2004: Digital Storage and a Short Sell on Bonds

by Briton L. Ryle

It's forecast time again – time for *Taipan* editors to lay it on the line, to publicly declare our expectations for the coming year. And if that's not enough, we'll even tell you how you can profit from our outlook.

Be it a broad economic trend or some technological innovation, whether a forecast is accurate or not is far less important than whether you can make any money off it. So I'm going to spare you my thoughts about the outcome of the latest Michael Jackson court case and stick to the kind of forecasting that can make us some money.

But before I get down to the nitty-gritty, the nuts and bolts, before I put the rubber on the road, let me just say a little something about forecasts. There are really two elements to a forecast – accuracy and timing. And as in comedy, timing is everything.

…on the other hand

In the simplest terms, a forecast can only be right or wrong. But even an accurate forecast is dependent on timing. And timing will always have an element of chance to it. To demonstrate, I'd like to refer to my *Taipan* forecast from two years ago – 2002.

That year, economies were shrinking everywhere. Except in China. I made the case that if the global economy stabilized in 2002, it would be bullish for China. And if the global economy showed signs of expanding, Chinese stocks would go through the roof.

Well, as you know, the global economy didn't show signs of stabilization until late in the year. And the bear market continued essentially through the end of the year. It looked as though I was wrong on all counts. And I guess if you read my Chinese investment thesis for 2002 in the most rigid, to-the-letter way, then I was actually wrong.

But – and I'm you sure you see this next point coming – investing is rarely successful if done in a rigid, to-the-letter fashion. Successful investing requires reassessment, revalidation and enough flexibility to change your game plan as conditions dictate.

From this perspective, my 2002 forecast was dead on. It just took a little longer to play out than I expected. That's all.

The Year(s) of the Dragon

As of this writing, **Brilliance China (CBA:NYSE)** is trading at US$50 for a 163% gain over my initial entry price of US$19 from January 2002. And **Petrochina (PTR:NYSE)** is trading at US$42, up 130% from my original entry price of US$18.25. I'll take that kind of "wrong" any day.

I must say, even though Brilliance China has outperformed Petrochina and has a much more "interesting" history – remember when the CEO went on the lam, pursued by Chinese authorities? – it's the Petrochina recommendation of which I'm most proud. And that's because I spotted the stock and told *Taipan* readers to buy even before the greatest investor of our time, Warren Buffett, started buying it.

But we must thank Mr. Buffett graciously, as it was he who brought massive attention – and buying power – to the stock. On a personal note, Mr. Buffett, if you have the time, I was wondering if you had a chance to peruse one of the 87 résumés I sent you last year? Just kidding, Christoph. Just kidding.

You may recall, there were actually four stocks included in my Year of the Dragon 2002 forecast. In addition to Petrochina and Brilliance China, I also recommended **China Unicom (CHU:NYSE)** and a fund focused on China, the **Liberty Newport Greater China Fund (NGCAX:AMEX)**. Please note: the name of

this fund has changed to the Columbia Newport Greater China Fund. The ticker symbol has remained the same. The China Unicom recommendation was stopped out soon after I recommended it, but the Greater China Fund is up around 20%.

But enough of reveling in past glories. It's time to look ahead and see what the New Year will bring. A flood of liquidity has done the trick for the US economy and equity markets. Corporate profits finally showed real growth, GDP growth is ranging ahead of expectations, and there are even signs that jobs growth is picking up.

At the heart of the economic recovery are low interest rates. There's no doubt that the economic powers that be (i.e. the Federal Reserve bank) want to keep rates low as long as possible. But the simple fact is that there's a limit to how long rates can remain ridiculously low before inflation sets in.

If you've been watching the price of gold over the last six months (and who hasn't?), you should be aware that the fear of inflation is rising. And with it will go interest rates. So let's start off with a discussion of the interest-rate environment and how you can profit from the inevitable rise.

Bond Trading Strategies for the Long-Term Investor

It's unfortunate, but there are a lot of people whose hands have been forced by the financial markets right now. Low interest rates have made money-market funds virtually obsolete. A retiree who needs to generate US$2,000 a month in income to survive has to have around US$2.5 million in a money-market account.

Bonds offer little solace, as it's clear that the bond market has already seen the bottom for yields and the top for prices. These two factors have forced a lot of retirement money into the stock market. But if the current uptrend proves to be just another bear-market rally, you can be sure that no one on Wall Street will be issuing any apologies for the hit a lot of 401(k) and IRA money will take.

I don't want to say that Fed Chairman Alan Greenspan's interest-rate policy has been geared toward driving money into stocks, though there's evidence that this is true. He's on record as saying that any economic rebound begins with renewed corporate investment and that a rise in corporate investment is contingent on higher stock prices.

