

BAD MARTINIS, DOT-COM STOCK AND THE LOUISIANA PURCHASE:

A TREATISE ON INVESTMENT FUNDAMENTALS

Article II

by Rob Hill

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Something vaguely sinister happens when anything becomes popular enough to be a trend. Invariably, whatever becomes trendy stops serving whatever purpose it originally served that made it popular to begin with.

Martinis were popular because of the way they tasted, which, depending on your preference, was mostly like either vodka or gin, but always cold. Martinis became trendy and bartenders began making them taste like something else, chocolate for instance. They also began serving them in Jolly Green Giant sized glasses so that most of it would be warm by the time you got to it.



The same thing happens with investments. We saw that in the late 1990s when investing in stocks became all the rage. Like all trends, at some point you wake up and realize that the big, warm glass of gin, vermouth and Ovalteen that you just paid \$11.95 for really doesn't taste very good (or complement the flavor of those sushi hors d'oeuvres either).

And so it was, that sometime around the year 2000, investors suddenly realized that they weren't going to get rich selling Intel to each other. And on top of that nobody wanted that perpetually diluting iVillage.com stock that sounded so impressive to own at last season's cocktail parties.

Virtually overnight the decidedly un-trendy concept of "phantom money" reentered the national consciousness. Along with it, other such wet-blanket terms as "bubble" and "crash" – notions that *Fortune* magazine (not to mention our brokers) had been telling us were gone for good – landed on the front pages.

Yet, despite the shrill cries from latter day Chicken Littles, the economy recovered in relative short order. (That is, unless you were in commercial office leasing or working for iVillage.com.) This was due in no small part to a national monetary policy of which historically low interest rates have been the most conspicuous component.

Couple a monetary policy that almost pays the *borrower* interest on loans with very few appealing havens for investment dollars, and you have a situation in which everyone is now looking at commercial real estate. Whether it's an entire building or an office condominium, buying commercial real estate seems to be the next big thing.

And like corporate stock, real estate has been – and in many cases will always be – a good investment, from a profitability standpoint anyway. However, realities peculiar to real estate such as cash flow management and further investment after the purchase are often overlooked by investors.

One need only look at the current record vacancy rates (just under 23% in metropolitan Atlanta) and the broad differential between face rates and effective rates on leases (upwards of 20% or more in some cases) to understand just some of the many additional pitfalls of owning commercial real estate.

To put it simply, investing in real estate must be justified by reasons far beyond mere tax incentives and cheap money. A realistic means of extracting value between the acquisition and subsequent sale of the property, in addition to a practical exit strategy are also gravely important.

For a classic lesson on these vital principles we need look no further than the greatest speculative real estate deal in the history of this (or possibly any) nation: the Louisiana Purchase.

From at least 1682, when the Sieur de LaSalle claimed no less than the entire Mississippi River Valley for France (never mind that the Pope had given it to Spain or, for that matter, the fact that the Indians, through several thousand years of squatter's rights, held a rather indisputable legal claim to the property), no one disputed that this vast territory would one day be "profitable".

"I can calculate the motions of the heavenly bodies but not the madness of people."

-Sir Isaac Newton, upon losing £20,000 in the South Sea Bubble of the same year.

But real estate is, in general, what is known as a *long-term* investment; and raw land, in particular, mandates the longest of terms. Therefore, French ownership of the Louisiana Territory remained largely *strategic* (a Wall Street term meaning "unprofitable").

In fact, in light of France's horrendous losses during the French And Indian War, it could be reasonably said that Louisiana was a downright liability to its owners. But that was okay because like the owners of that iVillage.com stock, the French were in it for the *long-term*, ...right?

Enter Scottish financier John Law, who moved to France for personal reasons, of which a



Period Engraving of John Law

murder conviction in Great Britain was most certainly paramount. While evading the hangman's noose, Law managed to convince the French government to allow him to print paper money on its behalf –

backed by the gold and silver of the King of course – as a way of solving France's substantial economic woes.

Eventually, he went so far as to be allowed to set up the Mississippi Company that was then granted a complete monopoly on all trade with colonial Louisiana in return for assuming the entire national debt. To get actual money to run his company, Law sold stock – a lot of stock. In fact, the people of France – and several other European nations – tripped over each other to buy as much of the stuff as they could. Such was their firm belief in the immense cut that shareholders would soon receive from ... well ... all of the "trade" that would soon sprout from the heretofore conspicuously unprofitable Louisiana Territory.

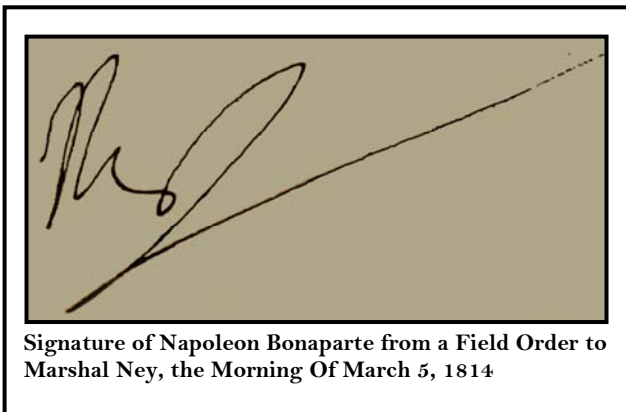
What was somehow lost on nearly everyone was the fact that trade requires some kind of goods, and that all of this requires people to actually get those goods. But why go all the way to an uncharted wilderness and face God knows what kind of peril when you could stay

safely at home in France and make a killing on stock whose value was based on some other suckers doing all of the heavy lifting. Surely any fool could figure that out.

