Over the years I have written about the stock market several times. I thought given the up and downs of the market, now would be a good time to replay some of those posts

The Stock Market

Apr 13th 2004 11:20AM

I get asked all the time to write a book about business and my approach to it. I'm not ready to take that leap yet, but along the way, when I find a book that really impresses me, I try to help it find an audience. In this case, it wasn't long ago I read my now favorite book about the stock market called The Number by Alex Berenson. I liked it so much, I volunteered to write the forward for the paperback edition which comes out this week.

Here is the foreward I wrote for The Number. I recommend that anyone with an interest in the market jump at the chance to buy it.

In 1990, I sold my company, MicroSolutions – which specialized in what at the time was the relatively new business of helping companies network their computer equipment – to CompuServe. After taxes, I walked away with about $2 million. That was going to be my nest egg, and my goal was to protect it at all costs, and grow it wisely.

I set about interviewing stockbrokers and settled upon a broker from Goldman Sachs, Raleigh Ralls. Raleigh was in his late 20s, and relatively new to Goldman. But we hit it off very well and I trusted him. As we planned my financial future, I made it clear that I wanted my nest egg to be invested not like I was 30 years old, but as if I were 60 years old. I was a widows and orphans investor.

Over the next year I stuck to my plan. I trusted Raleigh, and he put me in bonds, dividend-paying utilities and blue chips, just as I asked.

During that year, Raleigh began asking me a lot of questions about technology. Because of my experience at MicroSolutions, I knew the products and companies that were hot. Synoptics, Wellfleet, NetWorth, Lotus, Novell and others. I knew which had products that worked, didn't work, were selling or not. How these companies were marketed, and whether or not they were or would be successful.

I couldn't believe that I would have an advantage in the market. After all, I had read A Random Walk Down Wall Street in college. I truly thought that the markets were efficient, that any available knowledge about a company was already reflected in its stock price. Yet I saw Raleigh using the information I gave him to make money for his clients. He finally broke me down to start using this information to my advantage to make some money in the market. Finally after more than a year, I relented. I was ready to trade.

Notice I didn't use the word invest. I wasn't an investor. I just wanted to make money. The reason I was ready to try was that it was patently obvious that the market wasn't efficient. Someone like me with industry knowledge had an advantage. My knowledge could be used profitably. As we got ready to start, I asked Raleigh if he had any words of wisdom that I should remember. His response was simple. "Get Long, Get Loud".

Get Long, Get Loud. As we started buying and selling technology stocks, most of which were in the local area networking field that I had specialized in at MicroSolutions, Raleigh put me on the phone with analysts, money managers, individual investors, reporters, anyone with money or influence who wanted to talk technology and stocks.

We talked about token ring topologies that didn't work on 10BaseT. We talked about what companies were stuffing channels – selling more equipment to their distributors than the distributors really needed to meet the retail demand. We talked about who was winning, and who was losing. We talked about things that really amounted to the things you would hear if you attended any industry trade show panel. Yet after hanging up the phone with these people, I would watch stocks move up and down. Of course as the stocks moved, the number of people wanting to talk to me grew.

I remember buying stock in a Canadian company called Gandalf Technologies in the early 90s. Gandalf made Ethernet bridges that allowed businesses and homes to connect to the Internet and each other via high-speed digital phone lines called ISDN.

I had bought one for my house and liked the product, and I'd talked to other people who'd used it. They had decent results, nothing spectacular, but good enough. I had no idea Gandalf was even a public company until a friend of Raleigh's asked me about it. What did I think about Gandalf Technologies? It was trading at the time at about a buck a share. It was a decent company, I said. It had competition, but the market was new and they had as much chance as anyone to succeed. Sure, I'll buy some, and I would be happy to answer any questions about the technology. The market size, the competition, the growth rates. Whatever I knew, I would tell.

I bought the stock, I answered the questions, and I watched Gandalf climb from a dollar to about $20 a share over the next months.

