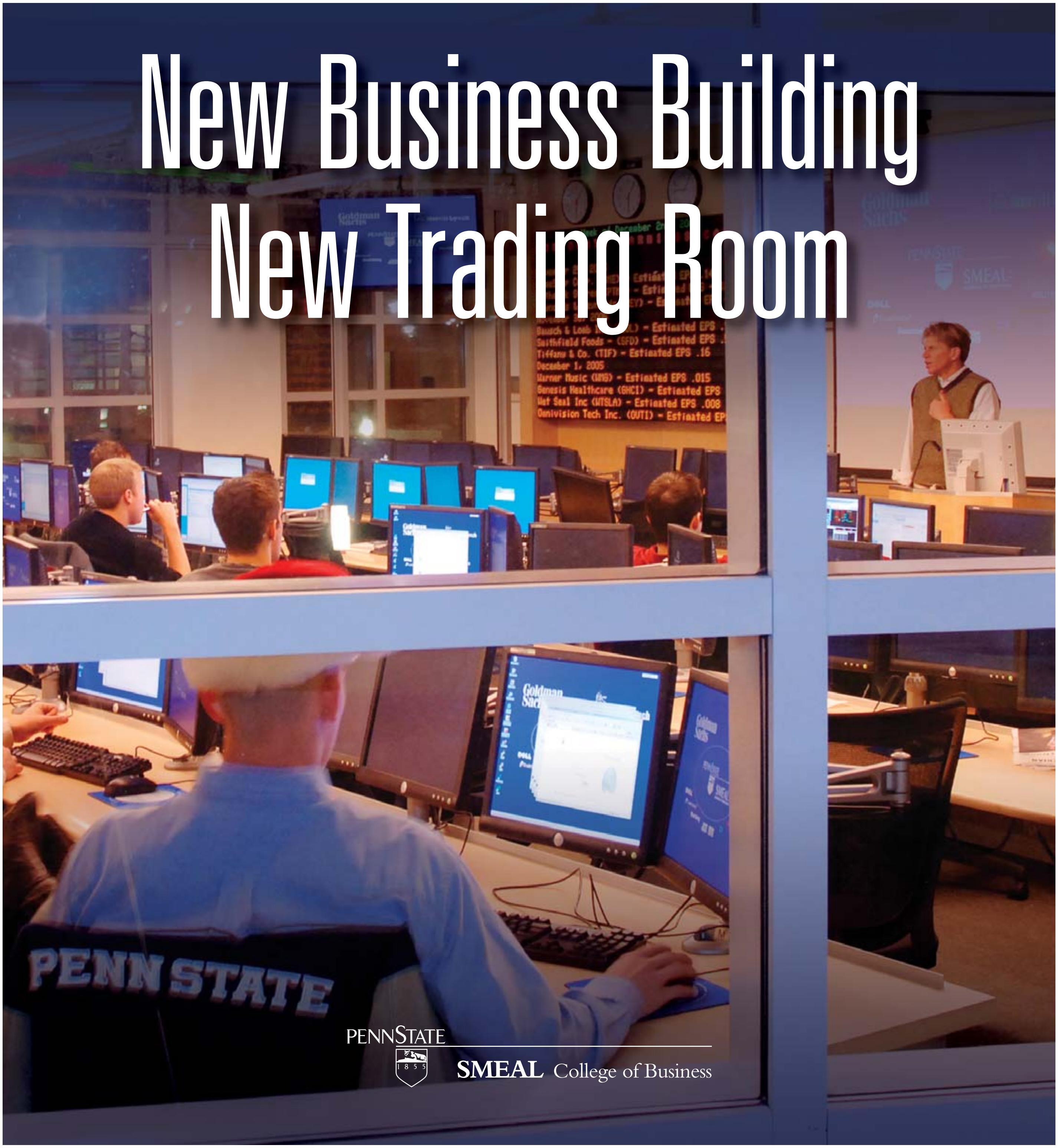
LION Trader

Volume 6

The Official Newsletter of the Smeal College Trading Room

New Business Building New Trading Room



PENNSTATE

SMEAL College of Business

LIONTrader *Inside this Issue...*

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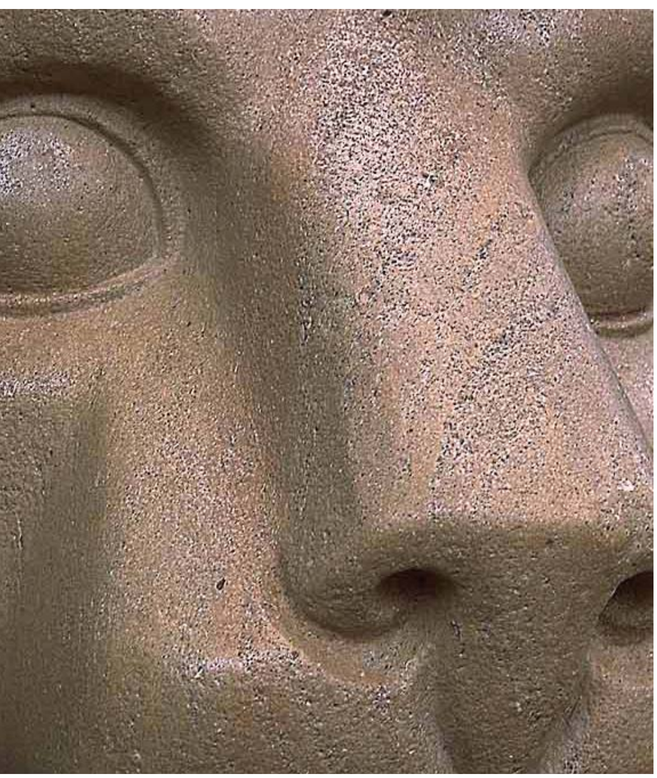

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On the cover: Trading Room interns meet with Academic Director David Haushalter in the Trading Room.

