SaratogaRIM

2018 Quarterly Report

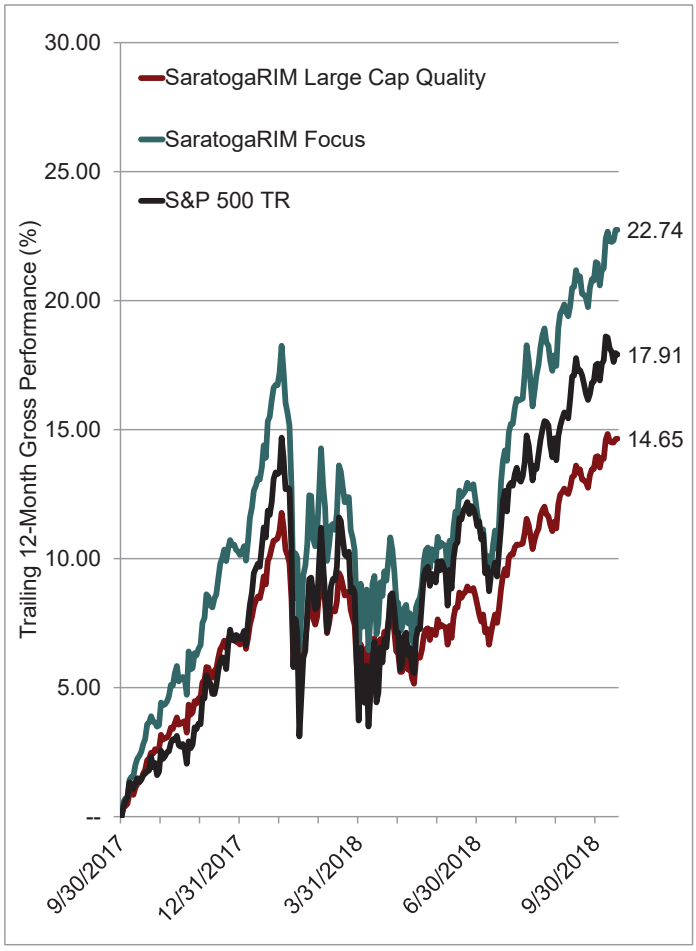
October 5, 2018

Q3

Unintended Outcomes

Market Statistics								Source: FactSet (Sept. 30), Federal Reserve, * Spot prices (Sept. 30)
Stocks		**Yields (%)**				**Commodities**	
DJIA	26,458.31	Fed Funds	2.25	US Tr. 3-Y	2.88	Baltic Dry Index	1,540
P/E ratio	21.89	Disc. Rate	2.75	US Tr. 5-Y	2.95	Gold ($/oz)	1,191.50
S&P 500	2,913.98	Libor 1-Mo	2.26	US Tr. 10-Y	3.05	Silver ($/oz)	14.31
P/E ratio	20.16	US Tr. 1-Y	2.58	US Tr. 30-Y	3.20	Crude ($/bbl)* (NYM Light Sweet Crude)	73.25

Fig. 1: SaratogaRIM Large Cap Quality & Focus vs. S&P 500 TR 9/30/17 - 9/30/18



Past performance is no guarantee of future returns. All returns presented gross of (before) fees. This chart is supplemental and comprises daily return estimates calculated by FactSet utilizing month-end holdings data and may differ from actual daily performance. See full disclosures at the end of this report.

Over the 12 months that ended September 30th, net of fees, the SaratogaRIM Large Cap Quality composite generated a total return of 14.03% and our Focus composite earned 22.06%. Over the same period, the S&P 500 Total Return generated 17.91%, the Russell 1000 Growth rose 26.30%, the Russell 1000 Value was up 9.45% and the MSCI World Index returned 11.24%. Performance was consistent with what we would expect at this point in the economic and market cycles. The SEC requires that we remind you past performance is no guarantee of future returns (see full disclosures at the end of this report).

Contents **Page**

Letter to Investors

Think in terms of ranges. That, in a nutshell, is what I emphasize when our investment team discusses the all-important topic of valuation analysis. Given an uncertain future, it's essential to think about valuation across a spectrum of potential outcomes. Our scenario analysis seeks to apply a mental process where alternative future returns are probability weighted and evaluated within a range of potentialities. Thinking this way puts us in a better position to judge the adequacy of margins of safety and to incorporate potentially asymmetrical exposures to risk and reward into our decision making process.

Last quarter, Marc Crosby examined a scenario that all long-term investors should consider as they ponder the future. If global interest rates normalize over the next few years – IF being the critical component here – then the discount rates now being applied (both on and beyond Wall Street) to price risky assets are way too low. WHEN (not if) gravity reasserts itself, investors will have no choice but to reprice risk as discount rates rise and present-value calculations fall, taking asset prices down with them. It's simple math with predictable consequences.

In the essay that follows, George Wehrfritz delves deep into another dark scenario worth pondering: the non-trivial probability of a globalized corporate zombie apocalypse. George first examined the rise of zombie companies in his January 2002 *Newsweek* cover story on the slow collapse of Japan's largest retailer (the article can be found immediately following the digital version of this report).

Of the many unintended outcomes created by radical central bank policies enacted in response to the 2007-09 financial crisis, ballooning corporate debt has become an important potential breaking point to watch. As Figure 2 illustrates, the number of companies now unable to earn enough to sustain even the interest payments on their debt is astounding.

Perhaps the most interesting angle on this is found in the teachings of American economist Hyman Philip Minsky, who died in relative obscurity back in 1996. His research focused on the causes and characteristics of financial crises – which he attributed to cyclical swings between

Fig. 2: % of Zombies in the S&P 1500

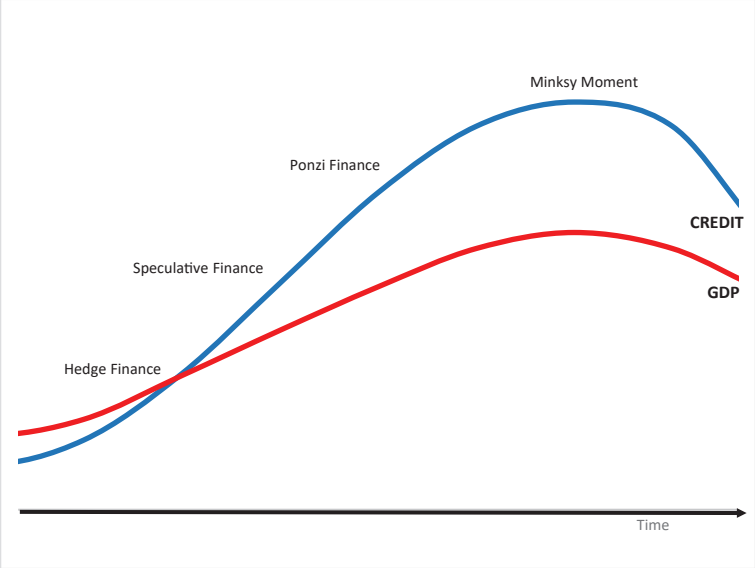
Source: SaratogaRIM. See full disclosures at the end of this report.

stability and fragility. Minsky's famed observation that "stability breeds instability" is but a taste of his theoretical framework. Minsky was posthumously immortalized when PIMCO economist Paul McCully coined the phrase "Minsky moment" in his analysis of the asset price implosion during the fast-evolving Russian financial crisis of 1998.

A *Minsky moment* is the point in a credit or business cycle when asset values suddenly collapse under their own weight. Minsky theorized that long periods of prosperity and increasing valuations foster speculation and the piling on of borrowed money – which is to say that stability leads to corporate and investor risk-taking and, ultimately, systemic instability. Minsky's work was discovered anew when financial markets shuddered in 2007 then completely froze up in 2008 as the financial crisis unfolded.

Minsky describes a credit cycle which starts from a point of stability and equilibrium which he dubs "hedge finance." In such an environment companies can borrow and invest with the expectation of covering both interest and principal out of cash flows generated by the new investment. As the cycle moves forward into what Minsky terms "speculative finance," confidence and optimism drive market prices higher. In this phase, higher

Fig. 3: Minsky Moment Cycle



Source: SaratogaRIM. See full disclosures at the end of this report.

prices reduce expected returns from the new investment to the point where only interest can be serviced from income but returns are insufficient to repay principal. In the final phase, dubbed "Ponzi finance," cash flows can't even meet interest obligations and are clearly inadequate to pay off the debt taken on to acquire them. "Zombie finance," a term coined in Japan in the 1990s, refers to treadmill lending that enables deeply indebted companies to forestall insolvency by servicing old debts with new loans.

As losses proliferate, lenders retrench and call in their loans. At this point a cash crunch occurs because borrowers shift from complacency to panic and seek to avoid insolvency by liquidating assets. Graphically, Minsky moments resemble the instant when Wile E. Coyote dashes off a precipice, looks down and sees nothing below him but air; with similar suddenness, in Minsky's model, liquidity dries up and the Ponzi phase collapses. When that happens, the over-leveraged are forced to sell even their least-speculative positions to make good on their loans.

That was precisely the environment former Federal Reserve Chairman Ben Bernanke, Treasury Secretary Hank Paulson and their global brotherhood of financial policymakers faced at the height of the financial crisis a decade ago. Their collective response was a hodgepodge of untested and radical policies – zero or even negative interest rates, gargantuan corporate bailouts and outright money printing through Quantitative Easing, all intended to stop Minsky's cycle in its tracks. And stop it did. By suppressing interest rates and flooding the world with liquidity, leading central banks drove asset prices higher and prevented the liquidation phase that should have occurred at the end of the last cycle – supercharging the proliferation of zombie corporations portrayed in Figure 2.