And I've heard more than one market guru put forth the theory that all the deflation talk is a smokescreen for the Fed to keep interest rates low and increase the money supply. My personal opinion is somewhere in the middle – that deflation is a real, albeit unlikely, threat. And Greenspan's assertion that it doesn't cost much to fend off deflation through lower interest rates masks his secret glee at being able to hold rates at 50-year lows.

Mo' money

It's no secret: the US economy is driven by consumer spending. It's also no secret that consumer spending has been supported by a refinancing boom as homeowners take advantage of low interest rates.

Yes, the US is awash in cash. Low rates, refis, and tax cuts have expanded the money supply dramatically over the last year. Meanwhile, the Federal government is ringing up record levels of debt. I can see only two outcomes for the pickle we're presently in. And they're both bad for bond prices.

The first outcome is inflation. Now, some would argue that the cheap imports that have kept a lid on inflation for the last few years will continue to do so. But that's only part of the picture. Oil prices remain stubbornly high, housing prices continue to rise, my grocery bills seem to keep getting bigger, gold is uncomfortably high.

The only thing that keeps the US out of an inflationary environment is those low prices for consumer goods. Still, it's hard to imagine real inflation jacking rates to 7% or 8%.

The second outcome of the current environment is a sustained economic recovery. In which case, the Fed will start hiking rates. That's bad for bonds. 'Nuff said.

Back in June of 2003, Mr. Greenspan suggested the US economy would grow 3.5% or so in the second

half of this year. And bonds got nailed. They took the first step to pricing in a return to strong GDP growth. The yield on the 10-year note has risen to over 4%. That is still a historically low yield. There's no reason to think the 10-year's yield can't rise to 4.5% or even (gasp) 5%, despite Mr. Greenspan's pledge to keep rates low.

The problem for many investors is that their hands are being forced. It's nerve-wracking to put all your money in stocks right now. But money markets and bonds aren't going to offer enough return on capital to be worthwhile. Gold has some upside, but you can't rationally put more than a token amount of your investment money in the barbarous relic, because the major gold producer stocks are as ridiculously priced as Yahoo. And owning the physical asset incurs not insignificant storage costs.

The window for real-estate investing has closed. Which leaves investors few options beyond the lottery and stocks.

If you can't beat 'em, short 'em

It's little wonder that more and more investors are turning to short-term trading strategies in an effort to grow their investment capital. To be sure, there are risks associated with this approach to investing. And for many, the risk of losing retirement money is too great to justify.

But for those of you who are looking for some trading ideas, here's one for you: short bonds.

Despite a three-year bear market, short selling is still something of a mystery to many individual investors. And the idea of shorting bonds is even more esoteric. That's where I can help.

Stock marketing

In the never-ending search to find more products to sell to the investing public, the big brokerage houses have really expanded the individual investor's universe. From sector indices like the Philadelphia Semiconductor Index (SOX) and the Biotech Index (BTK) to exchange-traded index funds like the QQQ, DJX or SPY's, investors can now trade entire sectors and indices as easily as they can trade stocks.

So it was only matter of time before exchange-traded bond funds became available. My favorite is the **iShares Lehman 20+ Year Treasury Bond Fund (TLT:AMEX)**. It has good liquidity on both the stock and the options. In fact, my Taipan Traders doubled their money on some put options overnight as this fund dropped from 94 to 92 the last time Greenspan cut rates. I know, I know, we should have held longer.

As the name implies, the iShares Lehman 20+ Year Treasury Bond Fund holds longer dated bonds. That means the share price of this fund will be more sensitive to factors that cause yields to rise and prices to drop. In fact, for every percentage point rise in interest rates, TLT's price should drop approximately 13%.

The 30-year note is currently yielding at just under 5.5% and the 10-year note is just under 4.2%. The national average for a 30-year mortgage is approximately 6.25%. A one- or two-point move in interest rates would in no way be dramatic. And it would be worth a minimum of 25% to a short position in TLT.

What's even better about this exchange-traded bond fund is that there are options available on it. That means you can leverage your investment and potentially make a triple-digit gain. The one problem with options is that a one or two percent move in bonds could take a year or longer. And most options strategies begin to lose their attractiveness with a longer time frame.

How to play

The safe, conservative way to enter this trade is simply to short the common shares of the iShares Lehman 20+ Year Treasury Bond Fund (TLT:AMEX). Currently, US$88 to US$90 appears to be a good level for a short position.

If you prefer the leverage and potentially larger gains of put options, you'll need to implement a more complex strategy. I recommend maintaining a TLT put option position with two to three months until expiration and rolling it forward when the time until expiration gets below one to two months.

For instance, as I write you can buy the March 83 TLT put option for around US$140 per contract. At the end of February, you'd simply sell that position and buy one a couple months out, and so on.