David Haushalter, Clinical Assistant Professor of Finance, and Academic Director of the Trading Room

The fall semester was very eventful for the Trading Room with a move to the new Business Building. The room is situated on the first floor, flanking the building entrance, making it a focal point of the new building. This improved visibility has increased the flow of students into the Trading Room, many of whom rarely visited the room in its former—somewhat secluded —location. The new room features a layout which is much more conducive to teaching, as well as additional resources, particularly ReutersStation, that increase the ability to integrate financial data and technology into our classes.

As with any move, there have been a few challenges. One of the largest logistical challenges was moving the room's seventy-one foot ticker. After several reconfigurations and a six foot section making a round trip visit to Kansas City (in a very large box), the ticker now flows around the perimeter of the Trading Room providing real time quotes to passers-by.

The success of the move is largely due to people who went above and beyond the call of duty, including Gary Field, the technology manager of the Trading Room. There are still lingering questions regarding whether Gary ever left the building during the week between the delivery of the furniture and the dedication of the new building on September 30th. Within this week, Gary managed to get all of the furniture set up and most of the computers in working order. Thanks to Gary, access to the room's data resources went virtually uninterrupted during the course of the move. The success was also largely due to the generous support and assistance provided by Ginger Breon, director of administrative and information services for the Smeal College, and former Dean Judy Olian and the many donors who made the new building possible.

As described in the following pages, the new Trading Room has hosted a wide range of visitors and events in the few months since its opening, including students from high school investment classes, prospective Penn State honor students, classes by Reuters product specialists, and lectures by industry professionals. Although the room was not ESPN-enabled until late in the football season, we also hosted a regular stream of visitors in the mornings prior to home football games. In addition to finance courses taught in the room, students also regularly attended classes taught by the student Trading Room interns on how to use the financial technology and data available in the Trading Room.

The spring semester will feature a number of key events. Through our in-house trading competition, we will select a group of students to attend the Rotman Trading Competition at the University of Toronto. During the past two years, the Penn State team has returned from this competition with top honors, third place in 2005, and first in 2004. Smeal's Global Trading Competition will be held later in the Spring. The inaugural Global Trading Competition was held in 2003 and featured 140 student competitors representing 42 universities and eight countries. We hope to make the 2006 version bigger and better. Other upcoming events include visits from Bloomberg product specialists and our inaugural Friday Finance Film Festival.

We always welcome visitors. The next time that you plan to be in the area, contact us at *tradingroom@email.smeal.psu.edu* to schedule a tour or just stop by.

PSU Alum Donates Bell to Trading Room

When Howard Trauger ('69 B.S., '79 M.B.A.), originally visited the Trading Room, he noticed that there was something glaringly missing. The computers were there, the trading platforms were commendable, but it still did not feel right. Finally, he realized that the Trading Room needed a *bell*—every trading floor has a bell.

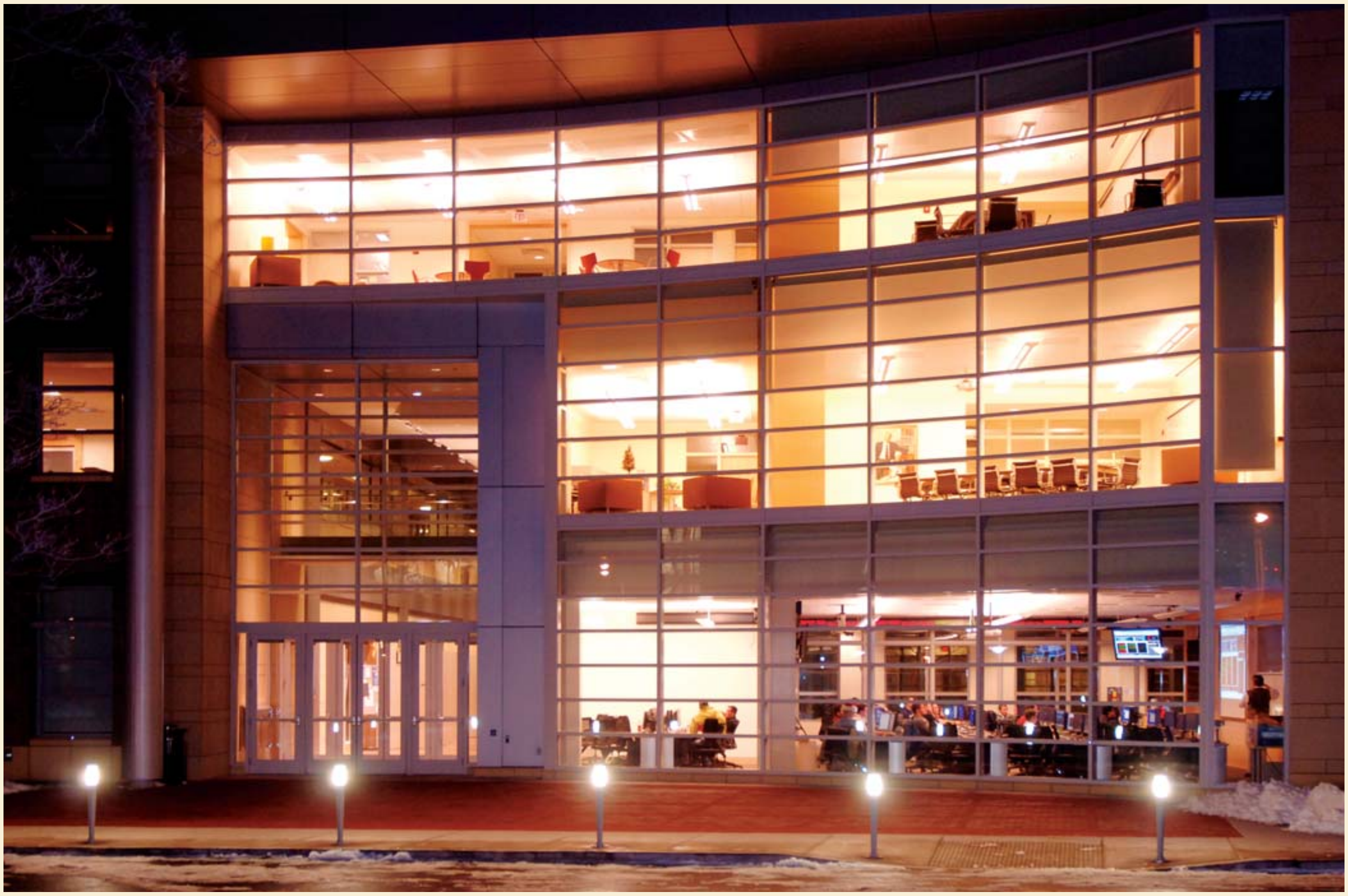
He soon found the perfect bell in an antique shop, a Pennsylvania Railroad bell that was used in the late-1800's through the turn of the century.