At a dollar, I could make an argument that Gandalf could be attractive. Its market was growing, and compared to the competition, it was reasonably valued on a price-sales or price-earnings basis. But at $20, the company's market value was close to $1 billion – which in those days was real money. The situation was crazy. People were buying the stock because other people were buying the stock.

To add to the volume, a mid-sized investment bank that specialized in technology companies came out with a buy rating on Gandalf. They reiterated all the marketing mishmash that was fun to talk about when the stock was a dollar. The ISDN market was exploding. The product was good. Gandalf was adding distributors. If they only maintained X percentage of the market, they would grow to some big number. Their competitors were trading at huge market caps, so this company looks cheap. Et cetera, et cetera.

The bank made up forecasts formulating revenue numbers at monstrous growth rates that at some point in the future led to profits. Unfortunately, the bank couldn't attract enough new money to the stock to sustain its price. It didn't have enough brokers to shout out the marketing spiel to entice enough new buyers to pay the old buyers. The hope among the "sophisticated buyers" was that one bank picking up coverage would lead to others doing the same. It didn't happen. No other big investment banks published reports on the stock. The volume turned down.

So I did the only smart thing. I sold my stock, and I shorted it to boot. Then I told the same people who asked me why I was buying the stock that I had shorted the stock. Over the next months, the stock sank into oblivion. In 1997, Gandalf filed for bankruptcy. Its shares were canceled – wiped out – a few months later. I wish I could take credit for the stock going up, and going down. I can't. If the company had performed well, who knows what the stock would have done?

But the entire experience taught me quite a bit about how the market works. For years on end a company's price can have less to do with a company's real prospects than with the excitement it and its supporters are able to generate among investors. That lesson was reinforced as I saw the Gandalf experience repeated with many different stocks over the next 10 years. Brokers and bankers market and sell stocks. Unless demand can be manufactured, the stock will decline.

In July of 1998, my partner Todd Wagner and I took our company, Broadcast.com, public with Morgan Stanley. Broadcast.com used audio and video streaming to enable companies to communicate live with customers, employees, vendors, anyone with a PC. We founded Broadcast.com in 1995, and we were well on our way to being profitable. Still, we never thought we would go public so quickly. But this was the Internet Era, and the demand for Internet stocks was starting to explode. So publicly traded we would become and Morgan Stanley would shepherd us.

Part of the process of taking a new company public is something called a road show. The road show is just that. A company getting ready to sell shares visits the big mutual funds, hedge funds, pension funds – anyone who can buy millions of dollars of stock in a single order. It's a sales tour. 7 days, 63 presentations. We often discussed turning up the volume on the stock. It was the ultimate "Get Loud." Call it Stockapalooza.

Prior to the road show, we put together an amazing presentation. We hired consultants to help us. We practiced and practiced. We argued about what we should and shouldn't say. We had Morgan Stanley and others ask us every possible question they could think of so we wouldn't look stupid when we sat in front of these savvy investors.

Savvy investors? I was shocked. Of the 63 companies and 400-plus participants we visited, I would be exaggerating if I said we got 10 good questions about our business and how it worked. The vast majority of people in the meetings had no clue who we were or what we did. They just knew that there were a lot of people talking about the company and they should be there.

The lack of knowledge at the meetings got to be such a joke between Todd and I that we used to purposely mess up to see if anyone noticed. Or we would have pet lines that we would make up to crack each other up. Did we ruin our chance for the IPO? Was our product so complicated that no one got it and as a result no one bought the stock? Hell no. They might not have had a clue, but that didn't stop them from buying the stock. We batted 1.000. Every single investor we talked to placed the maximum order allowable for the stock.

On July 18, 1998, Broadcast.com went public as BCST, priced at 18 dollars a share. It closed at $62.75, a gain of almost 250 percent, which at the time was the largest one day rise of a new offering in the history of the stock market. The same mutual fund managers who were completely clueless about our company placed multimillion orders for our stock. Multimillion dollar orders using YOUR MONEY.

