
CASE STUDIES

“Case Studies” presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

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POOSHA-CARTA FOOD STORES

The board of Poosha-Carta Food Stores believed that instead of being stampeded into trading its stock by every rumor, by every provocative story in the media, institutional investors would take the time and trouble to understand their business. That’s why they wanted to make its stock attractive to institutional investors.

The board had come to the conclusion that one way to increase the stock’s appeal to institutions was to give it a stable risk character. But the board split on how to do that. While some argued for maintaining constant leverage, others argued, instead, for maintaining a constant beta. And some board members argued that this was a distinction without a difference—that constant leverage would assure a constant beta.

Expecting that the controversies would come up again at the next board meeting, CFO John Roselli wanted to be ready. To this end he had prepared a list of questions.

Was it really useful to measure leverage in accounting terms—in book values? Unlike book values, market values fluctuated constantly. What would a policy of constant leverage really mean? What is the nature of the link between leverage and beta? Specifically, is it true that constant leverage will produce a constant beta?

DISCUSSION

Leverage is a simple concept when it is measured using the book values of debt and equity. But if the relevant values are market values, then leverage is not so simple. Instead, it entails two different processes:

- (1) random, continuous fluctuations in market values and
- (2) adjusting transactions that exchange debt for equity, or equity for debt.

When the first process moves the company's leverage away from the intended value, management can use the second to bring it back. By the time management has completed the adjusting transaction, however, the randomly fluctuating market values have moved on. Far from being a simple concept, leverage entailed endless pursuit of an elusive target.

The "market" is itself a collection of levered companies. When the general level of stock prices is rising, the "market" is becoming less levered. So, if the ultimate goal is stabilizing beta, it's not clear that stabilizing leverage is the way to do it. Indeed, stabilizing Poosha-Carta's leverage is almost certain to destabilize its beta.

It is clear that constant leverage is

- (1) not a simple idea,
- (2) not even strictly attainable, and
- (3) probably not even desirable, once one focuses on beta.

But most investors probably don't expect either constant leverage or constant beta. Neither goal is meaningful enough to preoccupy Poosha-Carta's board.