How this all ends is a timely question. Following in the Fed's footsteps, Europe's Quantitative Easing program appears set to begin winding down. One by one, as the world's central banks seek to revert to more normalized monetary policies, the conditions that have enabled zombies to persist will cease to exist. As that happens, we will learn whether a Minsky-style liquidation was truly avoided or simply delayed for a decade.

For those who find thinking about volatile scenarios disturbing, welcome to our world. Nevertheless, we understand that the future is not written, and note that even today the so-called Goldilocks scenario – in which the economy plugs ahead neither too hot nor too cold – surely has more adherents than those Marc and George have articulated. While we will only experience one future, it's still important to understand that there are many different paths it could take. What Marc and George describe are just that: potential pathways. They are scenarios we think about and seek to work into our bottom-up, company-by-company analysis.

Ending on a positive note, the types of environments that tend to get tagged with Minsky's name have also proven to be the most fertile buying opportunities for long-term, value-oriented investors – provided they have access to liquidity. We do, and we're always ready. Come what may.

Respectfully,

Kevin Tanner
Chairman, CEO & Chief Investment Officer

Darwinism in Reverse

The growing menace of zombie companies

By George Wehrfritz

Many lamented the fall of the much-loved purveyor of childhood joy, Toys "R" Us. Yet as it held fire sales, laid off 33,000 employees and shuttered some 800 stores last April, the real question wasn't how the venerable retailer came to such a fate, but what took it so long? Barney and holiday memories notwithstanding, it had long since lost its magic amid the rise of cheaper online competitors – a secular shift facing all big-box retailers. Nevertheless, successive owners engineered serial restructurings to sustain unprofitable operations for years by piling new IOUs atop a jutting Matterhorn of old debt estimated at $5 billion. *Barron's* called the liquidation "a sign that the era of forgiving financing has ended."

The death of America's iconic toy-seller exemplifies a blight that has spread across the world's industrial economies during a decade of ultra-loose monetary policies imposed amid the Great Recession. Namely, too many going concerns have joined the realm of the walking dead. These companies can't afford even the interest on their debts anymore yet retain sufficient access to new credit to stagger on. Back in the 1990s Japan popularized a term for such businesses: zombies. Even now, that country still struggles to put enough of them out of their misery to rekindle the forces of capitalist renewal.

If that saga seems distant in place and time, think again. Zombies represent misallocated capital and proliferate wherever cheap, plentiful credit persists – which is to say, under conditions that virtually define the past decade. In the U.S. their prevalence has risen from less than 4% of S&P 1500 companies in 2001 to more than 14% at the end of last year. Europe's zombie infestation is larger still, say Deutsche Bank researchers. Even China hasn't escaped the problem (see Figure 4). These corporate undead undermine capitalism the way dense undergrowth chokes a forest. Their rise represents "a kind of anti-Darwinian survival of the un-fittest," wrote Jim Grant in his eponymous newsletter back in March.

It's a bad news, bad news story. According to a groundbreaking cross-country analysis undertaken last year by the Organization for Economic Cooperation and Development (OECD), the rise of zombie companies over the past two decades has coincided with a drop in potential output per capita in industrialized countries from above 2% in 1998 to just 1% today. Competition, the very lifeblood of markets, has diminished sharply because zombies have retarded new business creation and reduced pressure on sector-leading companies to innovate. Much blame for this phenomenon rests with central banks, which intervened with tsunamis of cheap credit to temper past recessions – thereby assuring that "the zombies – the errors – don't die but live on," Grant argues.

The landscape gets even uglier as one looks into the future. As Marc Crosby examined in last quarter's letter, even a moderate rise in interest rates could prove deadly for marginal businesses. Their Earnings Before Interest and Taxes (EBIT) face being overtaken from behind by rising interest expenses. "In a world awash in money, Toys 'R' Us ran out of it," wrote Mary Childs in her *Barron's* essay on the company's demise. Others could soon meet similar fates.

Terms of Impairment

Capitalism is both ruthless and straightforward. Businesses start, grow and die on their ability to deliver goods and services at a profit. Commerce is regulated only to preserve fair play; outcomes ride on the collective action of market participants who consume and invest for personal gain. That's the theory, anyway. And since the Industrial Revolution real-world versions of it have spurred companies towards greater efficiency, caused the rise and fall of entire industries and driven humanity's technological progress – all as living standards rose over time virtually everywhere. As Adam Smith famously observed in *The Wealth of Nations*: "It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest."

An essential attribute of market economies is that they're naturally cyclical absent the machinations of men. Recessions (even depressions) serve an essential role in well-functioning capitalistic systems, much as periodic brushfires keep natural forests healthy. Recessions that kill off obsolescent, weak or imprudently-run companies set the

stage for future growth. Too often, though, governments seek to manipulate this process with countercyclical monetary and fiscal schemes crafted to prevent recessions – undeterred by strong evidence that the cure is worse than the illness.

Indeed, zombies are born of efforts to subvert the very capitalist forces Smith extolls. For example, Japan's post-WWII system of "convoy capitalism" preserved laggard companies (particularly small banks) via protection or even rescue from bigger ships in the national 'flotilla' on the logic that no company was too compromised not to founder. Over time, misguided collectivism stalled Japan's entire financial system; innovation in all but a few key industries slowed to the pace of a rusty barge, incapable of dynamism or reform.

To define our terms, a zombie is a business that can't pay the interest on its debts as determined the ratio EBIT/Interest Expense slipping below 1.0 for an extended period. As money-losers, these companies lurch forward in pursuit of the next friendly loan, junk bond sale or public handout to feed their cash hunger. Per the OECD, zombies display "a declining ability or incentives … to adopt best practices" and hog resources better deployed elsewhere, which has all -but halted productivity gains in some industries. Suppressed dynamism lowers business startup rates, weakens job creation and reduces worker mobility, all the while raising the "survival probability of marginal firms." In other words, zombies beget more zombies.

Fig. 4: Research Note

The Edge of Lawful Power

Most researchers concur that zombies owe their very existence to central banks. Handmaidens to this zombie creation: political leaders unwilling to refuse corporate handouts or restrain government spending. Monetary easing and fiscal largesse blunt recessions and counteract business cycles so that too few companies fail. By preventing bad firms from dying, interventions also forestall new, dynamic businesses rising.

Keynesian-style deficit spending dates back to the 1930s. Yet a major shift in scale occurred beginning 2007, when the Federal Reserve coordinated efforts with the Department of Treasury to ring-fence the subprime mortgage crisis before it hobbled the entire U.S. economy. The problem: Investment banks and non-bank financial institutions had larded billions of complex mortgage-backed securities onto their books and, to minimize reserve requirements, categorized them as investment-grade assets based on the self-serving thesis that a synchronized decline in real estate values could never happen.

It all went wrong once key banks recognized the true nature of the messes hidden on their books, and to suspect (rightly) that counterparties held similar junk in the shadows. Soon, everybody stopped lending to everybody else as a system increasingly underpinned by securitization and derivatives froze like an engine suddenly denied oil. "Simply stated," former Fed Chairman Paul Volcker explained during a speech to The Economic Club of New York in April 2008, "the bright new financial system – for all its talented partici-

RED TIDE: *Chinese zombies have proliferated at an alarming rate*

Even the world's fastest-growing major economy is not without its own class of profitless serial borrowers. In point of fact – albeit, one obscured by the glitz and din of pell-mell modernization – China's zombie problem rivals Japan's in the 1990s.

The differences tell the story. Whereas Japan's debt woes rose from corporate group-think and bank-led resistance to bankruptcies, China's is born of the still-vast state-owned economy – the key pillar of "socialism with Chinese characteristics." Strongman Xi Jinping is merely the latest leader to sustain the critical role state-owned enterprises (SOEs) play in maintaining social stability through job-creation and provision of services that often still include medical care and housing. SOEs also facilitate Beijing's long-range industrial policies (as with high tech manufacturing, which China aims to dominate by 2025). "The real advantage of China's system of state ownership isn't that the cleanup is easier than in market economies," argues Dinny McMahon, who spent a decade as a financial journalist in China. "It's that the cleanup is easier to put off."

The surfeit of loss-making companies is as old as China's economic reforms; Beijing maintains it is under control. Yet even though talk of competitiveness reforms date back a decade, SOEs are increasingly leveraged and thus reliant on cheap money. And that is dangerous in an era of rising interest rates initiated by the U.S. Federal Reserve last year due to the yuan's soft peg to the dollar, which could add "enormous pressure" on indebted Chinese firms, Bloomberg warned in mid-August. The International Monetary Fund's most conservative estimates of zombie

pants, for all its rich rewards – has failed the test of the market place."

Never a shrinking violet, Volcker chastised the institution he once headed for creating a "too-big-to-fail" mindset:

> *To meet the challenge, the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices. The extension of lending directly to non-banking financial institutions – while under the authority of nominally "temporary" emergency powers – will surely be interpreted as an implied promise of similar action in times of future turmoil. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time honored central bank mantra in time of crisis – "lend freely at high rates against good collateral" – to the point of no return.*

Since that speech we've witnessed a decade of policy finance: central banks sustained monetary accommodation unprecedented in modern history, lending freely at near-zero interest against scant collateral; governments deploying every available fiscal tool to prevent the next Great Depression. Bailouts became normative. America's first and third largest automakers received huge infusions of taxpayer money to keep their assembly lines running; financial institutions too numerous to list (one topped by insurance giant AIG) took bailouts. Just as Volcker lamented, every major U.S. investment bank received fast-track changes of status that afforded them access to the Treasury's overnight borrowing window, a privilege once reserved for commercial banks that forewent proprietary trading. Corporations that had profited spectacularly from speculation survived a crisis caused by their own misdeeds on government handouts – the very definition of moral hazard.

