	172.3
2005	150.5
2004	128.8
2003	110.3
2002	83.1
2001	53.9
2000	32.8
1999	28.3

Another difference is that catastrophic events like Hurricane Katrina would not reduce the surplus capital of the insurance brokerage as it would for the insurance industry. The periodic occurrence of such calamitous events is definitely a negative for the insurance industry in the sense that they diminish the industry's capital, which has to be replenished from some source. These events don't have any impact at all from the point of view of the brokerage industry.

The brokerage industry is prospering to a greater extent than the insurance industry from the exact same variable. Brown & Brown is a croupier inside of the insurance industry. To review, a croupier is a financial intermediary that doesn't risk its capital, as opposed to the financial intermediaries that do risk capital. The croupier seems to perform better.

One can construct a similar trade by replacing Brown & Brown with Willis Group (WSH) as the long position, or one could use Willis Group and Brown & Brown as a brokerage index. There are other publicly traded brokers that haven't done as well. There's Marsh & McLennan, which was involved in some skullduggery several years ago, from which they have yet to recover. There is also A.J. Gallagher, though that company doesn't appear to be as well managed as Brown & Brown. Nevertheless, even A.J. Gallagher would produce a superior return to the industry itself. The trade, therefore, is long insurance brokers like Brown & Brown and Willis Group, and short the insurance industry in its ETF incarnation called iShares Dow Jones US Insurance (IAK).

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Vanguard Extended Duration Treasury Index ETF (EDV)

Here is a simple short sale recommendation on the ETF called Vanguard Extended Duration Treasury Index ETF (EDV). One could engage in an equivalent strategy by shorting the United States Treasury STRIPS, because EDV is a STRIPS fund. STRIPS, by the way, is an acronym for Separate Trading of Registered Interest and Principal Securities, which means that STRIPS are Treasuries with their income components and principal components segregated, or stripped, from one another, hence the name STRIPS.

STRIPS have the unique characteristic that their duration is equivalent to the maturity of the bond, which is very unlike a mortgage or a typical bond; it is a pure time value instrument. The Vanguard STRIPS ETF in question is comprised of 47 bonds, all of which are STRIPS. It has a yield to maturity of 3.8% and a duration of 25.4 years.

The current long-term Treasury rates, with the exception of last month, are about the lowest they've ever been. The obvious reason for the low rates is that the economy is exceedingly weak, and the Central Banks of the world, not the least of which is the U.S. Federal Reserve, have undertaken extraordinary actions to lower interest rates and keep them low until the economy recovers. In addition, the United States Congress has enacted a major stimulus package that requires borrowing a lot of money.

According to the law of supply and demand, when demand for borrowed money is high, the price of money, which is interest rates, should ultimately go higher. If the current yield of the Treasury bonds goes higher, the best way of profiting from that is to be short the STRIPS because, by definition, its long duration makes it the most interest rate sensitive of all bonds.

As can be seen in Table 4 (next page), during the inflationary time of the late 1970s, the average annual 30-year Treasury rate ranged from 7.75% in 1977 to as high as 13.45% in 1981. In a more benign period of time from 1996 to 2000, the long-term Treasury yielded as high as 6.71% in 1996 and as low as 5.94% in 2000. These figures are averages, not the actual lows for the year. Even in the recessionary 2002 year, the 30-year Treasury yielded on average 5.43%.

The current 30-year Treasury yield is 4.07%. The Vanguard fund (EDV) has the unique distinction that its yield is lower than a portfolio of STRIPS, because there's a 15 basis point fee, so there's a carry advantage. When one shorts the EDV, one has a negative carry. There's a carry advantage in shorting the fund as opposed to shorting the STRIPS, although they're otherwise identical trades, in that the fee is a diminution of the negative carry.

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Table 4: Average Annual 30 Year Treasury Rates

Year	Interest Rate	Year	Interest Rate
1977	7.75%	1993	6.59%
1978	8.49	1994	7.37
1979	9.28	1995	6.88
1980	11.27	1996	6.71
1981	13.45	1997	6.61
1982	12.76	1998	5.58
1983	11.18	1999	5.87
1984	12.41	2000	5.94
1985	10.79	2001	5.49
1986	7.78	2002	5.43
1987	8.59	2003	-
1988	8.96	2004	-
1989	8.45	2005	-
1990	8.61	2006	4.91
1991	8.14	2007	4.84
1992	7.67	2008	4.28

From Feb. 18, 2002 to Feb. 9, 2006, the US Treasury discontinued 30-year Treasury issuance.

