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Stocks Are Trying to Forget 2020

By Matt Levine

18-22 minutes

Long-termism

Here's a simple model for stocks and the pandemic:

1. The price of a company's stock is the present value of the company's expected future earnings.
2. Earnings for the next little while will be real real bad, since the economy has shut down.
3. Every company's earnings from, say, 2021 until perpetuity will be "normal," in some sense. The economy was growing in 2019, and in 2021 it will get back on that growth trend. Companies that were good in 2019 will be good in 2021. If in 2019 you built a stock-price model that projected out 100 years of income, you will have to adjust one or two columns for 2020 and 2021, but after that everything can stay exactly the same.
4. Except companies that go bankrupt; if you go bankrupt, your shareholders will get no future earnings. (Maybe your current creditors will get those earnings, or maybe you will disappear and there will be no earnings, but anyway your current shareholders will be zeroed.)

None of these things is obviously true, and point 3 in particular depends on a lot of assumptions about the progress of the pandemic and the speed of reopening and changed in behavior and the loss of workers and know-how and a million other things. (And of course you *didn't* build a 100-year model, etc.)

But it's a model. In the New York Times Magazine, Michael Steinberger asks "What Is the Stock Market Even for Anymore?," and one possible answer is, you know, discounting the present value of all of a company's future earnings in perpetuity. Like a lot of people, Steinberger is struggling with why the stock market is so cheerful (the S&P 500 index is down about 6% year-to-date, and up about 36% from its March low) while the economy is so bad (businesses are closed, revenue has collapsed, the U.S. unemployment rate has soared to 14.7%).

There are grim possible answers about inequality, the allocation of wealth between labor and capital, gains of big businesses at the expense of small ones, etc., but there is also a more neutral possible answer about allocation in *time*. If companies lose profits for a while and then get back to having profits again, and if discount rates are low in a zero-interest-rate world, then their stocks shouldn't go down that much even if they have no revenue for months. It's just *months*; stock prices reflect decades. Steinberger talked to Jeremy Siegel:

> Siegel, who is 74 and teaches finance at the University of Pennsylvania's Wharton School, is a prominent scholar of the markets, a fixture on CNBC who is often referred to as ''the wizard of Wharton.'' …
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> For Siegel, there was nothing strange about the market's rising despite the gruesome unemployment figures: Investors already knew they would be ugly. ''It's Principle 1 of Finance 101: Anything that is expected doesn't move the market,'' he told me. People who were dismayed by its upswing since mid-March didn't understand how the market works. ''Over 90 percent of the value of stocks is dependent on earnings more than a year in the future,'' he said. ''The market is very forward-looking.'' Investors weren't thinking six months ahead; they were thinking a year or two ahead, Siegel said, by which point the virus would probably have been brought under control. ''We'll have a U-shaped recovery, not a V, but the market is looking at the upper part of the U,'' Siegel said.

I don't know about the epidemiological or economic claims here about the timing or shape of the recovery; I am interested in the *financial* claim that "the market is very forward-looking." It does seem like the simplest explanation, no? A pandemic crushes revenues. Stocks fall on general uncertainty and a fear of financial crisis and widespread bankruptcies, which would wipe out profits in perpetuity. The fears of financial crisis are resolved, more or less by the Fed and Congress pumping money into companies to prevent panic, so the bankruptcy risk is more contained. Stocks return to a price level that suggests a terrible year, followed by mostly normal. The market might be *wrong* about that, of course, but that does seem to be what it implies.

This is all trivial and obvious, the simplest possible textbook model of how the stock market works, the one that every sophisticated person finds simplistic and naive. “Har har har stock prices reflect the present value of future earnings,” people say knowingly when Tesla jumps around a lot for no reason.

In particular, a lot of people have spent years saying that the public stock market was focused only on next quarter’s earnings and forced companies to prioritize short-term profits over long-term investment. Startup founders wanted to stay private because they feared the short-termism of the public markets, public chief executive officers wanted to go private to escape that short-termism, commentators argued that the markets were destroying long-term value.

I have always had my doubts about the “short-termism” critique; it is often a way for corporate managers to defend *bad* decisions by saying that they’re actually *long-term* decisions. And now, you know, here’s a data point. Now next quarter’s earnings will be bad for almost everyone, and the stock market has essentially shrugged it off. “Ehh, what does next quarter matter,” the market basically said, “we’re in it for the long term.”

Kylie Jenner I guess?

If you run a public company, you have to be honest about it all the time. If your company is losing money and having a terrible quarter, and a journalist calls you up and says “hey are you losing money this quarter,” you can’t say “no everything is great, never been better.” You can say “yeah it’s terrible,” or you can say “on an adjusted basis we are confident that long-term trends are encouraging,” or you can say “no comment,” but you can’t *lie*. You also can’t tweet “looks like it’s going to be a record year for profits at our company” if it isn’t. That’s securities fraud. Regular people are buying and selling the stock all day long, and if they read the CEO’s comments, believe them, and buy stock, they are going to sue. The company’s official representative made a public statement that was misleading, people traded stock based on it, boom, securities fraud. [1] Elon Musk knows.