Ten years on, the systemic damage poor crisis-management inflicted upon capitalism itself has come into full relief. The widely-examined concept of secular stagnation – the thesis that industrialized economies are experiencing a permanent slowdown – is an outcome of zombification.

The OECD identifies a decline in "contestability of markets," which it defines as "less pressure on incumbent firms to improve." This occurs through financial repression, meaning the artificial compression of interest rates that allows any junk-bond addicted business to borrow on terms similar to those of its blue chip rival. "The concern is that [zombie] companies, which spend so much of their cash servicing interest payments, are unable to invest in new equipment or future growth areas – thus hogging resources that could have gone to more productive use."

With interest rates rising, the process of zombie creation could now be shifting into reverse, a development that surely would test Volcker's warning that the Fed, European Central Bank, Bank of

Fig. 4 cont'd

indebtedness in China's state sector rose from 2% of GDP in 2009 to 6% of GDP in 2016. That's a whopping $667 billion IOU, most in the form of "soft loans and implicit guarantees from banks and local governments," said an IMF study in late 2017. "The government's desire to boost growth has encouraged zombie firms to invest excessively."

Overcapacity, indebtedness and inefficiencies spell an end to the Chinese miracle, argues McMahon in his 2018 book China's Great Wall of Debt. It depicts a culture of debt-fueled exuberance undertaken with objectives wholly unlike those driving growth in the capitalist world, leading to mal-investment on a scale unprecedented in human history. At the core are loss-making companies kept alive by local government and Chinese Communist Party leaders who, quite literally, fear career-ending riots and lasting violence should the firms in their care ever go under.

Home-grown zombies challenge the vision of China as lean and ultra-competitive, and reveal the tether linking today's emerging superpower back to Chairman Mao's utopianism. Whereas most private-sector factories use migrant labor, a group more easily disbursed back to the villages when a business closes, state companies often sustain entire "local" communities with cradle-to-grave jobs plus benefits, making each failure potentially explosive. Writ large, such localized quests to preserve social stability have undermined China's national economic prowess, McMahon argues. "Local governments' predilection toward keeping zombies alive means that the Chinese economy is stuck with all these extra factories, which undermines the health of entire industries."

Monuments to waste now litter the Chinese landscape. The China Railway Corp., which builds and operates the world's largest high-speed railway network, represents Beijing's "debt-fueled response to the global financial crisis"

Japan, et al. have given "an implied promise" of future rescues.

B-B-Beware

Some economists argue even today that central banks not only could but should continue to suppress interest rates as a matter of standard policy on the belief that "normalization" would endanger orderly economic growth. And they're right, if one defines 'orderly' growth as economic expansion at the flow rate of fossilized tree resin. Europe as a whole already knows how debilitating ultra-slow growth feels; Italy's economy, in fact, has *shrunk* slightly in real terms since it adopted the Euro back in 2002. A capitalist alternative is lending, in Volcker's words, "at high rates against good collateral." But make no mistake: any such reversion to the old rules would end accommodative financing, the very lifeblood of zombies.

Jim Bianco of Chicago-based Bianco Research believes normalization would deliver a "double whammy" not just to bona fide zombie companies but also to a much larger group "on the bubble." He brackets this second group to include firms with EBIT/Interest Expense ratios greater than 1 but less than 4, a range also susceptible to negative impacts from higher interest rates and rising bond yields. This group is vastly larger than the 14% of S&P 1500 firms already earning less than their interest expenses. The "energy, real estate, telecom, and utilities [sectors]," he notes, "have median [EBIT/Interest Expense] ratios below five."

In an echo of the subprime mortgage fiasco, most companies on Bianco's warning list have investment-grade credit ratings, meaning BBB or better. It's possible, Bianco's analysts argue, that over the next year the Fed could hike interest rates above the so-called reversal rate – the inflection point where lending growth and financial leverage begin to contract. Such tightening would render the second group "susceptible to turning into zombies," warns the firm. In an April article, Bloomberg cited what it called a decade-long "push into the bottom end of high-grade bonds" driven by "the search for yield amid record-low rates following the 2008 financial crisis and unprecedented stimulus from central banks." BBBs alone "total about $3 trillion, almost the size of Germany's gross domestic product," the news service said.

No Easy Fix

Today stock markets remain near record valuations, the U.S. economy hums at full employment and longer-term interest rates have barely budged off the lows set during the last recession. These are outcomes of unprecedented Fed policies including near-zero interest rates for all and successive rounds of Quantitative Easing undertaken to boost asset prices and prevent deflation. With no historical precedent available, imagining what unwinding might look like is pure conjecture. "We've never had QE, we've never had reversal," quipped JPMorgan Chase boss Jamie Dimon in May. On August 6th Dimon cautioned that rates were potentially poised to rise much higher than most investors expect and that the 10-year Treasury yield could eventually hit 5%.

Again, each uptick in the cost of borrowing tightens the screws on companies that depend on

Fig. 4 cont'd

for its ability to consume steel, concrete and vast labor pools, the *Financial Times* recently observed. According to the newspaper, with some 25,000 kilometers of track today, the state-owned railway monopoly has since 2015 failed to earn operating profits to match even the interest payments on debts that now surpass $700 billion. Its longest route, connecting the western regions Xinjiang and Lanzhou, was built for 320 trains a day but now offers just eight scheduled runs and earns less on the service than the cost of electricity necessary to run those trains.

In 2013, the China Center for Urban Development, a think-tank, estimated that existing plans for new districts and cities contained enough housing for 3.4 billion people – a staggering figure even for a continental power with a population approaching 1.4 billion. One Deutsche Bank economist calculates that in the mega-city Tianjin, SOEs together only earn enough revenues today to cover 40% of the interest payments on their debts. May bailouts for two Tianjin development firms with debts surpassing $100 million show that "China hasn't killed off the implicit guarantee," this expert told *The Economist*. Vacancy rates in Tianjin's commercial areas – which include the 1,800-foot-tall skeleton of what would have been the world's fifth tallest skyscraper – approach 70%, even as the city's growth rate has fallen to just 3.5% from 13.5% annualized over the previous decade. "The city's sharp deceleration serves as a stress test of China's economic problems, and as a warning of the difficulty in fixing them," said the magazine in its August 4th issue.

China's zombie problem has global dimensions, too. Of great concern is Xi's monumental Belt and Road Initiative (BRI), an effort to fashion modern "silk roads" across Eurasia; the scheme is highly leveraged and Beijing-

cheap credit for survival. Ultimately, though, to reverse the decline in global productivity gains and ramp up potential growth rates, the bulk of zombie companies need to be put where they belong: in the ground. But that's a classic pain-before-gain scenario, a 'can' most politicians prefer to kick down the proverbial road given the vast scale of necessary restructuring. Recently, *Grant's Interest Rate Observer* screened companies listed on the NYSE and Nasdaq and found 471 "prospective zombies" with combined debt totaling more than $400 billion. Workouts of that magnitude would surely trigger a major recession.

One historic analog is the dilemma Volcker himself faced during his tenure as Fed chief (1979-87). He used monetary forces to create a "controlled burn" to cure a comparable set of ailments that had sapped U.S. productivity. These included stagnant growth, rising prices and rampant government overspending against a backdrop of two oil shocks that undermined America's industrial base – shorthand for which became the dreaded word *stagflation*. To break the downward spiral, he applied the then-novel theory of "*rational expectations*" to reprogram market participants convinced that high inflation was inevitable. That took almost three years, pushed interest rates to 14.8% at their peak in 1980, and drove unemployment above 10%. Volcker's steadfastness paved the way for America's economic renewal during the Reagan, Bush and Clinton presidencies.

Volcker is lionized today. During his tenure, however, political leaders across the ideological spectrum routinely pressed the Fed boss to ease his treatments. They sought to keep recessions short/shallow while extending booms as long as possible. "Volcker deflected repeated threats, including a bill of impeachment, and stuck to his principles," wrote the former Fed Chairman's biographer, William L. Silber, in his 2011 masterwork *Volcker: The Triumph of Persistence*. "In the last great economic crisis, the epic battle against the Great Inflation of the 1970s, Paul Volcker was the hero." In the most recent one Ben Bernanke may yet prove the goat.

Expectations again are askew. Investors have become desensitized to a corporate landscape littered with companies addicted to nearly free money, and too many have reached for yield to boost their own portfolio performance by holding stocks and bonds of companies that fit the definition of the living dead. According to *Grant's,* three quarters of all businesses that went public last year "showed negative net income – the highest percentage since 2000."

No central banker looks poised to step into Paul Volcker's shoes. So one must ponder the implications of their remaining empty for too much longer. Put another way, could Japan's spirit-sapping economic slide after 1990 be prologue to similar stagnations in Europe and the United States? It's a thesis worth worrying about – and one, based on the decline of productivity growth, that's "data-driven," as the Fed itself might say. Failures like that of Toys "R" Us are no laughing matter. But many more of them are necessary across the industrialized world if the globalized capitalist order is ever to be reenergized. ■

Fig. 4 cont'd

financed, making it "a conduit through which China's debt problems are transmitted overseas," warned the *Financial Times'* James Kynge in August. Sri Lanka already defaulted on loans for its massive Hambantota port project and has instead leased the strategic facility to China for 99 years, an outcome some have called a "colonial land grab." Burma, Malaysia and Laos are reviewing China-funded infrastructure projects to avoid similar traps, and Pakistan reportedly plans to seek yet another IMF bailout due in part to ballooning debts owed to China.