It's worthwhile noting that from February 18, 2002 to February 9, 2006 the U.S. Treasury discontinued issuing 30-year Treasuries. It's only recently that the Treasury decided to begin issuing them again. It's not hard to understand the motivation: interest rates are very low. The United States debt is weighted very heavily to the short term and, like any good manager of interest and debt liability, when rates are low it's much better to extend that liability. It's reasonable to anticipate that, apart from issues of a deficit, the Treasury may well wish to sell more, not fewer, 30-year Treasury bonds. The mere issuance of supply might have some impact on this.

If the long-term Treasury rate merely returns to the benign 2006 interest rate level of 4.91%, making it, in the context of history, not far above current levels, then the short would return 17.11%. Obviously, if long-term rates return to the high of 5%, or over the 6% level, this trade could provide a very high rate of return. Unlike a standard short position, there's no risk of takeover. It's hard to imagine that rates could go much lower from these levels.

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Market Vectors High-Yield Muni ETF (HYD)/Vanguard Extended Duration Treasury Index ETF (EDV)

Understanding the logic of shorting the Vanguard Extended Duration Treasury Index ETF (EDV), there's another type of trade that could be done. It could be converted into a pairs trade in which one would short the EDV and pair it on a dollar equivalent basis with going long the Market Vectors High-Yield Muni (HYD).

The characteristics of the HYD are as follows: a 35 basis point expense ratio, a distribution yield of 7.07%, a yield to worst of 9.3% (because most of the bonds trade at well below par), an average time to maturity of 18.61 years, and a duration of 8.29 years. The duration is an important point, because it is very different from that of the EDV. The average credit quality is also very different, because these are low-grade municipal bonds, which have a pronounced tendency to default. The average credit quality as rated by Moody's is Ba1 and BBB by S&P.

According to a study by Fitch, the cumulative default rate on municipal bonds generally during the period from 1980-1986 was 1.5%. The default rate between 1987 and 1994 was 0.63%. This study embraced 2,339 instances of actual municipal default. Since most of the studies embrace municipal default, that statistic is very misleading, because it overlooks the nuance that most of the defaults occur in the low-grade municipal bonds.

The cumulative default rate for low-grade industrial revenue bonds, which comprise a not inconsiderable portion of HYD, is 14.62%. This cumulative default rate measures the default rate in each year through the life of a portfolio of low-grade industrial revenue bonds, and adds them together. The cumulative default rate over a 20-year life is 14.62%. It's even higher, believe it or not, for hospital bonds, which have a cumulative default rate of 17.03%.

Let's convert these figures into more usable statistics. If one bought a portfolio of hospital bonds with a 20-year life to correspond more or less to the 18.61 year life of this fund with a 17.03% default rate, it would amount to an 85 basis point default rate per year. That statistic means that a little bit less than 1% of the bonds in this portfolio, assuming they were all hospital bonds of low grade, would default in any year.

The average recovery rate in a municipal default is 68.33%, and the reciprocal of the recovery rate is the loss rate. For example, if the recovery rate were 68%, the loss rate would be 32%; one would lose 32% of one's investment, assuming one made the investment at par. In this particular case, since the recovery rate is 68.33%, the loss rate (the unrecoverable portion) would be 31.67%.

If one multiplies the 31.67% loss rate times an 85 basis point default rate, that should, in principle, give one the number of basis points one loses by default in any given year. In this example, it works out to be 26.9 basis points. Given the distribution yield, not the yield to maturity, of the HYD, if one were to subtract 26.9 basis points (let's round it to make it 27 basis points) from a distribution yield of 7.07%, one still has a tax advantaged

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rate of return of 6.8%, assuming no appreciation whatsoever. This strategy becomes a positive carry trade, even assuming a very high default rate.

This default rate is further mitigated by the fact that most of the low-grade bonds in this fund trade well below par value. If one assumes, as one should, that the average bond in this fund already trades at between 75% and 80% of par value, and one calculates the loss rate as in the previous example, one would see that the loss rate is actually de minimis. For example, if one were calculating at 75% of par value, which is the current price at which the fund holds the bonds, and given a recovery rate of 68.33%, the typical loss rate would only be 6.67%. Using an 85 basis point default rate in any given year, the economic loss from default per annum should be no more than 6 basis points.

The better way to calculate this loss rate would be to use the yield-to-worst, which is 9.3%, rather than the distribution yield. Yield-to-worst is a much better measure of the economic value of the bonds. This low-grade municipal portfolio trades, if you're using yield-to-worst, at 2.28 times, or a 228% yield advantage to the 30-year Treasury, and an even greater yield advantage to the EDV in its STRIPS incarnation.

All of the above is a longwinded way of saying that I think the market has very improperly valued this segment of the municipal bond market. It discounts a negative scenario that is not likely to materialize and, therefore, the credit spread between HYD and Treasury should, in principle, narrow. To take the other extreme, if instead of yielding 228% of the Treasury, it were ultimately to yield, let's say, 114% of the Treasury (and that's not actually so extreme, given the fact that municipal bonds typically yield less, not more, than Treasuries), a given trader making this investment would double his or her money, not counting the positive carry. This trade is very interesting, and it is easily constructible, so I'm recommending it.

