Is Debt Really an appropriate Financial Instrument for the 21st Century?

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Corporate Debt: Limitations

- Saddles ***Issuer*** with Fixed Costs
- Exposes ***Investor*** to the risks of Inflation
- Low ***Placement Agent*** Fees
  - Net of customization expenses
- ***Illiquid*** Secondary Market
  - Transaction costs are large relative to the small changes in credit ratings and the value of imbedded options

Sales Certificate

A contract like a bond, but ….

- Payout = a function of gross revenues (sales)
- Expires worthless at maturity
- Standardized terms
  - Terms are reset in case of merger or acquisition
- This instrument is currently in use
- Consequences: ***risk shifts*** for issuer & investor
  - Tax on crime, non-usurious,

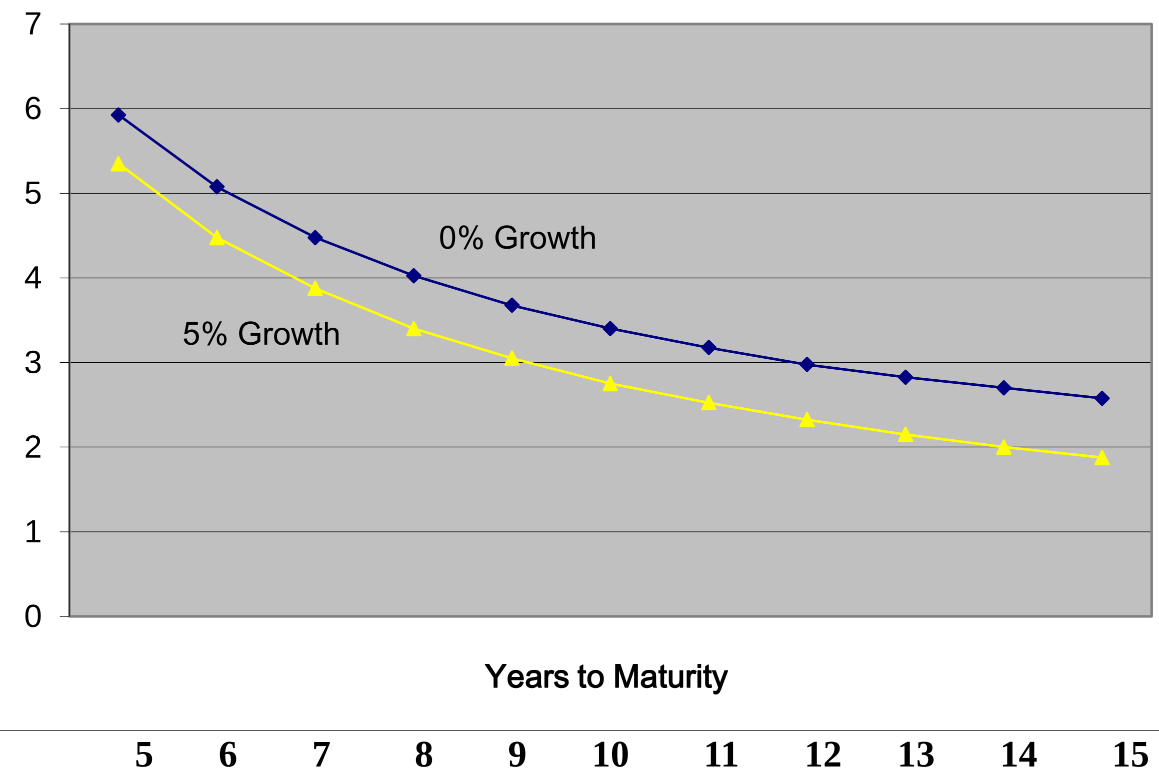
Issuer Benefit

- *Fixed cost* becomes a *variable cost*
  - Self Adjusting costs make these a Premium Product
- The “interest” equivalent is tax deductible
  - Ernst & Young letter
- Smaller liquidity premium
  - Changes in revenue prospects will swamp transactions costs versus the small changes in credit ratings and valuations of imbedded options of bonds
  - Sales are transparent

Investor Benefits

- In periods of inflation stocks & bonds are highly correlated
  - Certificates are hooked to sales & behave differently
  - Inflation insurance is important for both defined benefit & defined contribution plans & NOW is the time.
- High Cash Flow Vehicle
  - No-fee Term Annuity with inflation protection
- More liquidity
  - More transparent; higher probability of informed participation