Many BRI projects are either unjustified by market demand or over-scaled for the host country. According to a *Financial Times* study, most rely on large state-owned Chinese construction giants wildly more indebted than their overseas competitors; China's ten largest contractors have a ratio of total debt to EBITDA of 9.2 – categorized as "extreme indebtedness" – compared to just 2.4 for their foreign rivals. China's behemoths "are rewarded for political loyalty and motivated by a desire to please their party bosses by getting involved with big BRI projects," a senior Chinese official told the newspaper, adding: "Debt is just not a big concern." According to *The Economist*, 89% of BRI contractors thus far funded with soft loans from Beijing to other countries are Chinese companies, noting that "projects full of Chinese workers paid for by host-government debt raises hackles."

Plainly, the BRI has trade, commercial, cultural and geopolitical dimensions. Yet it is nonetheless true that China's vast construction sector is running out of domestic projects to undertake and requires growth abroad to stay afloat. Whether new businesses are economically viable seems of secondary concern – much as it ever was. That makes China's zombie companies a horror show worth watching. - GW ■

SaratogaRIM
Composite Statistics

Q3 2018

Saratoga Research & Investment Management
Tel: (408) 741-2330
E-mail: Contact@SaratogaRIM.com

14471 Big Basin Way, Suite E
Saratoga, CA 95070
SaratogaRIM.com

SaratogaRIM Large Cap Quality - Composite Overview

The SaratogaRIM Large Cap Quality Composite (SaratogaRIM Equity Composite) invests strictly in long-only equity positions, including ETFs. The minimum requirement to establish a new account is $100,000. The minimum asset level is $50,000. Inception date: February 29, 2000. Creation date for GIPS: August 30, 2010.

SaratogaRIM Large Cap Quality Focus - Composite Overview

The SaratogaRIM Large Cap Quality Focus Composite invests strictly in long-only equity positions, including ETFs, with higher concentration, particularly in the top 10 positions; collectively, the top 10 positions will make up at least 50% of the portfolio. This strategy will likely have a greater turnover ratio than other composites and may hold up to 5% cash. The minimum requirement to establish a new account is $250,000. The minimum asset level is $225,000. Inception date: August 31, 2014. Creation date for GIPS: August 31, 2014.

SaratogaRIM Large Cap Quality - Snapshot

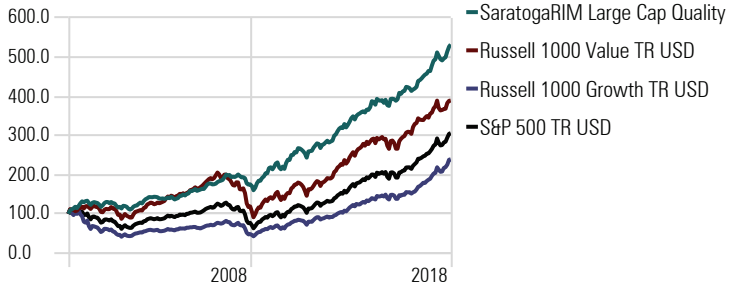
Name	SaratogaRIM Large Cap Quality
Manager Name	Kevin Tanner
Inception Date	2/29/2000
Firm Total Assets	$ 2,204,116,000
Strategy Assets	$ 1,520,319,000
GIPS Compliance	Yes
GIPS Compliance Date	12/31/2017

SaratogaRIM Large Cap Quality Focus - Snapshot

Name	SaratogaRIM Large Cap Quality Focus
Manager Name	Kevin Tanner
Inception Date	8/29/2014
Firm Total Assets	$ 2,204,116,000
Strategy Assets	$ 416,402,000
GIPS Compliance	Yes
GIPS Compliance Date	12/31/2017

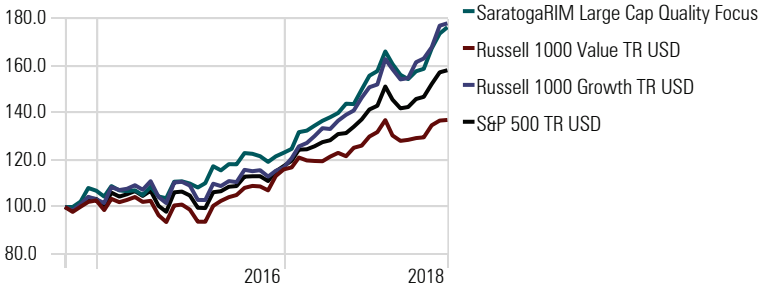
SaratogaRIM Large Cap Quality - Investment Growth (Gross)*

Time Period: 3/1/2000 to 9/30/2018



SaratogaRIM Large Cap Quality Focus - Investment Growth (Gross)*

Time Period: 9/1/2014 to 9/30/2018



SaratogaRIM Large Cap Quality - Performance (Gross)*

Time Period: 3/1/2000 to 9/30/2018

Calculation Benchmark: S&P 500 TR USD

	SRIM	SP500 TR
Return	9.42	6.20
Std Dev	8.88	14.36
Sharpe Ratio	0.88	0.38

SaratogaRIM Large Cap Quality Focus - Performance (Gross)*

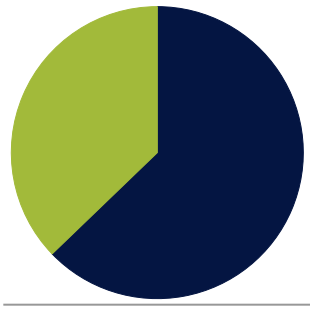
Time Period: 9/1/2014 to 9/30/2018

Calculation Benchmark: S&P 500 TR USD

	SRIM	SP500 TR
Return	14.92	11.89
Std Dev	9.21	9.75
Sharpe Ratio	1.49	1.14

SaratogaRIM Large Cap Quality - Asset Allocation*

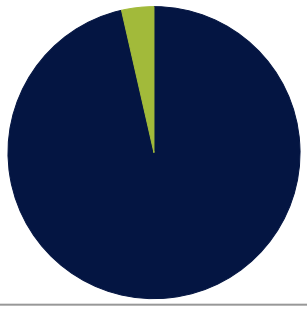
Portfolio Date: 9/30/2018



	%
Stock	62.8
Bond	0.0
Cash	37.2
Other	0.0
Total	**100.0**

SaratogaRIM Large Cap Quality Focus - Asset Allocation*

Portfolio Date: 9/30/2018



	%
Stock	96.4
Bond	0.0
Cash	3.6
Other	0.0
Total	**100.0**

Firm Overview: Saratoga Research & Investment Management, founded in 1995, is a SEC Registered Investment Advisor specializing in constructing and managing equity portfolios composed of high caliber businesses utilizing common sense investment principles for individual and institutional investors.

SaratogaRIM Large Cap Quality: SaratogaRIM claims compliance with the Global Investment Performance Standards (GIPS®) and has presented this report in compliance with the GIPS standards. SaratogaRIM has been independently verified for the period of March 1, 2000, through December 31, 2017. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. To receive a completed list and description of composites and/or a presentation compliant with the GIPS standards, please contact Aileen Braga, CCO, at (408) 741-2339 or Aileen@SaratogaRIM.com.

SaratogaRIM Large Cap Quality Focus: SaratogaRIM claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. SaratogaRIM has been independently verified for the period of March 1, 2000, through December 31, 2017. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The SaratogaRIM Large Cap Quality Focus composite has been examined for the period of September 1, 2014, through December 31, 2017. The verification and performance examination reports are available upon request. To receive a completed list and description of composites and/or a presentation compliant with the GIPS standards, please contact Aileen Braga, CCO, at (408) 741-2339 or Aileen@SaratogaRIM.com.

SaratogaRIM Large Cap Quality - Market Capitalization*	
Average Market Cap (mil)	151,817.47
Market Cap Giant %	77.16
Market Cap Large %	11.60
Market Cap Mid %	11.24

SaratogaRIM Large Cap Quality Focus - Market Capitalization*	
Average Market Cap (mil)	168,805.87
Market Cap Giant %	77.00
Market Cap Large %	13.74
Market Cap Mid %	9.27

SaratogaRIM Large Cap Quality - Holding Fundamentals*	
Dividend Yield	1.89
P/E Ratio (TTM)	26.60
P/CF Ratio (TTM)	16.52
P/B Ratio (TTM)	5.03
ROE % (TTM)	25.33
ROA % (TTM)	9.74
Net Margin %	12.87
Est. LT EPS Growth	9.49
Historical EPS Growth	-7.07
Portfolio Date	9/30/2018

SaratogaRIM Large Cap Quality Focus - Holding Fundamentals*	
Dividend Yield	1.71
P/E Ratio (TTM)	25.20
P/CF Ratio (TTM)	16.47
P/B Ratio (TTM)	4.83
ROE % (TTM)	25.63
ROA % (TTM)	10.44
Net Margin %	13.48
Est. LT EPS Growth	9.72
Historical EPS Growth	-4.36
Portfolio Date	9/30/2018

Market Capitalization and Holding Fundamentals statistics reflect the weightings of the stock portion of the portfolio. Items with an asterisk (*) are presented as supplemental data from Morningstar & SaratogaRIM. Results of Morningstar's calculations may vary slightly from SaratogaRIM's own reported statistics due to rounding.