This strategy will generate more commissions and fees, but it will keep you positioned for what's likely to be a multi-year move higher in interest rates.

Whichever vehicle you choose, this trade should be considered an investment and you should be prepared to stay in it for at least a year.

The Digital Revolution

Ok, so maybe the word "revolution" is a little strong. After all, the word "digital" was one of the culprits of the Internet bubble, and we all know what that got us. But the fact is, while many of the promises of the Digital Revolution proved to be completely hollow (like B2B, broadband, e-commerce, etc.), the Digital Revolution is here. I mean, chances are good that you, or someone sitting close to you owns, a digital camera.

And if you check, you'll notice some of the best-performing stocks over the last year have been digital stocks. And I don't mean digital in some kind of peripheral way like Amazon.com or Comcast. I mean the stocks that provide the actual technology that makes Amazon.com or Comcast viable companies. Or power your digital camera.

Stocks like SanDisk (SNDK:NASDAQ), which makes flash memory chips, an indispensable item for a variety of digital products. SanDisk hit a low of US$14.79 and a high of US$86.30 in 2003 as earnings grew around 600% for the year.

Then there's Omnivision (OVTI:NASDAQ), maker of semiconductor image sensors for digital cameras (among other things). It went from a low of US$12.66 to a high of US$67.66.

Or Lexar Media (LEXR:NASDAQ), another flash memory company whose shares went from a low of US$2.94 to a high of US$24.49 last year. If the digital revolution isn't occurring right before our eyes, then I'm in the wrong business.

Sonic boom

This company is in the process of creating the financial equivalent of a sonic boom. Revenues are taking off. They're on pace to double since last year. And it's happening so fast, most people haven't even heard of the stock. But the big boom that lets everyone know about this company is coming.

Over the last year, I've been bullish on exactly one sector of the NASDAQ: digital video. My theory that digital video is the only new application that can drive PC and consumer electronics sales has led me to such investments as Pinnacle Systems and ESS Technology.

But this stock could be the single most important digital video company out there. It's called **Sonic Solutions (SNIC:NASDAQ),** and it's in the process of creating *the* standard for DVD authoring software.

Over the years, you may have heard a lot of hot air about tech stocks and standards. Only rarely are such claims ever meaningful. This is one of those times.

The Digital Revolution, Part II

Over the last year, Sonic has added many important licensees for its technology. I'm talking about Adobe, Dell, Hitachi, Sony, Pioneer, Fujitsu, Philips, Avid, Hewlett-Packard, InterVideo, and, yes, Microsoft.

All those deals have put a lot of money in Sonic's coffers. The company's cash position jumped nearly 500% in a year, from under US$2 million to just shy of US$10 million. Cash per share is a robust US$0.65, nearly twice the stated book value of US$0.35. Clearly, Sonic's book value, a trailing indicator, is due for a steep rise.

Perhaps a better measure of Sonic's potential is its return on equity. This measures how well a company is investing money in its business. For Sonic, return on equity is an amazing 85%. That means Sonic takes in

US$1.85 for every dollar it spends.

If I could get my household to work like that, I'd be retiring in about five years. In the meantime, I'm going to invest in companies like Sonic Solutions.

You call that a market?

The combination of falling prices for DVD players and a quick shift to DVD from videotape by Blockbuster and others has made DVD one of the fastest-growing consumer electronics categories ever.

But Sonic is mainly about the personal computer. Worldwide, some 130 million PC's will ship this year. Of those, something like 4 million will have DVD drives. And Sonic Solutions has a 75% market share of non-Apple computers.

The conclusion here is obvious. The number of computers with DVD drives is set to grow exponentially. And Sonic, by virtue of deals with Dell and Hewlett-Packard, will be embedded in 75% of them.

Plus, DVD is the *only* catalyst for PC sales right now. And the box makers know it. You can tell by the advertising. Last year, the hot PC commercial centered on young people making their own CD's. Well, Roxio (ROXI:NASDAQ) had its day in the sun. Now it's Sonic's turn.

I hear the train a-comin'...

For the six months that ended in September 2003, revenues grew 65% to US$24.7 million. 2003 revenues are expected to total US$56 million, and 2004 is expected to hit US$78 million.

At US$15 a share, Sonic's forward P/E is an attractive 21, very reasonable for a company growing revenues at better than 100% this year and 65% in fiscal 2004. At the current price, around US$15, 2004 price-to-sales will be below 4. And fiscal 2004 price-to-sales is around 3. Any upside surprise will only make these valuation metrics more attractive.

Based on these numbers, I've put a one-year target of US$24 on Sonic Solutions. If you add the hype the words "industry standard" and "market leader" can carry, the price could go significantly higher. If you buy one tech stock this year, Sonic should be it. ■