CHAPTER 12
PLAYING IN THE MAJOR LEAGUES

In February of 1989, I drove into downtown Indianapolis. Rolling clouds cast shadows on the White River and splashed across the Indiana State House rotunda. In the low winter sun, numerous mirrored office buildings illuminated downtown Indianapolis. Gold, green, silver, and blue lights reflected off building after building, cascading down streets and across parking lots creating a kind of light show. I was in Indianapolis on a so-called big game hunting expedition. My colleagues in our Indianapolis headquarters asked me to host a seminar explaining my High-Dividend-Yield investing strategy to a group of high-net-worth investors at the prestigious University Club.

As head of the investment management division and co-manager of the firm's equity recommendation team with my partner, Tom Lynch, I gave stock buy and sell recommendations via teleconference every Monday morning to our stockbrokers and investment bankers. Tom and I also wrote a monthly publication called "The Market Trend Portfolio" (MTP) that had a readership in the thousands, which discussed our recommended buys and sells and tracked the performance of the MTP. Our performance had been tracked since 1985 and had outperformed the S&P 500. My partner in the MTP, Tom Lynch, was also my partner in the investment advisory division.

During the seminar, I was to give my views of the overall stock market and discuss selected buy-recommended stocks with the group before dinner and introduce the new dividend strategy after dinner. When I first saw the agenda, I was concerned that everyone might get up and leave after dinner and not wait around for my dividend story. That turned out to be incorrect. In fact, more people arrived after dinner to hear the story.

I used an analysis of several electric utilities, telephone companies, and energy stocks that the attendees would know to introduce the High-Dividend-Yield strategy. The spreadsheets showed that each company's high dividend yield and rising dividend payments could produce attractive returns in a flat interest rate environment but would perform even better if interest rates continued to fall. Based on the strategy's success among my Evansville clients, I expected it to be met with enthusiasm. I was wrong.

The audience's early questions challenged my assertion that interest rates would fall. I presented one chart showing the tight correlation between interest rates and inflation. A second chart showed inflation was trending lower, and Fed Chair Alan Greenspan spoke often of inflation still being too high.

There were other questions regarding the risks of nuclear utilities and regulatory environments in Indiana and neighboring states. The last question of the night may have been intended to disparage my strategy but allowed me to make a solid argument in its favor: "Why should I pay someone to manage a portfolio of utilities when the companies are so much alike?"

"Well," I said, "if someone worked hard enough at it, they could own and manage high-yield stocks just as they could with any other type of company. But based on my research, there are surprising differences among the high-yield companies that cause their risk profiles to be quite different."

I asked for a show of hands of those who owned or had owned either Northern Indiana Public Service or Public Service of Indiana. About a third of the attendees slowly raised their hands.

"That's my point," I said. "Those two companies delivered great returns for years until their managements' bad nuclear plant decisions nearly destroyed both. Also, neither faced up to the problem until it was too late. Both companies are barely alive today.

"The years of success and good relations with their regulators lulled everyone to sleep," I said. "By the time we all understood what was happening, both stocks had fallen precipitously. Yet, if one looked closely enough at their financial statements, even during the good years, both companies' earnings were inflated.

"A big percentage of their reported earnings per share came from the non-cash returns they were accruing via the allowance for funds invested during the construction of the ill-fated nuclear plants. When it became clear that those plants would never be built, all those paper profits dissolved, revealing companies that were in big trouble. Unless one understood how much of those companies' earnings were phony, they looked great."

I explained that my research revealed a surprising number of blowups among the utilities. Utilities and other quasi-monopoly companies were not one-decision investments, I told them. "They require in-depth analysis to peg their true value, level of risk, and a watchful eye glued to the cost-benefits of their big capital spending projects. These companies are low-risk but certainly not no-risk."

By the time I finished, most of the guests were nodding their heads in agreement, and from this, I concluded it had been a good night. But to my dismay, after speaking to many attendees after the meeting, no one seemed ready to sign on. After a few more pleasantries, the guests drifted away.

A young investment broker approached me and asked if I had any institutional clients who used the strategy. I explained we did not because the strategy was so new to us. He said he believed he could arrange a meeting with a large local insurance company and asked how long I was planning to stay in town. I told him I had two more days of client meetings but could stay longer to meet with the insurance company.

The minute I walked into our home office the next morning, the young broker rushed in with a thick binder of paper.

"Here's the insurance company's portfolio I was telling you about last night. We're on for a meeting tomorrow at 2:00 p.m."