Before the bell could be situated in its new home, however, it needed to be initiated appropriately. He arranged for Dean Judy Olian and himself to make the inaugural ring of the bell at the Philadelphia Stock Exchange on May 13, 2004.

The bell was finally installed in the new Trading Room on Friday, September 30th, 2005, the day of the new Business Building's dedication. Mr. Trauger feels that the bell symbolizes "the standards of students at Penn State," paralleling its association with the quality and historical importance of the Pennsylvania Railroad in building our great country. Additionally, he feels that it would act as an emblem of the college, promoting the college's traditions and instilling its values in the lives of Smeal students for years to come.

Philadelphia Stock Exchange Vice Chairman, John Wallace (l), looks on as Penn State Alumnus Howard Trauger (center) and former Smeal College Dean Judy Olian (r) ring the Phlx inaugural bell on May 13, 2004.

— *Ryan K. Miller, LionTrader Editor*



The Trading Room is visible just to the right of the Building's entrance. It is a busy place for learning and teaching, even at night. Here, the Trading Room interns meet with Academic Director, David Haushalter.

New Business Building New Trading Room

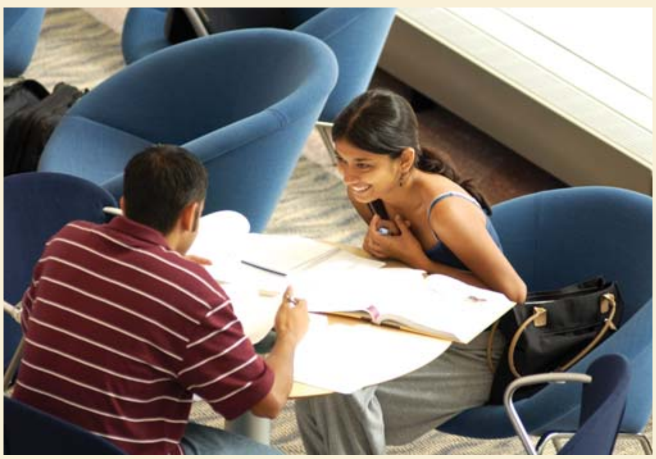
Situated on the corner of Park Avenue and Shortlidge Road, the new business building dominates the landscape. It was designed by Robert A.M. Stern, one of the world's preeminent architects and dean of the Yale School of Architecture. At 210,000 square feet with twenty-two classrooms, six research laboratories, and a-150 seat auditorium, the new building is the largest academic facility at Penn State. It is one of the most modern facilities among America's top universities.

Throughout the week, the building bustles with activity. Students attend class in multi-tiered classrooms, tap into global markets in the trading room, study and access the wireless internet in the four-story glass atrium, and meet with academic advisors and faculty. They interview with employers from across the nation in the interview rooms or through video conferencing facilities. Guests can also use touch kiosk screens to find classrooms and faculty offices and learn about ongoing events.

In addition to its state of the art technologies and amenities, the building gives the Smeal College of Business a concentrated community, something that was lacking in the past. This will serve to further the college's reputation for excellence by providing a more integrated business education.

— Leslie C. Vitale, LionTrader Staff

The Trading Room boasts the latest technology to give students realistic trading experience, including a real-time ticker, cable news feeds, stock boards, and software such as Bloomsberg and Reuters.



Tables, sofas, and chairs throughout the Foyer and Atrium create a comfortable "home away from home" for students.

The Building's main entrance, facing Shortlidge Road.

Penn State President Graham Spanier speaking at the Building Dedication in the Atrium.

The openness of the Building Foyer is spanned by overhead walkways that connect the different wings of the Building.

An Afternoon with Ken Kulju

Ken Kulju

Ken Kulju ('80 B.S.), the lead healthcare analyst at Credit Suisse First Boston, has spent 21 years in equity research. He has lived through a stock market crash and two recessions, and he is still excited to go to work each day, without ever knowing what to expect.

On September 30, 2005, Mr. Kulju visited Penn State to give students and faculty his perspective on the marketplace and comment on the current healthcare holdings in the Nittany Lion Fund, Penn State's student-run multi-million dollar investment portfolio. He was immediately impressed by the breadth and depth of the students' knowledge and the overall quality of the portfolio. It was a great opportunity for students to get the perspective of an established professional on current themes in the market place.

In his presentation, Mr. Kulju covered historical healthcare trends, current themes, and an evaluation of the Nittany Lion Fund's two healthcare holdings: United Health and Johnson & Johnson. Mr. Kulju believes that aging demographics and a steady rise in global healthcare spending present some great opportunities in this sector.