SaratogaRIM Large Cap Quality Composite Performance Statistics:

Year	Gross TWR	Net TWR	S&P 500 Total Return	Median TWR	Standard Deviation	3 Yr Ann Standard Dev Quality Composite	3 Yr Ann Standard Dev S&P 500 Total Return	Number of Portfolios	% Non- Fee Paying Accts	End of Period Total Assets	Pct of Firm Assets	Number of Firm Portfolios*	End of Period Total Firm Assets
2000 (2/29)	32.49	31.45	-2.45	n/a	n/a	-	-	48	0.0%	14,909,737.56	55.76	62	26,739,561.04
2001	-1.62	-2.56	-11.93	-1.65	3.58	-	-	64	0.0%	30,514,640.98	82.74	72	36,880,627.71
2002	-9.37	-10.17	-22.06	-11.06	3.01	-	-	89	0.0%	34,000,857.47	86.67	102	39,231,009.50
2003	18.24	17.18	28.68	16.69	2.44	-	-	96	0.0%	42,848,809.47	81.77	120	52,403,457.10
2004	1.58	0.66	10.88	-0.29	2.96	-	-	103	0.2%	47,681,947.54	82.16	129	58,032,372.36
2005	7.11	6.13	4.91	5.54	2.39	-	-	105	0.2%	50,517,691.96	82.30	130	61,384,012.72
2006	16.94	15.87	15.80	14.48	2.82	-	-	99	0.2%	56,390,733.75	76.99	127	73,239,570.68
2007	12.06	11.02	5.49	10.29	3.31	-	-	99	0.2%	61,759,766.08	77.97	130	79,206,822.92
2008	-11.91	-12.74	-37.00	-12.32	4.20	-	-	126	0.5%	63,833,081.54	78.86	162	80,940,276.85
2009	24.77	23.65	26.46	23.89	2.18	-	-	259	0.4%	149,451,161.47	81.46	300	183,475,713.20
2010	14.27	13.43	15.06	13.89	0.76	-	-	494	0.3%	308,594,397.72	72.87	544	423,498,666.41
2011	4.31	3.69	2.11	3.27	0.53	11.86	18.71	1,176	0.4%	675,644,949.35	89.07	1,306	758,587,627.80
2012	9.93	9.30	16.00	9.33	0.61	9.98	15.09	1,539	0.4%	952,297,851.47	91.19	1,689	1,044,258,285.00
2013	21.65	20.98	32.39	21.10	1.63	7.85	11.94	1,823	0.3%	1,260,548,699.31	89.81	2,033	1,403,561,317.89
2014	10.58	9.98	13.69	10.37	0.94	6.30	8.97	1,912	0.7%	1,338,762,813.12	82.94	2,163	1,614,090,178.92
2015	1.77	1.22	1.38	1.07	1.00	6.96	10.47	1,989	1.6%	1,268,091,067.90	77.41	2,298	1,638,083,262.30
2016	6.94	6.36	11.96	6.32	0.89	6.48	10.59	2,194	1.8%	1,329,975,377.78	73.85	2,573	1,800,854,794.70
2017	17.71	17.08	21.83	16.93	1.52	6.15	9.92	2,380	2.0%	1,481,470,247.11	70.11	2,887	2,113,099,369.12
09/30/18	7.71	7.28	10.56	n/a	n/a	5.55	9.05	2,463	2.2%	1,520,318,995.78	68.98	3,043	2,204,116,438.99

SaratogaRIM Large Cap Quality Focus Composite Performance Statistics:

Year	Gross TWR	Net TWR	S&P 500 Total Return	Median TWR	Standard Deviation	3 Yr Ann Standard Dev Focus Composite	3 Yr Ann Standard Dev S&P 500 Total Return	Number of Portfolios	% Non- Fee Paying Accts	End of Period Total Assets	Pct of Firm Assets	Number of Firm Portfolios*	End of Period Total Firm Assets
2014 (8/31)	6.95	6.71	3.46	n/a	n/a	-	-	31	0.0%	59,408,640.33	3.68	2,163	1,614,090,178.92
2015	2.84	2.28	1.38	2.70	0.25	-	-	88	0.0%	122,809,323.37	7.50	2,298	1,638,083,262.30
2016	11.93	11.33	11.96	11.18	0.63	-	-	151	0.0%	198,406,978.21	11.02	2,573	1,800,854,794.70
2017	28.21	27.49	21.83	27.49	0.55	8.70	9.92	287	0.1%	362,440,319.53	17.15	2,887	2,113,099,369.12
09/30/18	11.82	11.35	10.56	n/a	n/a	8.78	9.05	362	0.2%	416,401,575.40	18.89	3,043	2,204,116,438.99

Notes: Valuations are computed and performance reported in market value of U.S. dollars based on trade dates as of month-end, net-of-fees, while accounting for dividend reinvestment. The 3-year standard deviation (external dispersion) is based on net-of-fees returns. Net-of-fees returns are calculated net of actual management fees and transaction costs and gross of custodian fees and external consultant or advisory fees. Gross-of-fees returns are calculated gross of management, custodial and external consultant or advisory fees and net of transaction costs. Composite returns are calculated using asset-weighted TWR, beginning market values, and external cash flows. Gross and Net TWRs are calculated based on the geometric linking of the monthly internal rate of return for portfolios present for the entire month. Individual portfolios are revalued monthly; portfolios also are revalued intra-month when large external cash flows occur in excess of 10% of the portfolio's fair value. SaratogaRIM fee is normally 1% for the SaratogaRIM Large Cap Quality (Equity) Composite & 1.2% for the SaratogaRIM Large Cap Quality Focus Composite; may be negotiated, as warranted by special circumstances. Dispersion is calculated as the asset-weighted standard deviation of annual net-of-fees portfolio returns around the median portfolio return in the composite. Dispersion is based only on portfolios that were in the composite for the full annual period, and is only shown for the annual periods where the composite had more than 5 portfolios for the full year. SaratogaRIM's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Daily reconciliation is performed between the firm's records and the custodian and broker records through Advent to verify client assets. Prior to March 7, 2007, Saratoga Research & Investment Management was known as Tanner & Associates Asset Management.

Benchmark Disclosures: The S&P 500 Total Return is the total return version of the S&P 500® Index, which has been widely regarded as the best single gauge of large-cap U.S. equities since 1957. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. (Note: A total return index assumes that all dividends and distributions are reinvested.) The S&P 500 Index is a product of S&P Dow Jones Indices LLC ("SPDJI"), and has been licensed for use by SaratogaRIM. Standard & Poor's®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and these trademarks have been licensed for use by SPDJI and sublicensed for certain purposes by SaratogaRIM. SaratogaRIM's products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics. The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. The Russell 1000 Growth Index & the Russell 1000 Value Index (the "Index") is a trademark of Frank Russell Company ("Russell") and have been licensed for use by SaratogaRIM. The SaratogaRIM Large Cap Quality Composite (the "Composite") is not in any way sponsored, endorsed, sold or promoted by Russell or the London Stock Exchange Group companies ("LSEG") (together the "Licensor Parties") and none of the Licensor Parties make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to (i) the results to be obtained from the use of the Index (upon which the Composite is based), (ii) the figure at which the Index is said to stand at any particular time on any particular day or otherwise, or (iii) the suitability of the Index for the purpose to which it is being put in connection with the Composite. None of the Licensor Parties have provided or will provide any financial or investment advice or recommendation in relation to the Index to SaratogaRIM or to its clients. The Index is calculated by Russell or its agent. None of the Licensor Parties shall be (a) liable (whether in negligence or otherwise) to any person for any error in the Index or (b) under any obligation to advise any person of any error therein.

Disclosures

Saratoga Research & Investment Management, founded in 1995, is a SEC Registered Investment Advisor specializing in constructing and managing equity portfolios composed of high caliber businesses utilizing common sense investment principles for individual and institutional investors. Prior to March 7, 2007, Saratoga Research & Investment Management was known as Tanner & Associates Asset Management.

The opinions herein are those of Saratoga Research & Investment Management (also referred to within this document as “SaratogaRIM” and “the Firm”). The contents of this report are only a portion of the original material and research and should not be relied upon in making investment decisions. The Firm’s quarterly reports focus primarily on its equity strategies. Under no circumstance is this an offer to sell or a solicitation to buy securities. All data, information and opinions are subject to change without notice. Opinions and statements of a fundamental nature are geared towards the long-term investor. SaratogaRIM is not a tax/legal advisor and therefore assumes no liability for any tax/legal research. Any information that is furnished to you should be thoroughly examined by a professional tax/legal advisor.

SaratogaRIM Large Cap Quality Composite: SaratogaRIM claims compliance with the Global Investment Performance Standards (GIPS®) and has presented this report in compliance with the GIPS standards. SaratogaRIM has been independently verified for the period of March 1, 2000, through December 31, 2017. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

SaratogaRIM Large Cap Quality Focus Composite: SaratogaRIM claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. SaratogaRIM has been independently verified for the period of March 1, 2000, through December 31, 2017. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The SaratogaRIM Large Cap Quality Focus Composite has been examined for the period of September 1, 2014, through December 31, 2017. The verification and performance examination reports are available upon request.