Google Inc. (GOOG)

The fact that I'm making a short sale recommendation on Google will surprise some people, but the reasons will become clear momentarily. First I will say a number of positive things about Google. It's hard to say negative things about Google; in fact, it's impossible to make negative comments about Google in terms of cash flow, rate of earnings growth, market share domination, gain in market share or management vis-à-vis its erstwhile competitor Yahoo and the lesser search engines. Google has a war chest from which it can make acquisitions; it has also proved to be more technologically adept and more astute at pricing its product. I think that Google is far superior in every conceivable way that one can compare a company to its competitors.

More to the point, Google doesn't even have a high valuation. If one were to accept the consensus Google earnings forecast, which is a not implausible hurdle to achieve, the company trades at 21.66x projected 2009 earnings and only 18.8x projected 2010 earnings. Those earnings are achievable. Against those conditions, I can only say one

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negative thing about Google, and that will animate the recommendation, which is not to short Google as such, but to buy a put against the company.

In one limited sense, Google's business model can be said to be based on the 1998 Digital Millennium Copyright Act, a provision of which created the Online Copyright Infringement Liability Limitations Act. This act is a safe harbor within the larger Digital Millennium Copyright Act that basically exempts online providers from copyright litigation for making use of copyrighted material from other providers, like a newspaper, for example.

Section 512A of the Online Copyright Infringement Liability Act is probably what Google would rely upon if it ever came to litigation, because within the meaning of that section, it would regard itself as a passive conduit of information that is in the public domain. In other words, Google merely makes this information available to its universe of readers; it doesn't alter the information in any way, nor does it incorporate it in any other content created by the company. It's only a means of searching for content that the reader wishes to search for. In most cases, one is directed to the website of the creator of the material that presumably makes that website available to the public for free.

We would agree that Google is more or less immune to litigation. Irrespective of that fact, Google does sell advertising and earns a lot of money from it. Believe it or not, 98% of Google's revenue is derived from some form of advertising. This whole business model is based on the notion of externality. The cost of creating the searched-for content which, in sum, is quite considerable, is not expensed by Google at all, but is born by the creators of that content. The bulk of the revenue from the advertising-based model, however, is earned by Google.

As the months and years progress, the marginal tendency of a given reader to obtain the searched-for content through an Internet device, as opposed to through a hardcopy, is growing. With each passing month, Google becomes more dominant, not less, and it has more users, not fewer. This situation puts immense pressure upon the content providers to the point that many of them are losing money. One example, but certainly not the only one, is *The New York Times*.

Ultimately, the success of Google contains the seeds of its own ultimate problem. The conventional providers of content assert that they wish to be paid. They have, at best, a very poor and, at worst, no legal case for compelling Google to pay them anything, though there have been a few examples of the company paying for very limited amounts of content. Those payments, however, are hardly sufficient to support the advertising model generated by the content creators inasmuch as they seem to be losing advertisers, readers and subscribers with every passing month.

If this set of circumstances is carried to its logical conclusions, the content providers will be unable to provide content; therefore, it's not relevant whether or not the content providers have any grounds to sue Google. Neither do they have the wherewithal to compel Google to pay them, other than by making public statements. However, the mere

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fact of the externality is enough to put the Google business model in some jeopardy if it continues for a sufficiently long period of time.

What I would recommend is to buy the Google January 2011 \$300 puts. On May 13, 2009, they were trading at \$32.60 bid, \$36.00 ask. Google's current net margin is 28.5%, and it's not inconceivable that in the short run that net margin will rise. There are very few instances of companies achieving margins of that level that are able to sustain them for any period of time. The reason is that companies like that become so profitable that they end up demolishing their competitors, which Google is arguably in the process of doing. In fact, Google is demolishing its content providers, with which it doesn't have, technically speaking, a business relationship.

Let us assume that Google undertook, on a pure enlightened self-interested basis, to pay its providers for content, merely to keep the business model alive, and let's presume that those payments were sufficient to reduce Google's net margin to the 10% level. If that were the case, Google's earnings would decline by 61-62%. If that scenario had occurred in the first quarter, Google would've earned \$1.71 a share relative to what it currently earns.

On a ceteris paribus basis, if this practice were continued, in 2010 the projected earnings would have to be changed to \$7.94. Even if Google were to trade at a multiple comparable to the 20x that it trades at now, its shares would trade at \$158.80, and it might not trade at a 20x multiple. Given that scenario, the intrinsic value of the \$300 puts would be \$141.20, for an ROR of 271%.