Credit Suisse First Boston has an outperform rating on UnitedHealth Group, and a neutral rating on Johnson & Johnson. CSFB is bullish on UnitedHealth Group due to strong second quarter earnings and a large increase in membership for the health care service provider. CSFB is neutral on Johnson & Johnson, due to deteriorating trends in the pharmaceutical drug industry.

In Penn State's continued effort to put current students in contact with Wall Street alumni, Mr. Kulju has proven to be a great resource for members of the Nittany Lion Fund. "Ken's presentation gave me an enhanced perspective on how the healthcare industry operates and what is going to affect it going forward. This was an amazing opportunity for me and will definitely affect my investment decisions," said Nittany Lion Fund Healthcare Lead Analyst John Nelson.

— *Eugene E. Weissberger, LionTrader Staff*

Reuters

ReutersStation is one of several software applications available in the Trading Room. It is the preeminent information provider around the globe, with over 100,000 terminals domestically and more than 600,000 globally. It brings together all facets of the market from level II quotes to research in equity, fixed income, and currency markets. As a direct news source, Reuters is able to publish news faster than its competitors, making it the leading news provider globally.

Reuters prides itself in having "better quality, timeliness, accuracy and user interface," says Reuters Product Specialist, Darrin Pisani. This past November Pisani and his colleague Ted King, two Reuters specialists, presented on the varied functions available in ReutersStation. Topics covered included historical news searches, bond analytics, and real-time Reuters-linked financial modeling in Microsoft Excel.

"Having these Reuters representatives here provides our students with additional insights into regarding how the tools and data available in the trading room are used in the real-world," says David Haushalter, finance professor and academic director of the trading room. All Penn State students are welcome to come in and use the software. Student Trading Room interns are available to answer questions and help with Reuters software.

— *Daniel M. Kokini, LionTrader Editor*

Pisani (l) and King (r) during their visit to the Trading Room.

Online Purchases Unlikely to Remain Tax-Free

In December 2004, the U.S. Congress passed a three-year extension of the moratorium on multiple and discriminatory Internet taxes, as well as the ban on taxation of Internet access. Online retail was not included in this moratorium, however, and still remains a murky issue for both consumers and state tax agencies. Currently, some retail purchases are taxed and some are not; sites such as Amazon.com and eBay currently do not have a sales tax on most of their online purchases, but Walmart.com and Target.com are some of the many that do charge a sales tax. This article will explain the current determining factors of whether or not a sales tax is included in an online retail purchase, including the likely eventuality that all e-commerce will include respective states' applicable sales taxes.

Legally, purchasers of online goods are required to pay their respective state's sales tax. This concept is referred to as a "use tax," and state tax agencies have long complained about consumers failing to report the tax they owe from both online and mail-order purchases. In general, online retailers have been covered by the 1992 Supreme Court case of *Quill Corp. v. North Dakota.* In it the Court barred state and local governments from collecting taxes on most "remote" sales, ruling that it would be unreasonable to force mail-order and catalog sellers to collect sales taxes in the thousands of jurisdictions around the country where they don't have a substantial presence.

This past summer, Borders.com (now managed by Amazon.com) lost a pivotal case against the state of California in a related dispute, where the Court reasoned that, "Borders' receipts were sometimes imprinted with 'Visit us online at www.Borders.com,' and Borders' employees were encouraged to refer customers online to find merchandise not available at Borders stores."

Borders' headquarters are located in Michigan, and at the time, it had no employees, bank accounts, or property in California. Yet the close association between Borders and Borders Online was enough to push the case in favor of the state of California, and Borders was ordered to pay California sales tax on all internet purchases shipped to California during the time frame at issue.

The Borders.com case appears to have emboldened state tax collectors to more aggressively pursue tax receipts from major internet retailers, and more states are looking at using the "use tax" as justification for collecting sales tax. This past summer, tax collectors from 18 states announced an interstate agreement on uniform sales tax regulations. The agreement is set to smooth over the differences in state tax procedures. Proponents of the agreement hope the streamlined system, even with voluntary compliance, would attract participation from multistate companies that say the current tax system is too complicated.

As more states begin to enforce their use tax, it is only a matter of time before all online purchases are taxed. The most compelling piece of evidence in favor of this lies in Supreme Court Justice John Paul Stevens' opinion in *Quill Corp. v North Dakota:* "This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions." Translation: the clock is ticking.

— *Ryan R. Ward, LionTrader Staff*

STUDENT RESEARCH PAPER

The Economics of a Football School

General Overview:

"The Penn State Athletic Department operates similarly to about half of the schools in the Big Ten conference," according to Gregory Myford, associate athletic director of marketing & communications. Penn State Athletics supports all 29 varsity sports by collecting and dispersing revenue self-sufficiently without assistance from the University. Additionally, Penn State Athletics has certain obligations to the venues where the teams compete. For example, athletics must pay for maintenance and renovations/expansions to Beaver Stadium. Moreover, while the Bryce Jordan Center is operated by the Penn State Housing and Food Services division, Penn State Athletics must rent the office and storage space inside, as well as pay for both basketball teams to use the facility for practice, games, and locker room space.

Revenue Inflows:

Sponsorship and Advertising:

Penn State Athletics utilizes multiple methods to collect revenues in advertising and sponsorship. Most of the sponsorship capabilities are outsourced to Learfield Sports, a national sports marketing agency (football and basketball only). Learfield purchases the rights from Penn State Athletics (PSA) for an annual fee, and then they sell sponsorships to make a profit up to a certain amount, at which point the additional profits are shared with Penn State Athletics. Outsourcing the majority of the sponsorships allows PSA to have stability in their budget through constant revenue, and without hiring additional employees to sell the sponsorship deals. These deals include local radio and TV rights, promotional inventory, and other on-site and media opportunities. Outside of Learfield, PSA has direct sponsorship from Nike and the Penn State Alumni Association and receives financial benefit from university-wide agreements such as those with Pepsi and The Penn State Bookstore.