"Wow!" I exclaimed. "How in the world did you accomplish this?"

He said he had met the CEO several times at his dad's club and had been studying his company's Securities and Exchange Commission (SEC) holdings report for several weeks. He was trying to find an investment idea that would interest the CEO.

"When I heard your pitch on the high-yield stocks last night, I realized this was it because his portfolio is full of junk bonds," he said. "I thought that, because his insurance company buys so many low-grade bonds, they would like to hear about your High-Dividend-Yield approach."

His reasoning took me aback. "Let me get this straight. We are going to pitch my High-Dividend-Yield stock approach to an insurance company as a substitute for their bond strategy. Isn't that a bit of a stretch?"

"That's your job to figure out," he quipped. "I got us the appointment."

I told him I needed to study the holdings of the insurance company and would get back to him. When I examined the company's portfolio, its overall low quality amazed me. Many of their bonds had ratings less than investment grade. Some were not even rated. I had never seen a major insurance company with such a risky bond portfolio. The stock portfolio was full of midsize companies, which was also unusual for an insurance company. However, as I looked at the difference between the purchase prices and the current market values of both the stocks and bonds, the bond portfolio appeared to have held up well in the 1987 crash while the stocks had taken a hard hit.

As I dug deeper into the portfolio, I could see that there were two primary areas of weakness: most of the bonds had interest rates much higher than current rates, and they were subject to early redemption at the issuer's request. This meant that a significant percentage of the bonds would likely be redeemed in the next two to three years. My High-Dividend-Yield strategy promised rising income in the years ahead while the insurance company's bond portfolio income would fall due to early redemptions.

Later, I visited the young broker and told him I was ready to meet with the insurance company the next day. That evening, I put together a simple one-page presentation summarizing my recommendation that the company consider adding a segment of high-yield utility, telecommunication, and energy stocks. In a flat interest rate environment, I projected these stocks could produce 9 to 12 percent annually and nearly 20 percent if interest rates fell as much as I thought they would over the next five years. I argued that a high-dividend-yield stock portfolio was higher quality than the company's junk bonds, and the company would enjoy growing dividends and stock prices for years to come. On the other hand, if they kept their junk bonds, they would lose nearly half of them to early redemption and be forced to replace them at lower interest rates.

The decor of the insurance company's waiting room was full of sleek, modern furniture and stylish abstract art. It struck me as vastly out of place in the middle of Indiana. After waiting for nearly an hour, the CEO's secretary invited us into his office and said he would join us soon. Her demeanor was barely hospitable. The way she avoided eye contact gave me a strong signal that our time with the CEO might be short. I had no notion of how short. Remarkably, we waited another half hour before the CEO arrived.

He walked swiftly into the room, made no apology, and commanded the young broker to "Go on."

Surprised by his abruptness, the broker sputtered an introduction. Before he could finish, the CEO interrupted with another command.

"Let him tell it."

Then he looked at me for the first time.

I pulled out the single-page presentation and began to give him the basics of my strategy. After just a few minutes, he cut me off. "Your strategy is far too conservative for me. Your approach sounds to me like it will produce only 10 to 15 percent. I'm looking for 20 to 25 percent annual growth from my stocks."

I repeated that I saw my strategy as a substitute for his bond investments, not a replacement for his stocks. He cut me off again and stood up as though the meeting was over.

At first his rudeness shocked me; then I became angry. I did not rise as he stood before us. Then, as he started toward the door, I blurted out, "Look, sir, I have come a long way to share an investment strategy I believe can benefit your firm, and you are throwing me out without even hearing it. Please, at least give me the courtesy of allowing me to clarify my strategy."

Pausing halfway to the door, he muttered, "I'm listening."

"I am not talking about replacing your stock strategy; I am recommending that you add some high-yield stocks to your portfolio as bond substitutes."

He looked at me, and I could not tell whether he was interested in hearing what I had to say or interested in getting me to leave. But I went on. "I believe they are as safe as your bonds, and they will provide a 9 to 12 percent long-term rate of return, which will outpace your bond returns because many of your bonds will get called in a year or two. But there is more. If my prediction that interest rates will fall sharply over the next five years is correct, these conservative stocks can produce the 20 percent returns you are looking for."

"Not as advertised, gentlemen," he said flatly, then stood at his office door signaling our departure.

The broker and I looked at each other in amazement, then repacked our briefcases and headed for the door. As we sat in the broker's car in silence, neither of us could believe what had just happened. After a few moments, the young broker said, "What happened in there?"

"We just got tossed out," I replied.