2018 Q3 Report Charts: All charts within this report are supplemental and are created by SaratogaRIM. Fig. 1 comprises daily return estimates calculated by FactSet utilizing month-end holdings data and may differ from actual performance. Past performance is no guarantee of future returns. Fig. 2 was created by SaratogaRIM using data from Arbor Research, LLC. Fig 3. was inspired by a concept in the book *Can “It” Happen Again? Essays on Instability and Finance* by Hyman P. Minsky and recreated by SaratogaRIM. For further information or clarification regarding any of the charts or concepts within this report, please email your *specific* questions to sam@saratogarim.com.

Valuations are computed and performance is reported in market value of U.S. dollars based on trade dates as of month-end net-of-fees while accounting for dividend reinvestment. The 3-year standard deviation (external dispersion) is based on net-of-fees returns. Net-of-fees returns are calculated net of actual management fees and transaction costs and gross of custodian fees and external consultant or advisory fees. Gross-of-fees returns are calculated gross of management, custodial and external consultant or advisory fees and net of transaction costs. Composite returns are calculated using asset-weighted TWR, beginning market values, and external cash flows. Gross and Net TWRs are calculated based on the geometric linking of the monthly internal rate of return for portfolios present for the entire month. Individual portfolios are revalued monthly; portfolios also are revalued intra-month when large external cash flows occur in excess of 10% of the portfolio’s fair value. SaratogaRIM fee is normally 1% for the SaratogaRIM Large Cap Quality (Equity) Composite & 1.2% for the SaratogaRIM Large Cap Quality Focus Composite; may be negotiated, as warranted by special circumstances. Dispersion is calculated as the asset-weighted standard deviation of annual net-of-fees portfolio returns around the median portfolio return in the composite. Dispersion is based only on portfolios that were in the composite for the full annual period, and is only shown for the annual periods where the composite had more than 5 portfolios for the full year. SaratogaRIM's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Daily reconciliation is performed between the Firm’s records and the custodian and broker records through Advent to verify client assets.

Benchmarks are selected based upon similarity to the investment style of the Firm’s composites and accepted norms within the industry. Benchmarks are provided for comparative purposes only and holdings of the Firm’s clients’ portfolios will differ from actual holdings of the benchmark indexes. Benchmarks are unmanaged and provided to represent the investment environment in existence during the time periods shown. The benchmarks presented were obtained from third-party sources deemed reliable but not guaranteed for accuracy or completeness.

The S&P 500 Total Return is the total return version of the S&P 500 Index, which has been widely regarded as the best single gauge of large-cap U.S. equities since 1957. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. (Note: A total return index assumes that all dividends and distri-

butions are reinvested.) The S&P 500 Index is a product of S&P Dow Jones Indices LLC ("SPDJI"), and has been licensed for use by SaratogaRIM. Standard & Poor's®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and these trademarks have been licensed for use by SPDJI and sublicensed for certain purposes by SaratogaRIM. SaratogaRIM's products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Russell 1000 Growth Index & the Russell 1000 Value Index (the "Index") is a trademark of Frank Russell Company ("Russell") and have been licensed for use by SaratogaRIM. The SaratogaRIM Large Cap Quality Composite (the "Composite") is not in any way sponsored, endorsed, sold or promoted by Russell or the London Stock Exchange Group companies ("LSEG") (together the "Licensor Parties") and none of the Licensor Parties make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to (i) the results to be obtained from the use of the Index (upon which the Composite is based), (ii) the figure at which the Index is said to stand at any particular time on any particular day or otherwise, or (iii) the suitability of the Index for the purpose to which it is being put in connection with the Composite. None of the Licensor Parties have provided or will provide any financial or investment advice or recommendation in relation to the Index to SaratogaRIM or to its clients. The Index is calculated by Russell or its agent. None of the Licensor Parties shall be (a) liable (whether in negligence or otherwise) to any person for any error in the Index or (b) under any obligation to advise any person of any error therein.

The MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity markets across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country.

Clients may access their portfolio information and reports including client-specific information through SaratogaRIM's website. The Firm recommends that you compare your Saratoga Research & Investment Management reports with the ones you receive from your custodian(s). The custodian of record is required under current law to provide separate account statements. Market values reflected in the custodian's statement and those cited in this report may differ due to the use of different reporting methods. To the extent that any discrepancies exist between the custody statement and this report, the custody statement will take precedence. Values may vary slightly because of situations such as rounding, accrued interest or the timing of information reporting. A fee statement will be posted on the Firm's website showing the amount of the Asset-Based fee, the value of clients' assets on which the Asset-Based fee is based and the specific manner in which the Asset-Based fee was calculated. These statements will be posted for one year; statements prior to that timeframe are available upon request. As a general rule, SaratogaRIM does not disclose private information regarding clients' accounts unless the Firm relies on certain third parties for services that enable the Firm to provide its investment services to their clients. The Firm may also disclose nonpublic information where required to do so under law. If you are a client needing website access or assistance, please call (408) 741-2330 or email operations@saratogarim.com.

If you wish to become a client of SaratogaRIM, you will be required to sign an Investment Advisory Agreement that exclusively governs the relationship between you and SaratogaRIM. SaratogaRIM's Privacy Policy and most recent Form ADV are available on SaratogaRIM.com. To receive a complete list and description of composites, a presentation compliant with the GIPS Standards and/or a printed copy of the Firm's Form ADV, please contact Aileen Braga, CCO, at (408) 741-2339 or aileen@saratogarim.com.

Cover Page Illustration by Scott Pollack

SaratogaRIM.com

Aileen Kay Braga, IACCP®: Chief Compliance Officer

Matt Casas, CFA: Analyst & Portfolio Manager

Marc Crosby, CFA, CPA: President, Analyst & Portfolio Manager

Andrew Early: Operations Associate

Stephen Fung, MBA: Analyst & Portfolio Manager

Travis Hanson, MBA: Chief Financial Officer & Operations Specialist

Maria Harrington: Relationship Manager & Operations Specialist

John Lapava: Office Manager

Mark McClenahan, CFP: Director of Investor Relations

Robert Meng, CFA: Analyst & Portfolio Manager

Adam Oreglia: Information Security Manager & Operations Specialist

Joe Pollard, CFA: Analyst & Portfolio Manager

Adam Sato: Analyst & Portfolio Manager

Phil Spencer, CFA: Director of Research, Analyst & Portfolio Manager

Jim Tanner: Director of Operations

Kevin Tanner: Chairman, CEO & Chief Investment Officer

Samantha Tanner: Investor Relations Specialist

George Wehrfritz: Editor & International Advisor to the Investment Team

Saratoga Research & Investment Management
14471 Big Basin Way, Suite E ■ Saratoga, CA 95070
(408) 741-2330 ■ contact@saratogarim.com

ENRON: FAILED REGULATION? • KOIZUMI ON AFGHAN AID

newsweek-int.com

Newsweek®

THE INTERNATIONAL NEWS MAGAZINE

January 21, 2002

JAPAN'S ZOMBIE IT COMPANIES

Crippling Debt, Falling Stock Prices, Failed Leadership- And Yet They Stagger On

ニューズウィーク二〇〇二年一月二十一日発行 第一三九巻三号
昭和二十一年二月十三日 第三種郵便物認可（毎月曜日発行）
許可番号第3種郵便物 ISSN 0194-1763 定価 ¥800（税込）

T1120173010800

雑誌 20173-1/21
Japan ····· ¥800
本体¥762
Korea ····· Won5,200

As the specter of bank runs and capital flight haunts their land, Japanese blame a corporate debtor class known as the living dead. BY GEORGE WEHRFRITZ AND HIDEKO TAKAYAMA

KING OF THE ZOMBIES

EMPIRE: Daiei founder Nakauchi surrounded by images of his company holdings, including (from left) a domed stadium, a baseball team, supermarkets, hotels and apparel outlets

JAPANESE TYCOON ISAO Nakauchi took away a harrowing memory from his time as a foot soldier in World War II. Near the end, as U.S. Marines stormed the Philippines in 1945, he recalls cowering in the jungle and struggling mightily to stay awake—fearful his own comrades would kill and eat him if he dozed off. The experience, he later told his biographer, taught him two bitter lessons: "No. 2 is a loser" and "Trust no one." Molded by insecurity and mistrust, this credo would carry Nakauchi to the top, but also set him up for a fall that now mirrors the scary downward spiral of the Japanese economy.

The young soldier returned home and built his father's tiny drugstore into Japan's largest retail empire. In the 1950s he popularized cash registers. In the 1960s he pioneered discount retailing, making his company—Daiei—the Wal-Mart of its day in Japan. By the early 1990s he employed 100,000 people and owned some 300 businesses, including hotels, restaurants and a professional baseball team. Revenues topped $40 billion, making "Nakauchi's Shop," as insiders call Daiei, one of the most powerful players in Japan's domestic economy.

The drive to be No. 1 came at a price. As with many other Japanese companies its size, Daiei's rise was fueled by easy credit from friendly banks. In the mid-1990s, as the bubble burst, the banks feared widespread default on these loans. So they dispensed more cash, desperately trying to keep big borrowers afloat. In one recent tally, the Oriental Economist, a monthly newsletter, identified 66 Japanese companies with debts greater than $1 billion and share prices below ¥200 ($1.60). Together they owe a staggering $260 billion, or about double Argentina's national debt. Daiei alone accounts for $17 billion, putting it near the bottom of this class, which the Japanese know as the *zombie gaisha*, or "zombie companies."