If the value of a stock is what people will pay for it, then Broadcast.com was fairly valued. We were able to work with Morgan Stanley to create volume around the stock. Volume creates demand. Stocks don't go up because companies do well or do poorly. Stocks go up and down depending on supply and demand. If a stock is marketed well enough to create more demand from buyers than there are sellers, the stock will go up. What about fundamentals? Fundamentals is a word invented by sellers to find buyers.

Price-earnings ratios, price-sales, the present value of future cash flows, pick one. Fundamentals are merely metrics created to help stockbrokers sell stocks, and to give buyers reassurance when buying stocks. Even how profits are calculated is manipulated to give confidence to buyers.

I get asked every day to invest in private companies. I always ask the same couple questions. How soon till I get my money back, and how much cash can I make from the investment? I never ask what the PE ratio will be, what the Price to Sales ratio will be. Most private investors are the same way. Heck, in Junior Achievement we were taught to return money to our investors. For some reason, as Alex points out in The Number, buyers of stocks have lost sight of the value of companies paying them cash for their investment. In today's markets, cash isn't earned by holding a company and collecting dividends. It's earned by convincing someone to buy your stock from you.

If you really think of it, when a stock doesn't pay dividends, there really isn't a whole lot of difference between a share of stock and a baseball card.

If you put your Mickey Mantle rookie card on your desk, and a share of your favorite non-dividend paying stock next to it, and let it sit there for 20 years. After 20 years you would still just have two pieces of paper sitting on your desk.

The difference in value would come from how well they were marketed. If there were millions of stockbrokers selling baseball cards, if there were financial television channels dedicated to covering the value of baseball cards with a ticker of baseball card prices streaming at the bottom, if the fund industry spent billions to tell you to buy and hold baseball cards, I am willing to bet we would talk about the fundamentals of baseball cards instead of stocks.

I know that sounds crazy, but the stock market has gone from a place where investors actually own part of a company and have a say in their management, to a market designed to enrich insiders by allowing them to sell shares they buy cheaply through options. Companies continuously issue new shares to their managers without asking their existing shareholders. Those managers then leak that stock to the market a little at a time. It's unlimited dilution of existing shareholders' stakes, death by a thousand dilutive cuts. If that isn't a scam, I don't know what is. Individual shareholders have nothing but the chance to sell it to the next sucker. A mutual fund buys one million shares of a company with your and your coworkers' money. You own 1 percent of the company. Six weeks later you own less, and all that money went to insiders, not to the company. And no one asked your permission, and you didn't know you got diluted or by how much till 90 days after the fact if that soon.

When Broadcast.com went public, we raised a lot of money that certainly helped us grow as a company. But once you get past the raising capital part of the market, the stock market becomes not only inefficient, but as close to a Ponzi scheme as you can get.

As a public company, we got calls every day from people who owned Broadcast.com stock or had bought it for their funds. They didn't call because they were confused during our road show, were too embarrassed to ask questions and wanted to get more information. They called because they wanted to know if the "fundamentals" – the marketing points – they had heard before were improving. And the most important fundamental was "The Number," our quarterly earnings (or in our case, a loss). Once we went public, Morgan Stanley published a report on our company, as did several other firms. They all projected our quarterly sales and earnings. Would we beat The Number?

Of course, by law, we were not allowed to say anything. That didn't stop people from asking. They needed us to beat the forecast. They knew if we beat The Number the volume on the stock would go up. Brokers would tell their clients about it. The Wall Street Journal would write about it. CNBC would shout the good news to day traders and investment banks that watched their network all day long. All the volume would drive up the stock price.

Unfortunately, patience is not a virtue on Wall Street. Every day, portfolios are valued by at closing price. If the value of your fund isn't keeping up with the indexes or your competition, the new money coming in the market won't come to you. It just wasn't feasible for these investors to wait till the number was reported by companies each quarter. The volume had to be on the stocks in you fund. To keep the volume about a stock up, and the demand for the stock increasing, you needed to have good news to tell.