"That guy's always short, but something was very wrong about what happened in there."

"What in the world did you tell him about me?" I asked. "'Not as advertised.' Sounds like you puffed me up pretty good."

"You know that's not true," he said. "I told him exactly what you do. I did tell him that if interest rates fell, you believed your High-Dividend-Yield strategy could make as much as 20 percent, but that was just an aside to the main strategy."

"Sounds like that was all he heard," I said.

During the broker's apology, a thought came to me. "He's in trouble," I said. "His portfolio shows it because the costs and the prices are roughly equal. However, the more I think about it, a company as old as this one should have huge gains in stocks and that guy's portfolio is barely above water, with serious losses in a few of the positions. My guess is the stock market crash hit the company hard, and they have lost enough capital that he needs to either raise more capital soon or make a lot of money in a hurry."

I further speculated that the reason he did not invite his chief investment officer (CIO) to the meeting was that he hoped to hear something from us that might make a quick profit for him before the regulators showed up or his board of directors started throwing a fit.

"But," I said, "our High-Dividend-Yield investment strategy is just too conservative for what he needed, so he threw us out without even taking into consideration that the strategy has some chance of producing the 20 to 25 percent returns he was looking for."

My speculations about the CEO's behavior left me feeling somewhat better. "Now that I think about it, I'm happy he threw us out. That guy is desperate, and he is going to make somebody's life miserable. Thankfully, it won't be ours."

As I headed back to Evansville, I could not get the episode out of my mind. It seemed to touch something deeper in me—something beyond the obvious anger and shock of being kicked out of someone's office. I stopped for gasoline, called my office, and told my assistant to find out if we owned any of the insurance company's bonds, and if we did, to call the bond desk and sell them.

I decided to take the long way home following highways 67 and 57 that wind through the heart of the state. This route took me through territory I had been traveling for most of my life. My hometown of Petersburg was 130 miles south on these roads, and 40 miles farther was my current home just north of Evansville. The road flowed past classic Indiana farmhouses, rolling green fields and red barns—the bucolic landscapes of my youth. It felt like the aorta of my life, delivering a sense of place and hope. While navigating these winding curves and rolling hills through the years, I had gained insights into tough questions and found solace and peace while solving my life's most nagging problems.

As I drove, my thoughts returned to being kicked out of the insurance executive's office. Perhaps the CEO had abandoned civility because he was dealing with a lot of pressure, but why was his behavior so extreme? Then it occurred to me that something had changed in the man's demeanor after the broker said I was from Evansville. Was it possible that my being from Evansville—and not Indianapolis—played a role in the meeting's collapse? Perhaps in his mind, a guy from what he considered a place somewhere just this side of the tall weeds could not possibly bail him out of whatever big-city situation he had gotten himself into.

A deep sense of foreboding settled in my gut as I remembered another strange and unexpected event that involved a different Indianapolis-based insurance company. A few years earlier, our investment firm managed assets for one of Indiana's largest insurance companies. Although our tenure as money managers with the firm had not been long, the company's CFO had appreciated our excellent investment performance and hinted that more assets were coming our way because one of their other outside managers was not doing well. The company placed my partner on the firm's investment advisory council, and everything pointed to our rising among the company's key relationships.

When the insurance company hired a new CIO from a big mutual fund out East, he called and asked us to meet with him to explain our investment strategy and our predictions for the coming year. I had just taken my seat at the new CIO's conference table when he said, "We are one of the most important companies in Indiana, and we have several business initiatives that will make us even larger. We cannot have a large block of our assets managed by a small firm in Evansville."

My partner and I were dumbstruck at the notion we were being let go because our headquarters were in Evansville. We explained that even though we operated out of Evansville, our parent company's headquarters were in Indianapolis. He then informed us he had a rule that he would not employ any investment manager to whom he would not give all his assets and that we did not pass his test because we were such a small manager from a small city. But things grew even stranger and more insulting. In a condescending tone, he noted he had reviewed our investment results and found them satisfactory and offered to be a reference for us if we ever needed one.

Twice now, an Indianapolis insurance company had thrown me out. I had to figure out more about why Evansville or I did not play well among the power elite in Indianapolis. But in my heart, I already knew the answer. Indianapolis was the capital city of the state. It was headquarters for many major international firms, and it was a city with major professional sports teams. It was a major-league town. Evansville was a minor-league town a tenth the size of Indianapolis, and thus, in the judgment of some Indy folks, our ideas and capabilities did not have what it took to play in the major leagues.