This trade is not likely to succeed in the short run, because there's very little prospect of Google paying for content in the near term. I would also argue that there is very little prospect of Google sustaining the current model in which it obtains, at no cost to itself, massive and ever-increasing amounts of content that serves an ever-expanding universe of viewers and advertisers. Ultimately, something will happen. Therefore, some type of put-oriented trade is appropriate with regard to Google.

Q: Is it not the case that in the future Google will still be able to obtain its content largely for free, because it will be made available by the universe of billions of technologically savvy, so to speak, users that will create user-generated content?

A: I will comment on that question in two respects. First, the consensus view is expressed in the question, and there's something to be said for it. After all, there's an ever-expanding universe of individuals, already numbering in the billions, who are capable of posting their own content on the web, and many of them are already doing so. The problem with it is that the content, however intriguing and illuminating, cannot be the basis for an advertising-dominated model.

The reason is that, by definition, it's fragmented. The users post content that is interesting to them, but is not necessarily interesting to a large base of viewers. Only content that's interesting to a large base of viewers could ever be the basis for an

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advertising generated model, because the advertiser is interested in not merely low-cost per impression but, in the case of the Internet, in the potential of billions of impressions.

Second, the content that's posted by the users is not uniform in quality. Its mass is such that the problem of selecting what might be interesting is mathematically irreducible. How do you select from billions of users that which might be interesting for the mass public? Also, it's not available on a time systematic basis. Whatever deficiencies newspapers have, they are produced reliably every day. Each day there's news that, in principle, is eagerly awaited by the mass of news consumers.

User-generated content cannot, and will not, be produced upon a similar schedule or even upon a similar scale. Eric Schmidt, Google's CEO, commented upon this problem, and I agree with his view, which is that while the bulk of the user-generated content might be able to obtain a fee, it'll be a fee for the content, not an advertising support model. His idea, shared by myself, is that there'll be a micro-charge, let's say, a penny per view.

It'll be a business for those entrepreneurs that wish to charge for a view, but then the problem is how the universe of users will know that interesting content is available at a certain location. It's going to be exceedingly difficult to find. News is time sensitive. The only way to produce news within the time frame demanded by the users is to have a large infrastructure that can generate it, literally, within minutes. I don't think that's going to be the savior of Google, even though it is the consensus view.

Another point in that regard is that the mass of material produced for services like YouTube or Facebook is so vast that it requires more and more expensive servers to provide access to all that posted material. The cost has been rising at such a precipitous rate that Facebook and YouTube are losing money in their current incarnations. It's not clear when they might be profitable, if ever.

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

APPENDIX A

Money Manager Index

From Jan 1983 to April 2009

From Jan 1983 to April 2009														Annualized return		
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49									2009	79.49	17.1%	18.5%

<u>Name</u>	<u>Amount Invested</u>
Affiliated Manager	\$ 22,947
Alliance	\$ 7,633
BlackRock	\$ 23,205
Waddell & Reed	\$ 27,513
Eaton Vance	\$ 2,641
T. Rowe Price	\$ 2,423
Franklin resources	\$ 908
Legg Mason	\$ 1,000
Federated Inv	\$ 26,381

<u>Name</u>	<u>Amount Invested</u>
Pzena Investment Mgt	\$ 122,426

THE DEVIL'S ADVOCATE REPORT COMPENDIUM

APPENDIX B

International Money Manager Index

From Jan 1983 to Apr 2009

Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	Annualized return (since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63									2009	19.63	24.3%	14.1%

<u>Name</u>	<u>Amount Invested</u>	<u>Name</u>	<u>Amount Invested</u>
IGM FINANCIAL INC	\$1,000	HENDERSON GROUP PLC	\$14,447
F&C ASSET MANAGEMENT PLC	\$1,203	RAB CAPITAL PLC	\$24,603
INVESCO PLC (PREVIOUSLY AMVESC)	\$1,357	AZIMUT HOLDING SPA	\$21,908
SCHROEDERS PLC	\$1,208	AUSTRALIAN WEALTH MANAGEMENT	\$27,789
RATHBONE BROTHERS PLC	\$1,208	EVEREST FINANCIAL GROUP LIMITED	\$23,437
ABERDEEN ASSET MGMT PLC	\$1,208	CHARLEMAGNE CAPITAL LTD	\$36,848
CI FINANCIAL INCOME FUND	\$2,585	PARTNERS GROUP-REG	\$36,848
MAN GROUP PLC	\$2,862	INVISTA REAL ESTATE INV MNGT	\$36,589
AGF MANAGEMENT LTD-CL B	\$3,343	ASHMORE GROUP PLC.	\$36,688
SPARX GROUP CO LTD	\$11,762	BLUEBAY ASSET MANAGEMENT/UNI	\$37,469