Volume, The Number, whisper numbers, insiders granting themselves millions and millions of options – these are the games that Wall Street plays to keep on enriching themselves at the expense of the public. I know this. I have tried to tell people to be careful before they turned over their life savings and their financial future to someone whose first job is to keep their job, not make you money.

Till I read The Number by Alex Berenson, I never had a book that explained how the market truly worked that I could tell my friends, family and acquaintances to read. I never had a book that would truly warn them that the market was not as fair and honest as mutual fund and brokerage commercials made them out to be. I may be a cynic when it comes to the stock market, but I am an informed cynic, and that has helped me make some very, very profitable decisions in the market.

If you are considering investing in the market, any part of it, or if you are considering giving your hard earned money over to someone else to manage, please, please read The Number first.

– Mark Cuban, Dallas, Texas, January 2004

My Investment advice for 2006

Jan 2nd 2006 11:12AM

Every year at this time, everyone and anyone who has a vested interest in selling stocks comes out and talks about how great a year its going to be in the stockmarket. Of course its all nonsense and bullshit. NO ONE knows what the market is going to do.

Not timers. Not technical charts. Not economists, Not brokerage Heads of Research, Not stock pickers. No one. If you watch CNBC, over the last few months they have taken to putting "experts" who disagree up against each other on stocks and topics. Instead of having carte blance to come across as an expert, they have to offer some support and take some criticism. Its a blast to watch because there rarely is a winner. Its so rare that they get questioned that they have lost the ability to support their own positions. So much for experts.

If its hard to find an expert who can support their investmen choices, what about mutual funds ?

According to an ad for one family of mutual funds, there are 17,000 mutual funds on the market for purchase. How amazing is that ? How in the world can there be 17,000 fund managers that are worth a damn ? There cant be. How many are good ? How many suck ? How many of the funds will close every year taking your money with them ? Are you completely confident in the fund that is taking money from your paycheck every 2 weeks ?

Then of course there are the brokerages. I swear that there are few things that turn my stomach on TV more than watching commercials for brokerages. The guy who gives the toast at the wedding, Paul McCartney, the guy from Law & Order, all trying to con people into thinking that any of their stockbrokers can take you to a financial promised land.

Well guess what, they cant. Yes there are good stockbrokers that are worth the commissions you pay them, but guess what ? Most of the good ones work with people who already have money, not ones with very little hoping to build a nest egg.

One fun little thing I like to do is to look at "The Favorites". The list of the stocks held by he largest number of accounts at Merrill Lynch. These are the stocks that the largest brokerage, with the largest number of consumer clients is being enticed , convinced or directed to invest in. These are the stocks that Merrill Lynch stockbrokers have had the most success selling. They are their favorite products.

Its interesting how well the names are performing, but also how the names have changed , or in some cases, not changed over the years. A look at the last list of 2005 doesnt inspire overwhelming confidence in the ability of Merrill to pick stocks. 7 winners. 13 losers. Biggest winner was Exxon at 9.7pct. On the losing side, there were 7 stocks that lost 10 pct or more and 3 that lost 20pct or more. And these are the stocks that many would classify as todays "widows and orphans" stocks.

Of coure they are completely different from the widows and orphans stocks of yesteryear. GM, Ford, Utilities….Just put them away and dont think about them. Now that was good advice wasnt it. And here is the list from Jan of 2002. You havent done so well if you took Merrills advice then, or now. To be fair , Merrill is not better or worse than any other full service brokerage. They just happen to publish their list of widely held stocks.

So what to do if you want to invest your money ? What to do if you want to end this year with more than you started with ?

Simple, avoid risk.

Risk is what Wall Street lies about every day. Risk is what they try to sweep under the covers knowing that we all are addicted to the dream of financial freedom. Risk is the poison that is masked by the commercials.