Conference Media Agreements:

One of the major benefits of being in a major conference like the Big Ten is the division of the money received from broadcast rights agreements and corporate sponsorships that are given to the conference. The Big Ten Conference has many contracts with sponsors and programmers, including ESPN and ABC, of which the portions are equally distributed to each school in the Big Ten. The conference media agreements also include revenue gained from post-season football bowl appearances and other NCAA events.

Ticket Sales:

PSA charges admittance to seven of the 29 varsity sports. These sports include football, men's and women's basketball, women's volleyball, men's and women's gymnastics, and wrestling. Football makes up approximately 94% of the ticket revenues, basketball combined makes up about 4%, and volleyball, gymnastics, and wrestling make up the remaining 2%.

Parking and Concessions:

Concession revenue can only be counted from PSA facilities. This means that revenue can not be collected from the Bryce Jordan Center, because it is a Housing and Food Services venue. However, Beaver Stadium concessions are counted towards the PSA revenues. Additionally, parking is charged only for football games, while other sports parking is free in designated university lots.

Expenses:

Scholarships:

Each scholarship that PSA awards to a student-athlete includes paid tuition and board. The thought that other students pay for the scholarships of student-athletes is false. PSA pays Penn State for the scholarships, including out-of-state tuition scholarships. This is a significant expense to the Athletic Department.

Team Travel and Equipment:

Team travel, which includes lodging, food, and transportation, is also a very costly expense to the Athletic Department. Additionally, each team is provided with top of the line medical supervision, equipment, and other gear.

Employee Salary:

Penn State hires the best coaches and assistant coaches for each of its 29 varsity sports. In addition to the coaches, there are over 240 employees in various offices, including Administration, Athletic Communications, Marketing & Promotion, Events, Compliance, Finance, and more. The ever-increasing cost of salaries, insurance, and other benefits is a large operating expense for the Athletic Department.

Stadium Upkeep and Operations:

PSA is responsible for the upkeep and maintenance of Beaver Stadium and certain other athletic facilities. In addition to the upkeep, PSA must pay for utilities, such as water and electric, significant expenses for sports facilities.

Club and IM Sports:

While it is true that students do pay fees for the IM sports, and that club sports are partially funded via measures outside from PSA, PSA subsidizes both of these programs. PSA must help support the IM sports that student revenue does not completely fill. PSA also helps the club sports such as hockey and rugby.

— Jon Hammarstedt, LionTrader Staff

STUDENT RESEARCH PAPER

Hurricanes and Insurance

The damage caused this past September and October by Hurricanes Katrina and Rita is likely to have a long-reaching effect upon the insurance industry. The insurance consulting branch of Towers Perrin estimates that the total financial cost to the industry is $40 billion to $55 billion. Assuming that this estimate is accurate, Hurricane Katrina is now the most expensive disaster in the history of the insurance industry.

Insurance companies are using a variety of methods to cope with the losses associated with Katrina. Some corporations, particularly re-insurers, are issuing stock to raise money. According to Reuters, the reason for this trend is that these companies are "expected to raise rates" and that "companies with more capital can write more policies." This may result in the disaster becoming a source of long-term profits for these companies by allowing them to invest the extra capital and ultimately earn a sizable return.

The damage done by the hurricane will also have an international effect. Due to the global markets for insurance, the insurers are able to spread the losses to even more customers than they would be able to do in a solely domestic insurance market. This means that people all over the world experience a premium hike, but it has proven to be much smaller than expected.

The federal government has reacted to the Katrina disaster by introducing a change to the federally-subsidized flood insurance program. This proposal, sponsored by Senator Trent Lott and Congressman Gene Taylor, both of Mississippi, would allow people who suffered flood losses due to Hurricane Katrina to retroactively purchase flood insurance. Should this bill pass, a large number of flood claims may immediately be filed with private insurers that would indemnify homeowners who were not prepared by having flood insurance. While this will inflate the paper losses of the insurance sector, the companies themselves will not suffer greatly.

Fortunately for insurers, the federal government is still picking up most of the tab. Flood insurance works identically to standard insurance policies until the private insurer suffers underwriting loss (more money paid out in claims than made in premium dollars). From that point, the federal government reimburses the companies for any losses that they may suffer. Because the government is funding this program through a new Treasury bond issue, the Senate has allowed the National Flood Insurance Program to borrow up to $8.5 billion to cover its losses. It should be noted, however that this may not be enough. David Maurstad, director of the flood program, said that the agency may need "up to $22 billion."

A second disaster for the insurance industry occurred shortly after Katrina ravaged the Gulf Coast—Hurricane Rita. Thankfully, Rita made a much smaller dent in the industry than Katrina. According to the *Financial Times,* "analysts estimate that Rita will cost insurers between $3 billion and $6 billion." This equates to roughly 10% of the damage associated with Hurricane Katrina.

— Daniel Gibbs, LionTrader Staff

A Day in the Life

A collection of internship and co-op experiences

Ryan K. Miller

Investment Banking

This past summer, I worked in Investment Banking at a premier bulge-bracket investment bank. My first week consisted of training, where Wall Street experts lectured incoming summer analysts on corporate finance, accounting, valuation, and the use of various software packages. Most memorable to me, or rather more alarming, was the segment on the *do's* and *don't's* of banking. I was not exactly encouraged by the endless horror stories of past summer analysts costing the firm millions of dollars. Hopefully, I could learn from these mistakes rather than making them myself.

During training, every meal was complimentary, with delicious snacks and cold beverages in between every lecture. In the evening, the incoming class of analysts gathered for socials, cocktail parties, and various sports activities. These were nice opportunities to meet analysts, senior bankers, and many of the PSU alumni that had participated in the same program. Training was *great.* Unfortunately, this lifestyle deceived many of the summer analysts, as *work* began on the following Monday at 9 a.m.