And unfortunately for France every fool *did* figure that out. Hence history remembers this ambitious business venture as the *Mississippi Bubble*.

Thus was John Law forced to flee France for his life, only to die in squalor a few years later. Today he is remembered by many economists as the world's first Keynesian. This goes a long way toward explaining the swell economy of the 1970s following Richard Nixon's announcement that, "we're all Keynesians now". With this in mind, we should probably count ourselves lucky to have merely had to face stagflation and disco.

Meanwhile the ensuing economic depression in France resulted in, among other things, the French Revolution - which, resulting in something worse - resulted in France turning the whole mess over to Napoleon Bonaparte. Napoleon solved France's unemployment problem by enlisting everyone in the French military and setting off to conquer the world. However, even those "bits of ribbon and hunks of tin" that Napoleon was so fond of giving out cost money - something that had become rather scarce in France, what with conquering the world and all.



Signature of Napoleon Bonaparte from a Field Order to Marshal Ney, the Morning Of March 5, 1814

Fortunately for us, the Louisiana Territory was now finally viewed as the great white elephant that it truly was - that is, to everyone except for the people who were already moving in and making money on it: the Americans.



Free Frank Signature of Thomas Jefferson from an Envelope Addressed to "William Plumer Governor of New Hampshire", Dated Simply "24th of July"

So, America wanted the land and Napoleon needed money; but America - after a protracted revolution of its own and existing on a largely Jeffersonian agrarian economic base - found itself a little short on cash. So our nation did what the rest of us do; they got a mortgage. Several banks, most notably Baring Brothers of London, got together and issued us a mortgage for the purchase price of \$11,250,000.00, fully backed by an equal amount of US 20-year bonds, rather than the land itself. (After all, no one really believed they could foreclose on 820,000 square miles of real estate, evict everyone and sell the deed on the courthouse steps.)

In today's world where our government spends well over \$15 million every five minutes, 24 hours a day, it is - to put it mildly - difficult to put \$11.25 million in perspective. Suffice it to say that in 1803 that amounted to nearly twice the annual expenditures of our government.

In essence, France "sold" Louisiana to Baring Brothers of London (and Hope and Company of Amsterdam) in return for 52 million francs. Baring and Hope then transferred title to the US in return for \$11.25 million in 6% bonds. The rest, as they say, is history.

The moral of this history lesson for those of us who are in, or anticipate being in, commercial real estate is that no matter how “hot” or how highly touted any investment is said to be, it’s the fundamentals in relation to the specific investor that will be the greatest determinant in its ultimate success or failure.

Internet stocks collapsed because people – even those who owned stock in the companies themselves – didn’t suddenly start buying everything that they saw on banner and “pop-up” ads. In the same sense, robust trade – in whatever it was that was supposed to come from Louisiana in the mid 1700s – did not immediately materialize for the Mississippi Company.

Furthermore, investing in something simply because the price keeps rising is virtually always a recipe for financial ruin. (This is what economists, in possibly the only common-sense term economists have ever employed, call the “Greater Fool” principle.)

Generally speaking, for the small to medium size investor in commercial real estate, it is very often the owner-occupants or local landlords who fare the best. For the small to medium size absentee landlord, particularly in today’s market, who hopes to buy commercial property, contract the management to a local service provider, and make money on the cash flow from rent, it may be wise to reflect on the lessons of colonial rule. (And to consider seriously a leverage structure that keeps loan to value ratios low and debt service coverage high.)

For even with all of the immense wealth and value that the vast Louisiana Territory held, only America possessed the practical means by which to access its riches. It can be fairly said that by ignoring this very simple concept, much of the true, realized wealth of France, Spain and many other nations was needlessly squandered in pursuit of a real estate deal whose fundamentals did not match their circumstances.

As someone once said, “If they’re selling two elephants for a quarter, it’s a great bargain – – but only if you have a quarter and need two elephants.”



Map of the Louisiana Territory c. 1720 By J. B. Homann

*Baring Brothers, later the Barings bank, who made the Louisiana Purchase possible and thus did our nation a great service, carried on in its proud tradition. In fact, just a few years after the Louisiana Purchase the prime minister of France complained, “*There are six great powers in Europe: England, France, Prussia, Austria, Russia and Baring Brothers.*”

In a sad postscript to the story of the Louisiana Purchase, Barings was brought to ruin less than 10 years ago through the criminal mismanagement of funds in its Singapore offices by one very young and very corrupt manager. (Who, by the way, is now a free man and has just published a book on - you guessed it - “business ethics”.)

I recall at the time feeling a rather un-capitalistic sadness on hearing of the downfall of the institution that had done our country such a great service some 200 years ago.

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