When you see a commercial for a brokerage, they are telling you in a very subtle way that they remove risk. Invest with them and the risks regarding investing that you have heard about will be reduced or eliminated because they are so smart. All of which they say before they rush through all the disclaimers that confirm that everything they just said is nonsense, that they cant really avoid risk.

You can however make the personal decision to avoid risk. Avoiding risk allows you to sleep at night. Avoiding risk allows you to have more at the end of the year than when you started.

Lots of people spent a lot of money on commissions this year. If you put your money in the bank, in a CD or in treasuries, you not only slept better than them, there is a very, very good chance you kicked their ass in total return. Your interest compounded, they probably paid interest on their investments.

I get emails every day asking me where people should invest. I tell them all the same thing, and I will say it here. Put your money in interest earning investments.

For every stock you buy, there is someone selling you that stock. What is it that you know that they dont ? What is it that they know, that you dont ? Who has the edge ? If its not you. Chances are you are going to lose money on the deal.

If you want more info on how i feel about the stock market, here is another blog entry on the topic.

So here is my investment advice for anyone who doesn't have enough saved to walk away from their job and retire…

1. If interest rates stay where they are or go higher, look at 5 year or shorter maturity vehicles. It doesnt matter if its a bank CD, a money market fund, a tax free fund, treasuries or combinations there of. Bottom line is this, 4plus percent taxed, or up to 6 plus percent tax free equivalent (depending on your tax bracket), is not a bad way to go. If rates go down, do the same thing, evenif you earn a lower rate. At the end of the year, you are guaranteed to have more than you started with.

2. Evaluate your lifestyle. People forget that sometimes the best investment they can make is in wisely buying things they know they will use. If you track what you use and consume, whether its gas vs bus fare, buying bulk quantities or other discretionary spending, you can save more and earn a far greater return than you could in the stock market. If you can save 10pct per month on a hundred dollar per month budget, thats 120 bucks you can put in the bank. Thats the equivalent of earning 12 pct on a 1k dollar investment. If you can cut 100 bucks per month off 1k dollar monthly budget, thats like earning 12 pct on 10k dollars. Thats pretty darn good. Spend smart, put your savings in risk averse, interest earning offerings.

3. Invest in yourself. Do the things that can get you closer to your goals and dreams. It wont come from a brokerage commercial. It will come from preparing yourself , working hard and standing apart from your competition. You Inc is the best stock you can ever buy…if you are willing to do the work.

The Stock Market is for suckers….

Jan 3rd 2006 11:25AM

I wanted to respond to Tom Hawks comments. Someone i respect a lot, but who i disagree vehemently on this topic.

Tom I stand by what I said. You can have as long a term horizon as you want, but like most other long term plans we have, most peoples lives dont match up to their "horizons". Its amazing how life intervenes. Kids, whatever. its a fortunate few that can just shell it away and never touch it. Your "horizon" hits a dead end when you have to put money into a checking account. I have never seen any investing research that deals with random withdrawls that represents real world. And boy oh boy, if life hits you hard when the market is down, you make a withdrawl and you wont ever catch up.

But thats just the start of the problem. Lets say you buy into what the brokerages and funds are selling. Buy and hold, or whatever. How do you pick from the 17k funds ? By reading some websites ? By talking to some friends ? By watching the commercials ? By selecting among the options your company gives you in their plan ? Which of course was the result of a salespitch that the fund company put together to the person offering the plan to your company. Everyone is getting paid on the gravy train, except for the guy putting in the money at the end.

Wall Street has done an AMAZING job of creating conventional wisdom . "Buy and Hold " is the 2nd most misleading marketing slogan ever, after the brilliant "rinse and repeat" message on every shampoo bottle. We as a country have fallen for it. Every message from every marketer of stocks tell us. Young or old, if you can hold for the long term, things will work out for you.

That is total bullshit. Its for suckers.

Ive traded stocks for almost twenty years now. IM good at it. When i work at it. And it takes a lot of work. Not just reading all the 10K/Qs and corporate websites and product managers, or talking to people at the outskirts of the company where management doesnt reach. It takes often knowing the market for a company's product better than the company does. After all just because a company is public doesnt mean a thing other than someone has , and continues to make money buying and selling the stock as their own product.