They are the sick soul of Japan's economic slump. The postwar culture of reckless lending nurtured staggering inefficiencies. Today global export brands like Toyota and Sony are the exception in Japan, where 90 percent of the population works for companies that sell mostly to the domestic market. These firms are one third less productive on average than companies in the United States, says the McKinsey Global Institute. They also carry twice as much debt, says the Bank of Japan. Japan itself is graded an increasingly dangerous risk by credit trackers like Moody's and Standard and Poor's, and now falls in the same debtor category as Slovakia. Some analysts are beginning to warn that Japan could be headed for a debt crisis similar to Argentina's, but with far more frightening implications for Asia and the world (following story).

Japan is still afloat despite its incompetent domestic economy, but just barely. Its stellar multinationals are sputtering as well. The crisis could come to a head on March 31, when as part of its "big bang" financial reforms Japan will stop insuring large bank de-

FROM LEFT: KYODO, COURTESY OF FUKUOKA DAIEI HAWKS, PHOTOGRAPH FOR NEWSWEEK BY YASUO KOBAYASHI, SANKEI SHIMBUN, JIJI PRESS, SANKEI SHIMBUN

posits. The plan was to encourage Japanese to move money out of savings and into the economy. The fear is that ordinary people have lost confidence in their own country, and will clear out accounts and send the money abroad. Bank runs and capital flight are all too likely. Credible reform might lower the risk, but will probably result in the collapse of many of Japan's largest companies, forcing tens of thousands of layoffs and a political crisis for Prime Minister Junichiro Koizumi. "If Japan continues to delay, debts will reach an uncontrollable magnitude," warns Takashi Watanabe, a banking specialist at Bunkyo University. "There is a possibility not just of the bankruptcy of major industries, but of the Japanese economy as a whole."

Daiei stores are vivid testimony to the decay inside Japan. At the Daiei in Akabane, a popular Tokyo bedroom community, everything from the mannequins to the costume jewelry is a generation out of date. The music is by the Carpenters, piped in from the 1970s. The food courts are grimy. Rows of rolling apparel racks are bathed in naked fluorescent light. Signs promise SALE, DISCOUNT and HALF PRICE, but customers rarely bite. On one recent evening they included several homeless people resting beside the escalator. A young couple traded whispers at the nearly empty snack bar. One of the few real shoppers, a woman with her teenage son in tow, flipped through denim skirts. "These are to wear at home," she stressed. "If I want anything fashionable I try the stores at the other side of the station."

Daiei is now emerging as a high-profile test of how far the government will go to fix the rot. In coming months, according to senior politicians and bureaucrats in Japan, the watchdog Financial Services Agency (FSA) will order banks to cut off dozens of the most indebted businesses. Most are in construction, real estate, retail and finance—the crumbling pillars of the domestic economy. In November the FSA included Daiei in an unprecedented audit aimed, according to the FSA, at exposing bad loans to shaky corporate borrowers. The likely outcome: pressure on Daiei's four main banks to abandon the ailing giant. "My sense, at this point, is that 70 percent of Daiei will be cut off," perhaps as early as this month, a senior government official told NEWSWEEK. That would result in the liquidation of most of Daiei's assets—a fire sale unprecedented in postwar Japanese history.

The ironic side of the Daiei story is that Nakauchi started out as a rebel attacking entrenched interests before he became one. After the war Nakauchi entered Japan's booming black markets, according to biographer Shinichi Sano, author of "Charisma: The Postwar Era of Isao Nakauchi and Daiei." "He traded everything but drugs and women," says Sano. In the late 1950s, Nakauchi took over the family drugstore in Kobe and soon bought another. He defied Japan's pervasive sales cartels by selling beef for ¥39 per gram—about half the "fixed" retail price. Over the years he undercut cartel pricing on everything from soap to consumer electronics in his expanding chain of modern grocery stores.

Nakauchi hungered to be Japan's biggest retailer. Like many business leaders of his generation, he valued volume over profitability, and expanded relentlessly. He built an empire by acquiring or starting companies, often in leveraged deals with chummy banks. By the late 1960s he was Japan's retail king, no longer a rebel but a symbol of the system.

In some ways, Nakauchi was less a retailer than a real-estate tycoon. Skyrocketing property prices were the main inflater of the 1980s bubble economy, and Nakauchi built his empire on them. He bought land in suburbs and small towns to build his huge grocery stores, both reshaping the countryside and earning huge paper profits on the land. He then used the property as collateral to secure more loans to buy rival chains or more land to build more stores. Thinking property values would rise forever, lenders played along. They bankrolled Daiei's expansion into hotels, convenience stores, restaurants, pachinko parlors and—in 1988—professional baseball.

No outsider knew enough about Daiei to question these moves in detail. Until very recently Nakauchi kept an iron grip on the group and made all the key decisions. He shuffled store managers frequently to prevent the emergence of local fiefdoms. On several occasions he sidelined assertive executives in favor of yes men. In 1969 he sacked his own brother for advocating steady growth over pell-mell expansion. The trend continued through late 2000, when Nakauchi forced the resignation of group president Tadasu Toba, allegedly for suggesting that Daiei shed its noncore assets and contemplate merging with a foreign partner. "Toba tried to implement hard solutions," says Takayuki Suzuki, retail-industry analyst at Merrill Lynch Japan. "The family said no."

An old saying conveys one of the cardinal rules of banking: size matters. "If you owe the bank $10,000 you have a problem," it goes, "but owe $10 million and you have a partner." Nowhere is that more true than in Japan. Most of the biggest debtor companies are virtual wards of their banks. They have seats on their boards and wield veto power over management. The bank's goal is always to keep the company afloat. Called credit monitoring, the system is Japan Inc.'s alternative to the shareholder monitoring popular in the West.

Japan's ways of managing corporate failure were once considered more efficient than the U.S. tradition of bankruptcy, hostile takeovers and shareholder revolts. In the 1970s, for example, Mazda was rescued from the brink of financial collapse by its main lender and the government. Sumitomo Bank injected new credit and a crisis-management team. The government urged rivals not to undermine Mazda in its time of trouble. A 1983 American study of "The Mazda Turnaround" praised the rescue as evidence of "an implicit social policy of protecting the inner circles" of corporate Japan.

The strategy proved disastrous following the collapse of Japan's asset bubble in 1990. Unwilling to write off or even reveal the growing volume of bad loans on their books, banks turned to a practice called "evergreening": covering old loans with new ones, so the dead leaves would never drop. Dai-Ichi Kangyo Bank, for example, funded retailer Mycal until the eve of its collapse last September under $8 billion in debt. Aoki Construction had received almost $2 billion in debt forgiveness from its main banks since 1999, but shut its doors last month anyway. Delay only magnified the losses. "A quick resolution lets markets operate, providing fuel for increases in economic activity," said the head of the U.S. Council of Economic Advisers, R. Glenn Hubbard, during a recent visit to Japan. "A slow resolution leads to paralysis and stagnation."

Daiei is a textbook case. It lost billions in paper wealth when Japan's bubble burst, but kept expanding anyway. In his autobiography, "The Distribution Revolution Never Ends," Nakauchi hailed the 1994 acquisition of three competing retailers for completing his 37-year march to create "a national chain from Hokkaido to Okinawa." The mergers gave Daiei a total of 356 outlets, with sales of ¥2.6 trillion. Counting on Japanese recovery, Daiei kept borrowing and spending. It bought Hawaii's biggest shopping mall and built a $1 billion stadium for its baseball team.

But Japan stagnated. By 1996 Daiei's operating profit had plunged 93 percent. In response the company split in two, creating the Daiei Group and Daiei Holding Corp. The idea was for the holding company to sell stocks in gems of the empire, as a fund-raising alternative to more loans. But unlike Sony or Toyota, Daiei found few buyers. Japanese analysts and media warned of huge hidden losses in undisclosed family businesses.

Like Japan itself, Daiei was lurching toward a crisis. By mid-2000 the company was $30 billion in debt (a sum that has since fallen, due mainly to the weakening yen). The strain triggered a power struggle between Nakauchi and Toba, then Daiei's president. In November that year both men resigned, reportedly battling over Toba's plans to save Daiei by breaking it up. Toba refuses to dis-

Japan is graded an increasingly dangerous risk BY CREDIT TRACKERS LIKE MOODY'S. It now falls in the same debtor category as Slovakia.

KOJI SASAHARA—AP

The only way to kill a zombie? Corporate staffers gather at a Tokyo shrine for an annual rite intended to exorcise evil spirits on the first working day of the year

THE WORST COMPANIES

Found mainly in the sectors below, the "zombie companies" suffer from high debts and weak stocks.

KEY: Debt/Share price

CONSTRUCTION

FUJITA
$621 million/$0.11

KUMAGAI CONSTRUCTION
$493 million/$0.15

HASEKO CORP.
$397 million/$0.15

RETAIL

DAIEI
$17.6 billion/$0.74

TOKYU DEPARTMENT STORES
$189 million/$0.72

KOTOBUKIYA
$128 million/$0.01

REAL ESTATE

DAIKYO
$819 million/$0.58

TOWA REAL-ESTATE DEV.
$366 million/$0.34

NICHIMO
$81 million/$0.34

NONBANK FINANCIAL

ORIENT CORP.
$18.7 billion/$0.98

APLUS
$774 million/$0.78

SOURCES: THE ORIENTAL ECONOMIST, NEWSWEEK

cuss his ouster. "I'm from a generation that believes that generals should not talk about lost wars," he told NEWSWEEK.

