Mickey Mouse analysis

A pedagogical note demonstrating the risks of believing in market commentary—and some pointers on interest rate risk

Wall Street loves a good tale just as much as anyone: Witness the reams of commentary generated by the $300 million issue of 7.55% 100-year bonds by Walt Disney earlier this year. But all that this clacking of keyboards produced was proof that when it comes to financial commentary, speed beats precision and novelty conquers substance.

Analytical missteps

A few samples of some prominent misconceptions surrounding the Disney deal show just how "Mickey Mouse" some of the analysis really was:

• "The investor wanted to lengthen the average maturity of his holdings in order to counterbalance short-term holdings," opined Thomas T. Vogel, Jr. in the *Wall Street Journal* on July 21, 1993. That sounds reasonable. Adding 100-year bonds to a portfolio would certainly amplify interest rate sensitivity and bring higher returns if interest rates fell.

Not by much, however. A 1% drop in interest rates would increase the value of an optionless 100-year $1,000 bond by $133, compared with the $129 increase that a 50-year bond would produce. The price of the Disney issue would increase even less, because it becomes callable after 30 years. Conclusion: Century bonds don't offer much extra interest rate punch. They just sound colossal.

• "The fact that it was bought so quickly means a lot of people agree Mickey Mouse will be around for a long time," according to Disney spokesman Tom Deegan.

In the credit markets, five years can be an eternity, as even casual observers of IBM can attest. Mr Deegan misleads by suggesting that Walt Disney shares the same permanence as Mickey Mouse. Investors were not fooled, however. Judging by the 7.5% coupon on the offering, they perceived some danger of default. If investors really saw Walt Disney and Mickey Mouse as one and the same they would have settled for a coupon close to 6 6%, the rate for long Treasury bonds—but the yield of the Disney bonds exceeded the long Treasury rate by 95 basis points. Even if we take into account the call feature, the issue's yield spread over Treasury's shows a significant default risk. By our estimates at least 65 basis points of the yield premium were directly attributable to credit risk.

• "Disney's interest rate is about 20 basis points, or 0.2 percentage points higher on its super-long-term bond than it would have been on a more traditional bond," noted David Pauly on July 21.

This statement can't be true on its face. In the current rate environment, the $1,000 principal portion of the more traditional 50-year bond has roughly the same value as $2 paid annually for 50 years. If Mr Pauly's statement were true, an investor could purchase a 100-year bond, collect the coupons for 50 years, and simply donate the rest to charity. This exercise in arbitrage shows us that the fair-yield differential between 50- and 100-year structures is less than 20 basis points.

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Next came the debt-is-really-equity-in-disguise delusion:

• Very-long-term debt "is like equity for the issuing company", said Scott Jacobson, director of fixed-income research at Piper Capital Management, on July 27. Mr. Vogel added, "A reason companies are issuing very-long-term bonds rather than stock is tax savings. Unlike stock-dividend payments, the company can take deductions for payments made on these bonds."

Wrong: This assumes that dividend and interest payments are equivalent. If this were true, only a modest growth rate would boost the present value of the dividend flow far beyond that of the coupon stream of very-long-term debt. Dividends and debt payments, however, have fundamentally different risk characteristics and they must be discounted differently. No company has ever been declared bankrupt because it omitted a dividend; failure to meet contractual debt payments, whether principal or interest, brings dire consequences.

And a bit of comic relief...

Who gains and who loses? In our opinion, century bonds probably offer more marketing sizzle than concrete benefits to the companies that issue them. What gave century issues a comic flair was the fuss financial commentators made over them. Their stabs at analysis were like cartoon punches, full of exclamation points but lacking real power. Almost a century ago Karl Krause, an Austrian poet and a member of Vienna's cafe society, defined a commentator as someone with no ideas and the ability to express them. Perhaps this notion can be expanded to Wall Street's financial soothsayers and their Mickey Mouse analysis.

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