If you are going to trade stocks, you just have to follow one rule and remember one thing. That rule is always have a definite knowledge advantage about the company you are trading, and always remember that every stock transaction has a sucker, and you have to know whether its you or the person on the other side of the trade. No one buys a stock from your, or sells one to you knowing they are leaving money on the table.

The bottom line is that unless you plan on making it a full time job to do your research and put yourself in a position to have an advantage, you are going to get your ass kicked at some point by someone who does. You just have to hope that it doesnt put a big financial hurt on you when it happens

The same logic applies to funds. Funds are in the business of making money for themselves first. You 2nd.

First check what the heads of some public mutual funds are making. Someone help me out, I cant find the link right now .Was it Mario Gabelli who not only paid himself more than his fund earned for its shareholders in a year (forget the people with money in his funds), but he was paying himself from like 3 companies at the same time ? Get me the links and I will update them here.

Then you should check the turnover of fund managers some day. You know where the good ones go ? To start or manage their own funds.

Then there is the portfolio turnover. How often they completely turn over the stocks in their fund. last numbers I saw was that on average funds turnover their portfolios 85pct every year. Thats not investing. Its fund managers doing whatever they can to beat their peers, knowing that if they dont, they are out of a job. Their bosses know that if they dont beat their peers, the money flows out, and that is a HUGE problem for any fund. So many funds take chances they shouldnt, with your money . We never see any headlines for funds that close. Why is that ? We never see any headlines for fund managers who get fired. Why ?

But even if performance sucks, rather than saying how bad it is, they pick the short stint when it wasnt so bad. Forbes did a nice job reviewing this little marketing habit of funds and referencing some manager turnover issues at Fidelity.

As far as ETFs. Which one ? Remember, the Dow and S&P are marketing tools. They change the indexes. Look at the stocks in there today, vs what was in there in years past. You are not buying a passive investment that tracks the economy. You are buying the stock pickers at those respective indexes. Last time I looked, both Dow Jones and McGraw Hill are for profit companies. They want people to think their DJ 30 & S&P 500 indexes are powerful indexes that can be reported daily as a reflection of market action. So they change the stocks when they think they need to. To help them with their product.

Ive said a lot of this before. The stock market is by definition a ponzi scheme. As long as money keeps on coming in, then there is someone to take the stocks from the sellers. If the amount of money coming in is reduced, the stocks, indexes, et al go down. What if, for who knows whatever reason, the amount of money going into stocks declined significantly ? Who would buy stock from the sellers. I mean goodness gracious, you could see something disastrous happen. Like the Nasdaq dropping from 5000, to under 2000 in just a few years. Its happened before, it can happen again.

Which is exactly why we get all these nonsensical commercials from brokerages. To keep the money coming in . I wish someone would index the amount of money spent on marketing by mutual funds and brokerages to the Nasdaq and Dow and see if it correlates.

Money inflows drives the business. We can get all the economic data we ever dreamed of getting, but if money inflows declined significantly for an extended period of time, then every rule of thumb would go out the window until money started flowing in. Yes it would flow in eventually as prices dropped. From big investors like me who wouldnt have gotten hurt by a huge market decline and could come in and buy huge chunks, or companies outright.

You ? You probably would be like Charles Ponzi's customers. You wouldnt be able to get your money out of the fund when it went down, and by the time you did, it would be too late. You would have been crushed.

Ive said it before, a stock that doesnt pay dividends is valued like a baseball card. Just whatever you can sell it for. The concept that you own "your share" of the company is a joke. You are completely at the whim of the CEO and board who will dilute you on a daily basis with stock options, then try to buy back stock to cover it up and push up the price, rewarding the shareholders who get out, rather than those that continue to hold the shares. Meaning you.

