The COMPLETE Guide to INVESTMENT OPPORTUNITIES

Encyclopedic coverage of 58 kinds of investments including • stocks • bonds • commodities • real estate • oil & gas • insurance • financial futures • gems • money market funds • gold & silver • options • leasing ventures • paintings • rugs and period furniture • foreign equities • mutual funds...et cetera...

by 68 leading investment specialists

Edited by Marshall E. Blume and Jack P. Friedman

The Complete Guide to
INVESTMENT OPPORTUNITIES

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Preface

Investors today are considering a much wider range of investment vehicles than they did ten years ago. Part of the reason for this change is the poor performance of the stock and bond markets in the 1970s in comparison to other types of investments, like real estate or even Treasury bills. Another part of the reason is the keen competitiveness of financial institutions in responding to this situation with a large number of new and imaginative investment products. Most persons would readily recognize some of them, like money market funds, but would be less familiar with others, like financial futures or Eurodollar instruments.

The purpose of *The Complete Guide to Investment Opportunities* is to provide in a single source reliable information about a wide array of investment vehicles. In this volume the reader can turn to a basic description of nearly sixty different kinds of investments, prepared by leading bankers, brokers, investment advisers, dealers, and financial specialists. A lawyer, asked by a client about strategic metals as an investment, can quickly obtain sufficient information to provide intelligent advice. An individual investor can use the *Guide* to learn about the tax consequences of investing in options. An institutional investor can obtain a concise overview of eight kinds of real estate investments. Estate executors and trustees, whether attorneys or bankers, can compare the performance of many new and traditional kinds of investment vehicles. Investors of moderate to substantial means should find the *Guide* a continuing source of interesting ideas and challenging insights.

To make the *Guide* easy to use, the entries for each investment vehicle are extensively cross-referenced and follow, to the extent possible, a standard format. Each entry begins with a general description of the vehicle itself. Then there is a discussion of the characteristics that make it an attractive investment and those characteristics that detract from its appeal.

Each entry examines — often in depth — the practical considerations of investing in the vehicle, such as

- The primary factors that determine the monetary value of the asset;
- Its suitability for specific types of investors;
- Where to obtain professional advice;
- How to buy and sell;
- Tax implications; and
- Unusual custodial problems and how to solve them.

The *Guide* ends with three articles of broad interest to investors. The first contains the latest investment return numbers of bonds, stocks, and real estate

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from the well-known Ibbotson-Sinquefield studies. Some performance statistics begin as early as 1926. The authors also include performance data on a number of other, less standard, investments. This discussion utilizes many tables and charts of unusual interest. The second article describes the fundamentals of portfolio management in nontechnical terms. These fundamentals are often associated with the term "modern portfolio theory," or MPT. The discussion provides numerical examples of optimal portfolio strategies under various possible future scenarios and then examines the implications of these strategies for attaining specific investment objectives. The third article discusses the tax implications of investing in collectibles, which in some respects are critically different from investing in more traditional vehicles. The Internal Revenue Code makes important distinctions between a "dealer" and "non-dealer," and these differences are carefully explored. In addition, the reader is warned of certain pitfalls in donating collectibles to nonprofit institutions.

Readers will appreciate a further attractive feature — the publisher's commitment to ensure the *Guide's* lasting usefulness through cumulative up-dates that will be regularly available.

As Editor-in-Chief of this volume, I have been fortunate in working with a large number of capable and dedicated individuals. My Associate Editor, Jack P. Friedman, who prepared the initial outline for the book, provided invaluable expertise in the real estate area and, in addition, carefully reviewed every contributed piece, including my own. The staff at Warren, Gorham & Lamont was superb. At the outset, I was highly skeptical that a group of contributors of the caliber I desired could be persuaded to participate, but Eugene Simonoff was persistent in arguing that his organization could do it. Indeed, an outstanding group of authors was assembled under the efforts of Gordon Laing, who also directed the editing of the authors' contributions. The quality of the *Guide* is a direct reflection of all these persons.

Final credit, however, is due to the contributors themselves. For their arduous efforts and unfailing cooperation in meeting high editorial standards and demanding deadlines, my Associate Editor and I are deeply indebted.

MARSHALL E. BLUME

June 1982
January 1984

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Arbitrage

Martin A. Weinstein *

BASIC CHARACTERISTICS

Arbitrage, in its purest form, is the practice of buying something in one market and simultaneously selling it in another market in order to take advantage of price differences existing at the moment of purchase and sale without risk of loss of capital.

Riskless Arbitrage

The usual subjects of arbitrage are currencies, currency futures, securities, and precious metals. For example, the British pound may be selling in Paris at $1.80 and in Tokyo at $1.81. An arbitrageur who buys a large quantity of pounds in Paris at $1.80 and simultaneously sells a large number of pounds in Tokyo at $1.81 can make a substantial profit based on the one-cent differential. In so doing, the arbitrageur has not risked any capital, but has merely taken advantage of an inefficiency in the marketplace based on differences in time and distance. Another example of a riskless-arbitrage situation is the purchase of a security on the New York Stock Exchange for $33 a share and the simultaneous sale of the same number of shares of the same security on the Pacific Coast Stock Exchange at a higher price. This procedure may be carried out in reverse by selling the shares short on the New York Exchange and buying them at a lower price on the Pacific Coast Exchange, in order to lock in the differential in price.