Percent of Sales to Service Issue



Growth Rate	Percent of Sales
10 Year Maturity	
0%	3.4%
5%	2.8%
15 Year Maturity	
0%	2.6%
5%	1.8%

% of Sales = $ Raised/PV Sales
Capital raised = ¼ Current Sales
6% Discount Rate Std Dev of growth rates = 8%

Potential Purchasers

- Those who need an Inflation Adjusted Annuity
  - High Cash Flow Vehicle with inflation insurance
    - Tailored protection
  - New Asset Class
- Investors such as
  - Endowments, Casualty Insurers, Pension Funds
  - Institutions with 401(k) clients
    - Fidelity, Vanguard, Schwab
- Entities under Shari’ah Law
  - Sovereign Wealth Funds

Potential Issuers

- Money Managers
  - Other Professional Organizations
    - Auditors (WSJ, Mar 12th 2007 pg A8), **lawyers**, software firms, consultants: firms with few assets but high margins, Co-operatives
- Private Firms, LBOs, Insurance Cos (AIG), Airlines
- Firms under Shari'ah law
- Firms financing stock repurchase programs
  - Chevron – Market Value / Sales = 1. So, 0.75% of sales redeems 10%+ of equity.
  - 1/3rd of listed firms have a Market Value / Sales ratio =< 1.0

Inflation Alphas

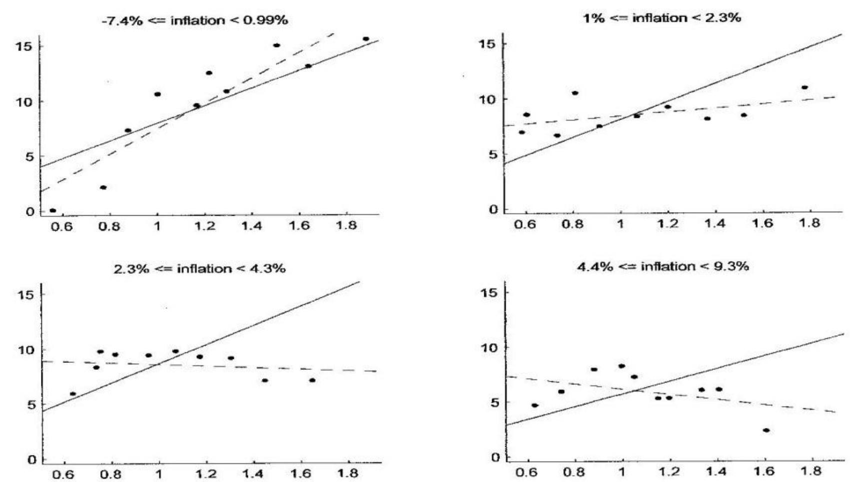


Figure 1: The empirical relation between average excess returns and beta in different inflation environments.

Cohn, Polk, Vuolteenaho: NBER Working Paper 11018 2005

Plus term-structure steepness

Spreadsheet

Problems Mitigated: - Corporate Debt

- **Mitigation:**
  - *Saddles Issuer with Fixed Costs*
    - **Certificates offer self adjusting cost**
  - *Exposes Investor to the risks of Inflation*
    - **Portfolios of Certificates allow tailored coverage**
  - *Illiquid Secondary Market*
    - Duration changes, need to trade or ladder: like bonds
    - **Little information advantage: standard terms**
  - *Low Underwriter Fees*
    - **Premium product**

Summary

- Modigliani-Miller still holds
  - Risks are reallocated, sensibly
  - Premium product, broader appeal
    - New asset class, new types of issuers
- Liquidity:
  - More transparent; trades on revenue prospects, higher probability of informed participation

Proposal

- US Government Sells:
  - “x”% of GDP for, say, 20 or 30 years
    - “x”% is the amount raised / Present Value of GDP
    - Certificates expire worthless
    - There is no guarantee of principal
  - With no guarantee, Certificates are not debt
    - Gilbert v Comm’r (2d Cir. 1969)
  - For tax purposes Certificates are annuities

Beneficiaries

- Legislators:
  - Debt ceiling goes away - temporarily
- Voters:
  - Certificates are self-liquidating
    - We pay our own way; no longer saddling our progeny with our debts
- Investors:
  - A marketable, no-load no fee term annuity with growth, inflation protection, low volatility and no counter-party risk that covers the economy
    - Intermediaries may disaggregate, allowing tailored sector exposure
- Treasury:
  - No rollover requirement
  - Decreases debt service burden in recession
    - The debt service relief can be used for tax decreases or stimulus projects