Have you ever seen Warren Buffet talk about buying 100 shares of anything k shares ? or does he take control of , or purchase a material percentage of a company ?

If you have enough money to have influence , take control or buy it outright, then the stock market can work for you. Thats why I buy stock in public companies that relate to my other business entities. When i pick up the phone and call the CEO of a company i own shares in, they call me back very quickly. When I ask if there are business opportunities that make sense for the company and another company of mine to work together, I wont always get the business, but I will always get a meeting. If Im smart about the investments I make, the more important returns come from the relationships with the companies than the action of the stock.

If the best you can do is buy shares that are going to be continuously diluted, then you are merely a sucker. There is a good chance that the shares you bought came from shares an insider who got stock options. You just helped dilute yourself with your first share purchase.

The wealthy can make the stockmarket work for them. Individuals buying shares of stock in non dividend paying stocks… they work for the stockmarket.

I know Ive painted a pretty bleak picture.

The stockmarket isnt going away. Would it shock me if the whole thing collapsed ? yes. it would. Its just too engrained in our way of life in the USA. What would change my mind is if a better investment vehicle came along.

The stockmarket used to be about investing capital in companies that came public or did secondary offerings. That money was used to create amazing businesses and return dividends back to people who truly were investors. There once was a day where most companies paid dividends higher than the interest rates on their bonds. Why ? Because stocks are inherently more risky. If a company goes belly up, bondholders collect first, shareholders usually last. People could buy and hold stocks, and get paid real cash money for being a shareholder in the company at rates far higher than the divident yields we see today. If the company did well, the dividends went up. Investors who held, actually got all their money back in dividends at some point and the rest was gravy. The good ole days.

But that changed when mutual funds came along and started marketing the concept of growth as a way to attract investors.

Its not inconceivable that the old mindset could comeback. That a new market of stocks could be created where companies didnt continuously dilute shareholders by issuing stock and options to themselves. Where earnings were earned for the same reason they are in private companies, to not only fund growth, but also provide cash back to investors. Now if that market existed today. Where I could buy 100 shares of stock, and even if it represented just 1/100000 of ownership in the company, I could have confidence that year after year, I would still own 1/100000th of that company, and if that company generated earnings , I would have at least some of that money returned to me. Well then, that wouldnt be a ponzi scheme. That would be a true market of stocks, and I would be happy to recommend to anyone to be careful, but buying stocks in that market could be something worth considering if your appetite for risk canhandle it.

Sorry for the long winded response Tom, but thanks for getting me going ■

If you put your money in safe bets like i mentioned in the last post, then you can spend that time you would otherwise have to spend researching funds and or stocks, either with people you love, things you love to do, or in yourself. Using those hours to be the best at whatever you love to do. Thats an investment you never have to pay a commission on. You never get a margin call. And the returns can be astronomical.

Microsoft, Dividends and Stock Buybacks

Jul 20th 2004 9:13AM

Props to Microsoft for announcing a 3 dollar per share special dividend. It's not inconsequential that at about 32 billion dollars, it's the equivalent of $300 per USA household. It has the potential to have a definitive impact on the economy. That is if the money doesn't find itself in the pockets of fund managers.

In addition to the special dividend, which I love, Microsoft announced a stock buyback, which I hate. There is no better example of trying to manipulate earnings and stock prices than through the stock buyback, and there is no worse message to send to long term sharedholders than through the stock buyback.

To stock traders, the buyback makes perfect sense. If you buy stock in the open market, you help maintain the stock price. If you buy back shares of stock, you reduce the number of shares outstanding, which in turn increases the earnings per share.

This of course is completely contrary to every message that every company CEO, particularly Microsoft tries to send, that they are not trying to manage earnings or the stock price.

More importantly, it rewards the exact thing that should not be rewarded. It rewards people getting out of their investment, while not rewarding keeping the investment.

Sell the stock, you get paid. Keep the stock, you get nothing. Yes, I know that the stock price is supposed to go up for those who keep it, but there are no assurances that it will. The only certainty is that the seller has cash in the bank. The holder has the same amount of risk.