My first day of actual work started off slow—learning the ropes, meeting colleagues, etc. By the end of the day, I was well-situated in my office and had a solid understanding of my responsibilities. Feeling comfortable, I made plans to meet my roommates, who were both Sales & Trading interns, for dinner. I was excited to see my roommates to discuss our first day of work. At around 6 p.m., just as I was getting ready to leave, an analyst approached my desk. I was flattered that an analyst would take the time to walk all the way over from his office to speak with me. Unfortunately, this analyst did not come to my desk to chat. Rather, he needed me to stay overnight to *flip books* for a presentation to be given by our senior bankers the next morning to the management of a $4 billion company. I immediately canceled my dinner plans in anticipation of a long and eventful evening.

I hung around the office for a few hours and helped out several colleagues with some presentations that they were working on. When the books were finally ready at 3 a.m., I walked sluggishly down to the printing station to pick them up. I carefully flipped through each of them to ensure that there were no mistakes, placed them on my associate's desk, and made my way out of the office just before 6 a.m. On my way out, I saw a good friend and fellow Penn Stater who was interning in Sales & Trading, refreshed and ready to start the new day. While her second day was just beginning, my first day had just ended – only 62 days left to go.

I would not say that my first day was typical, but a banker can expect an average work week of 70 – 90 hours. This dynamic differentiates Investment Banking from most other positions at a bulge-bracket investment house. Banking necessitates much longer hours, and the day-to-day work is completely unpredictable.

Although the hours seem intimidating, the day goes by quickly when you are working with smart, fun, and enthusiastic people who truly love what they do. And the professional experience is phenomenal. You work with some of the most talented minds in the business world, and develop financial modeling skills and unmatched analytical ability. I enjoyed the job, and without reservation, I would strongly encourage anyone interested in finance and accounting to pursue investment banking as a career. Bear in mind, though, that the lifestyle is not for everyone.

— Ryan K. Miller, LionTrader Editor

Corporate Finance

Last Spring I interned as a co-op with Johnson & Johnson in their finance department. I worked primarily in financial reporting with the global expense team. Spending six months with J&J, I got a first-rate feel for what a full-time position in

continued on page 12

corporate finance entails. My main responsibility was to provide financial support and information to the Human Resources, Communications, and Customer Service departments. I compared what they had spent so far this year to what they had budgeted. I was responsible for finding answers as to why there were variances between their actual spending and their forecast. For instance, if a department was $150,000 over their salary budget, what was the cause? This involved doing research and calling the necessary people who could provide valuable information. The spending discrepancy may have been caused by the hiring of an additional employee or an increase in bonus and salary for a particular employee, just to give a few examples. After speaking to other employees and doing the proper research, being able to provide my business partners with an answer and sometimes a solution gave me a tremendous feeling of accomplishment.

DJ Venn

Another of my primary responsibilities was to provide the Board and upper management with monthly financial reports. The financial reports are a snapshot of the entire company's financial position. These reports are essential to J&J and were used as a reference by all financial analysts and management. Other responsibilities included general ledger submissions, travel expense reports, capital account reconciliations, and expense accruals. Although most of these reports and accruals were only completed on a monthly basis, my average work days normally consisted of preparing these reports for that month's deadline. Although a month seems like a long time, in the corporate world it flies by.

The main difference between corporate finance and the other finance professions, such as investment banking and private wealth management, is that corporate finance focuses more on reporting, rather than investing and forecasting. The majority of my responsibilities included reporting and accruing, which is accounting intensive. I feel that this separates corporate finance from the investing finance that is normally associated with Wall Street.

The six months I spent with J&J was invaluable. It gave me real world experience that a classroom cannot provide. Before I began my co-op, I thought the only option for finance majors was Wall Street, but everyone should know that corporate finance offers excellent opportunities as well.

—DJ Venn, LionTrader Staff

John M. Beberus

Private Wealth Management

Private wealth management is becoming an increasingly important area of investment banks, not only for growth, but also for maintaining stable profits. Revenue from sales and trading and other market sensitive areas can fluctuate from quarter to quarter. However, the consistency of private wealth management to generate consistent revenues is making it a more attractive field to enter. As an intern for ten weeks in private wealth management, I was able to experience first-hand what makes the division such a vital part of any investment bank.

At the time, I had a very broad view of the financial markets and was unsure as to what opportunities there were. After a series of interviews, the opportunity to work in private wealth management was offered. The only way to describe my summer experience is to say that it was "fifteen feet wide and ten feet deep". In other words, in private wealth you gain experience in all different markets, but have the opportunity to only go so far in-depth.

Constructing asset allocations for clients was a major task of mine this summer. The clients that I worked with all had a minimum liquid net worth of at least $30 million. These clients have the chance to invest in funds and other areas not available to your average investor. Along with multiple equity strategies, including hedge funds, fixed-income funds, and commodities, clients also have the opportunity to invest in real estate and private equity. Multiple conference calls were held each week to discuss new strategies investors could use that were entering the platform as well as to discuss past performance. Conference calls were also held with prospective clients to discuss future strategies, and as my responsibility grew, I was put in charge of dealing with the clients directly.

Teamwork was emphasized to the fullest extent. I worked with a well-established group of investment professionals who took me under their wings and showed me the ropes. Teamwork they said was tantamount to building a strong and productive workforce for the clients. I will never forget a dinner with one of the professionals on my desk telling me, "It's so important to construct a good team. I've seen clients lost because of poor team performance." The investment professional, client analyst, and financial analyst must all be aligned when trying to exceed the client's expectations. However, the team wasn't always free from conflict. I received assignments from the three professionals on my desk, often creating issues on whose project should be completed first. Prioritization was crucial to being successful on the desk this summer.