If you run a private company, though, you can indulge your vanity a bit more. At the typical private company, no one trades stock. People only buy stock when you sell it to them, directly, with disclosure documents. The important thing is for *those* to be true. You can even write, in those documents, something to the effect of “you have to agree to rely only on these documents, and if anything else we’ve said publicly isn’t true, you can’t sue.” If you tell a reporter “we made a billion dollars last year,” and you post a smiling Instagram saying “so proud of our team for making a billion dollars last year,” and then you go sell stock to investors with disclosure documents saying how much money you actually lost —meh, seems fine? Not legal advice.

You have to be careful here, and the lines can blur. If you’re lying to journalists and on social media to try to get buzz so you can raise money for your private company, you might fall into error. Theranos Inc. founder Elizabeth Holmes was charged with securities fraud in part because she made lots of misleading claims to the media about Theranos’s blood-testing technology, and then sent binders full of those misleading media profiles to potential investors. (She also allegedly lied directly to the investors.) But if you’re very careful about keeping the sides separate—if you exaggerate in public to get buzz and attention, but are scrupulously honest and accurate with any potential investors—you can perhaps make it work.

In 2018, Forbes magazine wanted to publish an issue listing America’s richest self-made women. Kylie Jenner—the reality television personality, cosmetics entrepreneur, Kardashian, etc.—apparently wanted to be high on that list. Presumably she wanted to be on the list for the reasons that Kardashians generally want media attention, which I assume include that positive publicity is good for business. So her publicists talked to Forbes and said that her cosmetics company had done $330 million of revenue in 2017, and showed tax returns indicating $307 million of revenue in 2016.

Based on that, Forbes valued her net worth at $900 million, ranked her 27th, and put her on the cover, saying she was “set to be the youngest-ever self-made billionaire.” Presumably they put her on the cover (despite ranking 27th), and used the word “billionaire” (despite valuing her at $900 million), for the reasons that the media generally likes to give the Kardashians attention. There were obvious synergies; Forbes got some value out of being associated with Jenner’s brand, and vice versa. Fine, good, the sausage was made.

Forbes now says that all of this was wrong. "Inside Kylie Jenner's Web of Lies—And Why She's No Longer a Billionaire" is the headline. The way you can tell is that Jenner sold 51% of her company to Coty Inc., a public beauty company; Coty announced the acquisition last November, and it gave financial details that conflict with what Jenner had told Forbes. From Forbes now:

> Then there were Kylie's financials. Revenues over a 12-month period preceding the deal: $177 million, according to the Coty presentation—far lower than the published estimates at the time. More problematic, Coty said that sales were up 40% from 2018, meaning the business only generated about $125 million that year, nowhere near the $360 million the Jenners had led Forbes to believe. Kylie's skin care line, which launched in May 2019, did $100 million in revenues in its first month and a half, Kylie's reps told us. The filings show the line was actually "on track" to finish the year with just $25 million in sales.
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> "I think everybody was surprised," says Wissink, the Jefferies analyst, who was on the call. "The negative that came out of that announcement was that the business was a lot smaller than everybody had expected." …
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> More likely: The business was never that big to begin with, and the Jenners have lied about it every year since 2016—including having their accountant draft tax returns with false numbers—to help juice Forbes' estimates of Kylie's earnings and net worth. While we can't prove that those documents were fake (though it's likely), it's clear that Kylie's camp has been lying.

Jenner disputes this; her lawyer says that "Forbes' accusation that Kylie and her accountants 'forged tax returns' is unequivocally false and we are demanding that Forbes immediately and publicly retract that and other statements." It does seem like a lot of work to go to!

But in any case, the accusation here is that Kylie Jenner lied and forged documents to mislead Forbes about her business and get on their cover, but that she was scrupulously honest with Coty when it was negotiating to actually put money into that business. 2 Which is fine! That's how you do it! I have no problem with this. I mean as a journalist I will say, don't lie to journalists, it's mean. And as a lawyer I will say, I am not your lawyer, nothing here is legal advice, and going around lying to people is never a *great* idea. But as a guy who writes "everything is securities fraud" a lot, I am inclined to say that this isn't.