Risk Arbitrage

A variant of arbitrage that in practice involves risk of capital loss is the purchase or sale of a security at a discount or premium from some announced or stated value, with the hope that the price of the security will ultimately increase or decrease to this stated value. The magnitude of the discount or premium reflects the likelihood that the security will never reach, or will greatly surpass, the stated value. A very simple example of risk arbitrage is the purchase of a stock at $33 per share when another company has announced a tender offer at $35 per share. While the investor is trying to earn the $2 differential per share by buying at the lower price and selling to the announced purchaser at the higher price, there is a risk that the proposed offer may not be successfully completed. The

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material that follows deals exclusively with the various forms of risk arbitrage as practiced by specialists today.

TYPES OF RISK ARBITRAGE

Risk arbitrage may be undertaken in all forms of corporate reorganizations and capital restructurings, including tender offers, mergers, exchange offers, self-tenders and liquidations. These transactions generally require that the arbitrageur follow similar analytical procedures in deciding whether to make a purchase, but have different legal characteristics and requirements that may affect the outcome and shape of the final transaction, the price of the securities purchased when the transaction is completed, and the price of the securities during the period between the original announcement and completion of the transaction.

In order to evaluate each transaction fairly, therefore, it is necessary for the arbitrageur to know the mechanics, legal requirements, and possible pitfalls involved in each.

TRANSACTIONS

Tender Offers

A tender offer is the quickest and simplest way for one company to acquire any or all of the shares of another company. The advantages of the tender offer for the purchasing corporation are its speed, relative simplicity, and flexibility. A tender offer can be geared to acquire any specific percentage of a company that the buyer wants to purchase. In other words, Corporation A can tender for all of Corporation B or for any fixed number of shares that would result in A owning its desired percentage of B.

Mechanics of a tender offer. The purchasing company makes an offer to purchase for cash the number of shares of the company it seeks to acquire (the target company). The offer is made through an offering circular which, as required by the Securities and Exchange Commission (SEC) regulations, must disclose the salient terms of the offer, such as the source of the buyer's funds, the expiration date of the offer, the means by which an individual may withdraw the tendered shares, and where and how to redeem the stock certificates. Basic tax considerations concerning the offer are also included.

SEC regulations require that the mechanics of the tender offer commence within five business days of the public announcement of intent to purchase, and remain open for the following twenty business days. In non-regulated industries, however, no shares are actually purchased until the termination of a defined waiting period under the antitrust laws in order to give time to the Federal Trade Commission (FTC) or Antitrust Division of the Department of Justice to determine whether the combination resulting from the proposed tender offer would

violate the antitrust laws. In regulated industries such as utilities, banking, insurance, and transportation, the tender offer is made contingent upon the approval of the agencies charged with regulating those industries, and the buyer cannot pay for the shares until all such approvals are received. Since this can take quite a bit of time, combinations in regulated industries are usually structured as mergers.

Partial Tender Offers

In a partial tender offer where the purchaser only attempts to acquire a certain percentage of the shares of the target company, SEC regulations require that a bidder accept all shares properly tendered and not withdrawn during at least the first ten calendar days of an offer. If the tender offer is oversubscribed in this period, then all such shares tendered must be purchased on a pro rata basis. If the offer is not oversubscribed, the bidder may accept shares in the order in which they are tendered.

Hostile Takeovers

A hostile take-over situation develops when the management or board of directors of a corporation has turned down an offer to purchase made by another corporation. The would-be acquiring corporation might then make a tender offer for all of the target company's stock or a certain portion thereof in order to get voting control of the board of directors and of the company. If the acquiring company does not get the necessary number of shares in the requisite amount of time, it may either extend the offer, increase the offering price, or abandon the offer entirely. In some instances, the target company may attempt to seek out a candidate of its own to purchase its shares at a higher price than that offered by the company engaged in the hostile takeover and recommend that the shareholders tender their shares to that corporation. This new purchaser of the target company is frequently referred to as the "white knight."

Tender offers are the preferred type of transaction for a hostile takeover of another corporation because they do not need to be approved or endorsed by the target's board of directors, nor is a vote of the target corporation's shareholders required.

Exchange Offers

In an exchange offer a purchasing corporation offers to exchange its securities for the securities of the target company. An exchange offer is similar to a cash tender offer in that a shareholder vote of the target company is not required. The shareholders of the target, in effect, vote by either accepting or not accepting the offer. A shareholder vote of the acquiring company may also be required under certain circumstances, for instance, if that company is issuing new equity securities or if the shares to be exchanged have not yet been authorized for issue by its shareholders.

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