Shouldn't continuing shareholders be rewarded rather than the sellers?

That's why I am such a big fan of dividends. Dividends are the investors' best friend for several reasons:

- The obvious, it's cash in the bank
- It reduces your cost basis and rewards you for being a continuing shareholder
- It can put a cap on how much the company can dilute your holdings. When a company pays a dividend, it's much more expensive just to issue stock and options to insiders. They have to consider the cash implications of each additional share or option issued. That's a good thing. It keeps companies with legitimate dividends from going nuts.
- It creates a precedent of rewarding shareholders, hopefully with increasing dividends.

On the flipside, share buybacks are horrid for several reasons

- It allows companies to manipulate earnings per share. Buy back enough stock, and you will hit your Wall Street expectations.
- Companies will undertake risky cash management strategies to pay for the share buybacks. Since its one time, they can take greater risks
- Companies will undertake buybacks with CEO and management incentives and bonuses in mind. Hit those numbers, earn lots of stock and options.
- Companies will buyback stock so that they can re-issue it to themselves and employees. In essence they use the market as their personal and corporate piggybanks. They Buyback stock to push up earnings in hopes the stock goes up. Then they issue the stock to themselves. Then if the stock goes up, they sell the stock they awarded themselves to unsuspecting shareholders who have no idea the money they are paying for shares is going to insiders.

Stock buybacks are a very bad idea for investors and a very profitable idea for insiders and traders.

*****below is in response to some emails and comments this post has been getting********

You are assuming that once a buyback takes place everything else stops in time. It doesn't.

First in a buyback, you have no idea what price they are paying, or why they choose to sell at a certain price. All you know is that they cant sell at the end of the day. So they may try to prop up the price, unsuccessfully. They may pay any price but the best price, and most likely they will, given how difficult it is to get the best tick.

2nd. No one knows when the buyback takes place. So ifyou wanted to generate cash from a transaction, you have no idea if you are selling into the buyback or not. Which in turn means you are creating incremental transactions that impact supply and demand, and therefore the price of the stock

3rd. Cash is the most valuable asset a company has, when you give it to people exiting the stock, or selling a portion of their holdings, you are diminishing the most valuable asset available to the remaining stockholders. No other asset a company can intrinsically create more cash with zero risk

4th. You are using earnings as if it is a number that has real meaning , whether to the company or to investors. It has value to neither. Earnings is supposed to reflect the results of operations. They don't. Cash is the only variable that reflects the results of operations, and in giving it to people who are exiting the stock, you are rewarding the wrong people. Worse, if you think just because a company earned the same amount of money year over year, and there is a reduction in shares, you still have a very difficult time determining if the company's cash position increased. Still worse. There is a better than even chance that the company handed out stock and options to employees, so whatever benefit you thought you got from the buyback, has been diluted away. The shareholders who sold their stock, got cash. The insiders who sold their stock got cash. You got diluted back to where you were , at best, with no cash in hand.

5th. Still on the topic of earnings, you are assuming that stock price is a function of earnings. Its not. It's a function of the demand created for a stock. You could argue that stockbuybacks creates demand. I would argue its artificial demand that only reflects the inefficiencies of the market and the heard mentality of investors. Analogous to stocks going up after announcing a stock split.

How long that is sustained is a huge risk for a holder of stocks that has no dividends coming in. Just ask the holder of any Nasdaq tech stock the last 5 years.

Your position , prays that everyone follows the same investing rules in the same way so that everyone values stocks based on the same metrics. That works for spurts, but not over the longhaul. There are far more years in the historic database when stocks were valued as a multiple of dividends than as a multiple of earnings.

It also assumes that companies don't create continual dilution. They do.

Bottom line is that there would be far less need for buybacks if companies didn't dilute their shareholders with stock and options to insiders. Without this continual dilution, companies would only use buybacks to try to manipulate the stockprice, which, while not a good thing, would be far more obvious