Meanwhile in public companies

If a cruise ship company runs cruises on which people get infected with a deadly disease and then spread it further when they get off the ship, that could be bad for its passengers and bad for the world. Also shareholders though. Here's a press release from a law firm suing Carnival Corp. on behalf of shareholders. A sampling:

> On April 16, 2020, when Carnival still had at sea two (2) of its cruise ships, Bloomberg Businessweek published an article titled "Carnival Executives Knew They Had a Virus Problem, But Kept the Party Going." In that article, it was revealed that Carnival may have failed to adequately protect passengers from COVID-19 on a series of cruise voyages, and indeed continued to operate new cruise departures despite its knowledge that the threat posed by COVID-19 had materialized on its ships and was likely to proliferate further.
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> On this news, the Company's share price fell $0.53 per share from a prior close of $12.38 per share to close at $11.85 per share on April 16, 2020.
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> Then, on May 1, 2020, The Wall Street Journal published an article titled "Cruise Ships Set Sail Knowing the Deadly Risk to Passengers and Crew." That article detailed how cruise ships, particularly Carnival ships, facilitated the spread of COVID-19, and provided new facts on early warning signs Carnival and its affiliated cruise lines possessed and the Company's disclosure failures. Further, the article also noted that The House Committee on Transportation and Infrastructure had requested documents from Carnival related "to Covid-19 or other infectious disease outbreaks aboard cruise ships" and that testimony from a separate investigation in Australia revealed that Carnival and its affiliated cruise lines may have misled shore officials by concealing those exhibiting COVID-19 symptoms before docking.

> On this news, the Company's share price fell $1.97 per share from a prior close of $15.90 per share to close at $13.93 per share on May 1, 2020.

Sure passengers got a potentially deadly disease, and shore officials may have unwittingly let it spread in their countries, but think of the shareholders! The stock went … uh, well, the stock went *up* 12.5% between the first and last number cited by the press release but I am sure the shareholders suffered.

Obviously Carnival's stock went down a lot overall—it's down about 70% year-to-date—but that is mostly because, you know, they run a cruise line and there's a pandemic; these particular revelations are not really what hurt their business. But you can't sue a cruise company for securities fraud *just* because there's a pandemic; you also have to find something they lied about.

Vacation arbitrage

We talked on Friday about Credit Suisse Group AG's proposal that its employees buy extra vacation days, and about Credit Suisse's general financial-engineering-y approach to employee compensation. I got a little carried away and wrote:

> Maybe Credit Suisse could run a Dutch auction for the vacation time and sell it for whatever price clears the market. Set up a secondary market! Act as a market maker in the secondary market and collect the bid-ask spread! Sell futures and options on vacation time! Structured notes! Build an entire asset class, really, why not.

Several people emailed and tweeted about companies that actually *do*, or did, make two-sided markets in vacation days, letting employees buy extra vacation days and also sell them back to the company. Because my readers are amazing, they of course discovered an arbitrage. If vacation days are priced based on your current salary (that is, if you buy a vacation day at a price of one day's salary), then you can buy vacation days this year, get a raise, and sell it back next year at a profit. An upward-sloping vacation curve! Vacation contango!

My understanding is that most companies that do this limit how much vacation you can buy or sell, but if you work somewhere that *doesn't*, I hope you will lever up to buy 10,000 vacation days in your first year, work a few years, get a few raises and promotions, sell back the vacation days and retire. Obviously there is some counterparty risk.

Things happen

Poor Countries Face a Debt Crisis 'Unlike Anything We Have Seen.' Saudi foreign reserves fall as sovereign wealth fund spends overseas. Elon Musk's SpaceX Capsule Links Up With Space Station. This ETF Booms as Investors Bet on Airlines. Billions Flowing to China's Quants Takes Fight to Global Funds. NYC's Finance Jobs Won't Recover for Six Years, Analysis Shows. "The data suggests that there is just a far higher proportion of 'average' male-run hedge funds than female." Treasury Market Liquidity and the Federal Reserve during the COVID-19 Pandemic. Police Erupt in Violence Nationwide. Facing Protests Over Use of Force, Police Respond With More Force. Journalists blinded, injured, arrested covering George Floyd protests nationwide. How the Supreme Court Lets Cops Get Away With Murder. Ending Qualified Immunity Act. "Research-based solutions to stop police violence." Davos is going to be lit next year.

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1. This is part of my theory that "everything is securities fraud." If you're the chief executive officer of an oil company, you might be tempted to lie about global warming for political or commercial reasons. If you're a CEO who sexually harasses employees, you might want to keep that secret for fairly obvious personal reasons. But because of the general obligation of public companies to be honest with their shareholders, and because any public statement can be treated as a communication "to shareholders," lying about global warming or sexual harassment, for totally non-securities-related reasons, can get transmuted into securities fraud.

2. Coty filed the purchase agreement that it used to buy its stake in Jenner's company. Section 5.8 says: "Investor [Coty] is not relying nor has relied on any representations or warranties whatsoever by or on behalf of any Seller Group Party [the Jenners] or the Company regarding the subject matter of this Agreement, express or implied, except for the representations and warranties in" the contract. That is: If there's anything untrue about Jenner floating out there in

the world, even anything that Jenner herself said, it doesn't count; Coty has to rely on what's in the agreement.

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