When one thinks about the divisions of an investment bank and which ones are the most stressful and require the longest hours, usually it is investment banking that comes to mind, not private wealth management, but within two days my team had two client reviews, and a prospective client entering the office. Due to the training of the new full-time analyst, I became the full-time analyst for part of the summer. I was forced to hit the ground running and learn very quickly.

—John M. Beberus, LionTrader Staff

Sales and Trading

"Each day, I had to decide whether to walk through the mortgage trading desks. These traders emitted such evil vibes that I carved a wide loop around them every day. They were known for hurling phones at the heads of trainees and were said to have installed extra-long cords to increase their range," recalls Michael Lewis in his best selling novel, *Liar's Poker.* The trading floor is the pressure cooker of Wall Street, where millions of dollars change hands at the blink of an eye. It is a fast-paced, dynamic environment where only the most business-savvy and outspoken people survive.

Eugene E. Weissberger

Sales and Trading is the portion of Wall Street devoted to keeping a liquid secondary market in which investors can buy and sell securities. This past summer I had the opportunity to intern in Goldman Sachs' Sales and Trading program where I rotated through Bank Loan Trading, the floor of the American Stock Exchange, and Economic Derivatives.

The program started with a week of training, where summer analysts were taught about financial concepts, the culture of Goldman Sachs, compliance issues, and how an investment bank operates. We heard speakers from all across the firm, and had numerous networking events. While this was the only formal training we had, every Wednesday was "Curriculum Day," where we heard numerous traders and salespeople speak about the products that they work with. Every Thursday ended with "Open Meetings," where interns were grilled on their market knowledge and kicked out of the room if they gave incorrect answers.

After training I reported to my first desk, Bank Loan Trading, at 6 a.m., exhausted as my body adjusted to waking up before sunrise. I saw numerous deals enter the marketplace and watched frenzied traders scamper to exit positions after ratings downgrades and suspected fraud. Trader talk was peppered with choice four-letter words as I stood off to the side trying to learn as much as possible about the situation.

My next three weeks were spent on the floor of the American Stock Exchange. The atmosphere there was considerably different from the conventional trading desk. The culture of the American Stock Exchange is best depicted by the attire of the traders—ties and sneakers. Employees certainly didn't fit the description of a white shoe investment banker.

My final rotation was with Economic Derivatives, a product launched by Goldman Sachs in October 2002 to hedge risk associated with economic indicators such as non-farm payroll numbers and the consumer price index. Being such a new product, much of the group's activities were devoted to marketing these derivatives. It was extremely exciting being a part of such an entrepreneurial group.

The program was intense, yet rewarding, as I was challenged both mentally and emotionally. I gained a sense of confidence that I never knew I had after constantly presenting in front of large groups who questioned my ideas and opinions. I not only learned about the products being traded, but also about the mindset and personality of a trader. I learned the value of strong relationships and immediate information. In the place where cash is king and greed rules, Sales and Trading is not for those with thin skin.

—Eugene E. Weissberger, LionTrader Staff

STUDENT RESEARCH PAPER

Airlines:

The forces that keep air carriers from crashing into liquidation

Since September 11, 2001, it seems as though the airline industry has been on a perpetual downturn. Airlines, subsequently, have been a drag on fiscal government spending—subsidized as they have been through emergency relief ($2.5 billion was awarded to the airlines for the effects of the post-September 11 grounding) and excessive application of Chapter 11, a form of bankruptcy used when a company wants time to restructure their business and their debts so they can stay in business and eventually emerge from bankruptcy. For example, United only recently filed a restructuring plan, effective February 2006, after 30 months under Chapter 11 protection.

Ultraconservatives and Libertarians have been screaming to let the market solve the airline industry's dilemma. They say that there is currently an over supply of air travel provided by large American international and domestic carriers, like Delta, United, and Northwest, the three most recent airlines to file for Chapter 11. When a market is out of equilibrium and there is an over supply, businesses are compelled to reduce prices in order to stay competitive. In the scope of a pure capitalist society, these Ultraconservatives and Libertarians are right—the market will find its equilibrium when supply is diminished; i.e. a carrier or two file for Chapter 7 bankruptcy.

Chapter 7 bankruptcy occurs when a company does not emerge, but liquidates its assets to pay off creditors. Those who have purchased bonds or secured debt are the first to be paid off in the liquidation, but usually not dollar for dollar. There are six major forces keeping bankrupt airlines from Chapter 7. Some of them are interrelated, as you will see, which only makes them harder to break through.

Politics:

Let's start with the most obvious deterrent to any airline liquidation, politics. At the time this article was written, President Bush was riding the deepest trough of his job approval ratings ever—37 percent. With such low numbers, President Bush, nor any other politician for that matter—democrat or republican—wants to oversee the extermination of over 60,000 jobs by the liquidation of one of the nation's airlines.

Lenders:

The growing role of aircraft lessors has been a resilient life preserver for the airline industry. General Electric's Commercial Aviation Services (GECAS) is one such lessor. Not only is GE the leading maker of jet engines, but it is also the leading lessor within America. Over half of its roughly 1,350 planes are with American carriers. "At the end of 2004, GE had 150 aircraft financed to a value of $2.6 billion with US Airways alone," cites a May 19, 2005 article from *The Economist*. It is no wonder then that GE has been bending over backwards for the airline industry as it fights through this economic impasse. "The company led a syndicate that lent up to $630 million on a secured basis to Delta [and] has agreed to contribute $140 million to US Airways through loans and deferrals on lease/loan payments. Counting only US Airways, ATA, Aloha Airlines, and United, GE's exposure is $5.4 billion," reports the same *Economist* article.