The casualty count is not yet complete. According to Daiei spokeswoman Kikue Inoue, top management had hoped to hold on *only* to solid businesses and allow distressed operations to fail. It was the bankers, she says, who insisted that Daiei be kept whole. "Logically it made sense to divide them," says Minorn Nakano of Teikoku Databank in Tokyo, "but the trouble ,vith Daiei is that the banks know that if it goes under, they may go under too."

That's a real risk. Koizumi is trying to weed out the worst debtors without provoking a full-scale bank crisis. Last month the Parliament strengthened the Resolution and Collection Corp., the agency charged with cleaning up the loan debacle, making it easier for the institution to buy bad debt. Separately, the government has issued new mies intended to allow banks to fix bad companies while preventing messy disruptions for suppliers and employees. "Many reporters have asked me if these rules were tailored for Daiei," says lawyer Shinjiro Takagi, principal author of the workout scheme. "They weren't, of course, but sometimes I imagined it."

It will be impossible, however, to clean up this mess without pain. Stephen Church of Analytica Financial figures bad corporate debt now amounts to a whopping $19 trillion, or 44 percent of Japan's GDP. Officially, Japan's position has been that foreign analysts were grossly exaggerating the problem, but that may be changing. Last week Daiei confirmed that it is negotiating with its four main banks, meaning one of two things: another stopgap rescue or Daiei's breakup. Investors, betting that the company will survive, dn ve its share plice up more than 20 percent last week. "The banks can't just say no and cut off ties;' says Shigeharu Shiraishi of SG Yamaichi Asset Management Co. in Tokyo. "Under these circumstances, it is vety difficult for Japan to escape the [bad loan] ctisis."

There is a clear example for Japanese politicians to follow right neJ.t door in South Korea, which was forced to seek a humiliating IMF bailout in 1997. As in Japan, family-run conglomerates dominated the economy. Their distress swallowed bank reserves and froze many of Korea's prime assets. To revive the economy, President Kim Dae Jung nationalized more than 40 failed banks and empowered a special agency to shut down or sell off the heaviest debtors. The Korean Asset Management Company, or KAMCO, has since disposed of some $44 billion in distressed assets, most to foreign buyers, in deals that revitalized South Korea. The problem, says Chung Jae-Ryong, KAMCO chairman and CEO, is that ".Japan is scared of going tlu·ough this, so they're pushing tlle debt crisis forward to the next generation."

Recent histoly shows that restructuring can work in Japan. The freshest example: Renault's successful turnaround of ailing automaker Nissan, which under foreign management has battled back from near bankrnptcy through cost-cutting and better design. Yet Nissan is an exception to the rule. Mergers and acquisitions remain both rare and lisky. The main players are foreign investment banks, which still get overwhelmingly bad press in Japan for doing their jobs. Ripplewood Holdings of New Jersey has been a whipping boy since it acquired the failed Long-Term Credit Bank in 2000. In October the FSA scolded tlle bank for doing exactly what all smalt lenders do: denying credit to weak companies.

Can Koizumi transform this bad-debt culture? Breaking up Daiei would send a strong message, and there are signs an endgame is near. In December Sentaku magazine rep01ted that "like rats fleeing a sinking ship, [suppliers] have begun to leave Daiei." Last week Japan's financial pages blimmed with speculation that Daiei might be forced to sell major assets, including its baseball team and stadium. One analyst told NEWSWEEK that banks will be forced to forgive more than $ 10 billion of Daiei debt, a staggeling loss. "Even that is no solution,"hesays, since Daiei would be left with barely enough money to "clean the entrances and toilets" at its faded retail stores.

At 81, Daiei's legendary founder is fighting to stave off an ignominious unraveling of his empire. Though Nakauchi officially retired in 2000, he still appears at critical junctures. Most recently, in October, he lobbied banks to continue supporting the company after Moody's lowered its credit rating to junk status. In his autobiography, Nakauchi pledged to fo!Jow the path of a mythological samurai from Kobe who was killed in battle but reborn seven times: 'TIJ stay in active service as long as I live."

Daiei may not have long. Most analysts believe Nakauchi's multibillion-dollar shop is running out of loans and lives. The end, when and if it comes, would hit hardest in the small towns that are the healtland of Japan's domestic economy and the favored location of Daiei stores. "I don't tllink tllere is a single housewife in Japan who hasn't bought a radish from Daiei," says biographer Shinichi Sano. "When it collapses, all of the Japanese people will have to face the fact that we really must do something about this economy." For all its prowess on tlle global stage, Japan can no longer afford to subsidize incompetence at home. That's one bitter lesson that can come none too soon. ■

Portrait of a Crisis

Japan's bad loans have grown to a size that dwarfs other countries' earlier debt crises.

COUNTRY	CRISIS PERIOD	BADDEBTSASA%0FGDP
Japan	1990-2005	68.6
Argentina	1980-1982	55.3
Israel	1977-1983	30.0
Mexico	1995	13.5
Sweden	1991	6.4
United States	1984-1991	3.2

DOMESTIC PRIVATE-SECTOR LOANS DOMINATE BAD DEBTS

TOTAL LOANS ¥1,048.7 trillion (US $7.9 trillion)

SOURCES: ANALYTICA JAPAN, BOJ AND THE WORLD BANK

NIKKEI SHIMBUN

CORPORATE FAILURES: Aoki Corp. president Yoichiro Yano announces that the construction firm is broke

Could rich Tokyo go the way of rioting Buenos Aires? Well, not quite all the way. BY GEORGE WEHRFRITZ

JAPAN AS ARGENTINA

IT MAY SEEM OUTRAGEOUS to compare the gathering crisis in Japan to the chaos of Mexico in the '80s or Argentina today. Japan is so much more modern, wealthy and, one would think, stable. Yet serious analysts are starting to draw just such comparisons. Here's how the Third „VorJd-crisis scenalio might play out in Japan.

It begins with foreign hedge-fund managers losing what little confidence they have left in Japan Inc. Spooked, say, by a downturn in Japan's trade surplus, they might issue "sell" orders on billions in Japanese stocks and bonds and yen. Such a rush for the door, warns Takeshi Kimura, head of the international accounting firm KPMG in Tokyo, could be enough to upset the precarious equilibrium in an economy burdened by massive debts. The money flow out of Japan would accelerate the weakening of the yen, increasing the cost of impolts and reversing the deflation that has ravaged Japan oflate.

The endgame could leave Japan in new, perhaps even more dire straits. Exports would fall even faster, but with rising prices at home-creating a condition of stagflation roughly akin to Argentina's before the recent devaluation. "This is the pattern often seen when a developing nation's economy implodes;' Kimura wrote in a recent KPMG newsletter.

Japan is no developing economy, to be sure. Yet it has assumed that role oflate, threatening the global financial system like a moody emerging market. Its cmrency is unstable. Its banks are undercapitalized. Its neighbors are nervous that what ails Tokyo might jump borders. Japan and Argentina share another trait, too, one that spells headaches for the International Monetary Fund: stubbornness. Just as Argentina clung to the untenable (the peso's hard peg to the U.S. dollar), Japan still hopes against all logic for an economic soft landing. "Japan is stuck in a place where there is no solution," says one constiuction-industry analyst in Tokyo. "We need a clisis of control. We need the IMF to set policy. We ***needgaiatsu*** [foreign pressure] to reorganize our national economy."

Japan and Argentina aren't clones-far from it. But rejecting their similarities out of hand-as the IMF's own No. 2 man in Asia did last week in Tohyo, declaring: "I don't think there is any compalison"-blurs the big picture. Take debt. Argentina crnmbled under massive foreign borrowing, whereas Japan, in contrast, remains a huge international creditor. Tokyo's debt woes emanate from several dozen huge companies that together owe enough to bring down their banks. Despite its purely domestic nature, Japan's bad debts, by some estimates, now exceed 60 percent of the GDP, compared to about 52 percent of GDP in Argentina. And while Argentina's crisis has not destabilized its neighbors, Japan's larger debt bomb could prove much more dangerous.

Researcher John Makin of the American Enterplise Institute predicted earlier this month that Japan will fail to disarm the bomb in time. Tokyo, he forecasts, will dally until several major banks fail abrnptly, forcing tlle government to spend up to $1 billion bailing out the financial system-enough to sink the yen and collapse Japan's bond market. ".Japan's deflation and debt crisis," he argues, "now constitute systemic risk to the global economy."

ANDRES STAPFF—REUTERS

IS TOKYO NEXT? Bank runs recently hit Buenos Aires

As in Argentina, average folks would be tlle biggest losers in any crisis. Traditionally strong savers, Japanese households keep much of their net wortll in yen-denominated bank accounts. Depreciation already has cut the value of their savings by 10 percent in dollar terms since September. If enough of them opt to shelter assets elsewhere, Tokyo might look a lot like Buenos Aires when locals began queuing outside banks to ,:vithdraw all the money they could. That risk, albeit slight, will intensif), after March 31, tlle day Japan is set to stop insuring bank deposits larger than 10 million yen. Makin predicts "the inevitable outcome" will be the "the failure of the banking system." He also warns that, as in Latin America and Russia before, credit-ratings agencies won't raise a red flag about Japan because they're afraid to hasten the coming crisis.

Nobody expects riots or bloodshed oftllekind that has engulfed Argentina in recent weeks. But capital flight, Kimura's doomsdayscenalio, could be mere months away. The decisive factor: Prime Minister Junichiro Koizurni's ability to reform Japan's financial system and revive the world's second largest economy. On Jan. 4 he pledged "to use eYely available means to prevent a financial crisis." Should he fail, the damage might prove Argentine in magnitude-or even worse. ■