As a safeguard for lessors, a provision in Chapter 11 allows aircraft lessors to repossess aircraft if an airline is unable to pay their lease obligations within 60 days. Regrettably, though, if an airline was to liquidate, the flood of planes into the market would create an over supply and send the value of used aircraft plummeting, thus placing the lessors in a disadvantageous position.

Credit Card Issuers:

The most ubiquitous, yet unnoticed, industry affected by the airlines is the credit card industry. One indication of the interdependence of airlines and credit card companies is the amount of frequent flier miles accumulated to date. *The Economist* estimates that by the end of 2004, almost 14 trillion frequent flier miles had been accumulated world-wide; a value of about 700 billion dollars[1].

Banks with credit cards that offer air mile programs clearly have a substantial interest in keeping their respective airline in the air. One industry estimate links 40 percent of Citigroup's credit card revenue to American Airline's frequent flier program[2]. It is quite easy to understand, then, why American Express paid a $500 million advance to Delta Airlines[3] in order to support them through these turbulent times.

Fuel:

In years to come, the immediate economic wake of Hurricane Katrina will be characterized by record high commodity prices. Post Katrina crude oil, gasoline, and natural gas prices surpassed $69/bbl, $2.50/gallon, and $14/Mbtu, respectively. As the price of crude oil rises, the price of its refined products rise in tandem. In 2004, when the price of crude oil was 41 dollars per barrel[4], Delta paid an average of $1.16 per gallon of jet fuel. In the first six months of 2005, when the average price of crude oil was 51.50[5], Delta paid an average of $1.51, a 50% increase over last year.

Unfortunately, for airlines, the full increase in fuel price spikes is not passed on to their customers. This is because if short-term price spikes cause sharply rising ticket prices, less people will travel. The result is that ticket prices increase less than the increase in fuel prices, and margins decline. Unprofitable airlines, therefore, become increasingly unprofitable.

This explains the effects of fuel on the airline industry, but what about the effects of the ailing airline industry on their fuel suppliers? Delta and United each consume more than 2 billion gallons of jet fuel annually[6]. If one such airline were to liquidate, before other airlines could pick up its routes, there would be a surge in jet fuel supply resulting in decreasing fuel prices—jet fuel suppliers would lose money daily.

Manufacturers:

Aircraft manufacturers represent another industry hugely affected by airlines. Manufacturers such as Boeing and Airbus depend on airlines to continually update their fleets. Airplanes are not cheap, so most airlines do not pay for new craft with cash. For example, in 2004, customer financing accounted for $10.4 billion of Boeing's long-term assets[7]. Airlines either lease planes or enter into purchase agreements for several years into the future. At the end of 2004, Delta had 55 aircraft under purchase agreements. To the dismay of manufacturers, purchase agreement or no purchase agreement, a liquidated airline cannot purchase airplanes.

Assuming that manufacturers did not anticipate one of their major customers liquidating, the market for new airplanes would immediately experience a supply surplus, depressing new aircraft prices and, consequently, manufacturer margins.

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1 "Flying on Empty", *The Economist,* print edition, May 19, 2005; "Frequent Flier Miles Soar Above Sterling," *Guardian Newspapers,* August 1, 2005

2 "Flying on Empty", The Economist, print edition, May 19, 2005

3 "Flying on Empty", The Economist, print edition, May 19, 2005

4 http://octane.nmt.edu/marketplace/prices/Default.asp

5 http://octane.nmt.edu/marketplace/prices/Default.asp

6 Delta Air Lines 2004 annual report, 10-K

7 Boeing 2004 annual report, 10-k; Delta Air Lines 2005 second quarter report, 10-q; United Air Lines 2004 annual report, 10-k; United Air Lines 2005 second quarter report, 10-q

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Other airlines would need to move in and pick up the routes left behind. That would likely require the remaining airlines to purchase more planes. Even if the remaining airlines chose to purchase all new planes rather than used ones, the manufacturers would be left with the fewest bargaining chips at the table.

Employees and Unions:

By far the most publicized and well-known stakeholders in the airline industry are its employees and their unions. Politically, unions have tremendous power. Combined, Delta and United employ over 125,000 pilots, mechanics, flight attendants, and others. U.S. labor organizations represent 80 percent of United's 61,000 employees and 18 percent of Delta's employees[8].

Economically, employees represent the single largest cost to the industry. From total revenues of $15 billion and $16 billion, Delta and United paid $6.34 billion and $4.98 billion in "salaries and related costs," respectively. This means that if Delta or United were to liquidate, billions of dollars in wages would be siphoned out of the economy. However pensions would remain. The Pension Benefit Guarantee Corporation (PBGC), the federal government's pension safety net for employers who are unable to make the pension payments they promised to their employees, would be forced to pick up some of the tab. The maximum pension that the PBGC pays out is $45,000 per year, an amount less than the median income of every state[9]. This assumes that the employee has reached a pension status that allows them the maximum. To be conservative, we will assume that every employee has reached that status. This would translate into $3.11 billion and $2.75 billion paid annually to Delta and United employees, respectively—roughly half of the combined annual wages of the two airlines. In the end, $5.66 billion of consumer buying power would be stripped out of the economy in one fell swoop.

With everything at stake—jobs, wages, political careers, and industries that would be exposed to turbulent market conditions—it is no wonder that everyone works together to keep the sky buzzing with air traffic. The industry has effectively created a web of support, which they can continue to fall back on when times get tough. But what about the cost to the federal government and ultimately the American people? Just as businesses pass on increased costs to consumers through higher prices, in time shouldn't we expect the federal government to pass on these costs in the form of taxes?

-Daniel M. Kokini, LionTrader Editor, with John Beberus, LionTrader Staff

[8] Delta Air Lines 2004 annual report, 10-K

[9] http://www.usdoj.gov/ust/bapcpa/bci_data/median_income_table.htm