Chapter 1

Lead Us Not into Temptation*

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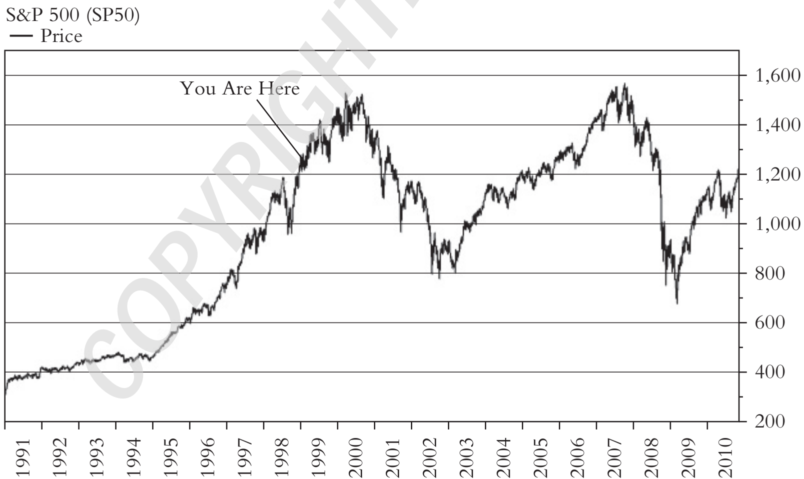

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*This material is adapted from the 1998 annual report of Martin Capital Management.

Throughout the book, you will see charts that include an arrow indicating "You Are Here." Like the ubiquitous directory map on a shopping mall kiosk, these charts are intended to orient the reader to what was known and what was yet to unfold as I took pen in hand to communicate with clients of Martin Capital Management. Since many chapters are constructed of excerpts from annual reports, the time period being reviewed is the preceding year. In some sections, the focus may be on a particular quarter or may involve a review of events over a long period of history. The first "You Are Here" map shown here, for example, tracks the market's steep ascent as I wrote the first document—the 1998 annual report for Martin Capital Management. The journey through subsequent years takes on the appearance of a rugged and dangerous trek through the Himalayas, but at that moment it looked as if the only direction for the market to go was up, up, up. How could we have known what lay ahead?

For the mathematically inclined, a point of clarification is required. Under most circumstances, we would use logarithmic scales for the vertical (price) *y*-axis. Logarithmic scales represent an equal amount of percentage change. Arithmetic scales represent an equal amount of numerical change. However, for the time period in question, most of the charts throughout the book reflect stock prices that typically range from flattish to downtrending, often accompanied by atypical volatility. The S&P 500 charts at the beginning of each chapter are a case in point. The arithmetic scales give a more accurate portrayal of the volatility in an environment that lacks no clear trend.

The first eight chapters of *A Decade of Delusions* are taken virtually verbatim from the book *Speculative Contagion* (2006), which, in turn, was based on Martin Capital Management annual reports, 1998–2004. Most of the bracketed material in the first eight chapters was added by the author for *Speculative Contagion* and in a few cases for *A Decade of Delusions*. Brackets are also occasionally used in quoted material for the sake of clarity.

May Reason Prevail

In June 1998 Warren Buffett, in a public-television interview with *Money Line*'s Adam Smith, was asked, "Why do smart people do dumb things?" Buffett opined that greed, fear, envy, and mindless imitation of others

are among the factors that mitigate the transfer of the mind's horsepower to the wheels that propel us along the road toward business and investment success. Rather than superior intelligence, Buffett confided, it is the capacity for unconditionally *rational* thought—followed by proportional action—that separates the winners from the also-rans. These qualities have distanced him and Charlie Munger from the pack by such a margin that the multitude is no longer even a speck on the horizon.

While reading for the first time the recently reprinted first edition (1934) of *Security Analysis*, authored by Buffett's mentor, Benjamin Graham, to which much-deserved attention is directed in this report, a similar thread was strikingly evident throughout the 700-page masterpiece. Written in the darkest depths of the Depression by a man who personally was not spared its devastation, the volume reveals Graham's genius for almost inhuman objectivity and rationality in the face of a financial and economic storm that wreaked such havoc and mental anguish on a whole generation of investors that most had no stomach for stocks throughout the rest of their lives.

To the extent that the writer is able to view the investment landscape from a similar frame of reference, this report in its entirety will ideally reflect the ascendancy of reason over emotion and fact over folly.

A Reader's Guide

This year's account is organized by topic, prioritized from most important to least important based on the presumed breadth of their appeal. Beyond the discussion of issues of immediate relevance, a lengthy essay [beginning a four-year diatribe against willful, and ultimately shameful, disregard for the necessity of an honest system of "weights and measures"] in accounting for corporate results follows—the value of which transcends the moment. A magnifying glass is used to examine the relaxation of standards in corporate financial management and reporting that came about when executives put pragmatics before principle in their run for the roses in the earnings-per-share-growth-at-any-cost derby. Readers of corporate annual reports know that this is a time to resurrect the Latin expression *caveat emptor*. [In this chapter, the section "It's a Numbers Game" exposes the progressively widening gap in GAAP (generally accepted accounting principles). By contrast Chapter 7 wraps up with "Fully Deluded Earnings," the S&P's

initial attempt to put the creative accounting genie back into the bottle. Three accounting sections in other annual reports were omitted to avoid beating a dead horse.]

The Year 1998 in Review

The past year brought to the fore an interesting and challenging—but not unprecedented—dichotomy. The most widely referenced equity-market benchmark, the Standard & Poor's 500 stock index, heavily weighted for the big and the beautiful, rose by 26.7 percent in 1998, achieving in the process a record-setting fourth year in a row of gains in excess of 20 percent. The Nasdaq index, dominated by large-capitalization technology companies, including several that have prominent places in the S&P index, put on an even more impressive show, rising 39.6 percent. Nasdaq volume, we parenthetically note with undisguised amazement (since we are aware that the companies of which it consists are among the least proven), regularly dwarfs that of the New York Stock Exchange (NYSE). During that same interval, the Russell 2000, composed primarily of so-called small-cap stocks, told an entirely different story, actually falling by 3.4 percent for the 12 months.

Surprisingly, despite the handsome showing of most of the major indexes, the majority of stocks suffered a losing year in 1998. Backsliders outpaced winners both on the Big Board and, more dramatically, on Nasdaq, where the 1,690 stocks that registered higher prices for 1998 were handily outnumbered by the 3,351 that fell. The two-tier market that emerged in the spring of 1998 is reminiscent of 1972. We took the "road less traveled."[1]

While the prices of the most favored companies rose farther and farther above what we believe to be their intrinsic worth, several fine businesses (but market wallflowers) presented us with attractive purchase opportunities during the late-summer rout. And while the S&P 500 and the Dow Jones industrial average backtracked by nearly 20 percent from July through August, the three that we purchased in larger quantities

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[1][2006, *Speculative Contagion*] Just as the "Nifty Fifty" skyrocketed to eventual oblivion beginning in 1972, so did technology and Internet stocks in late 1999 and the spring of 2000. The mundane "Main Street" companies fared far better in both episodes.

Figure 1.1 Coca-Cola Stock Price History
SOURCE: © FactSet Research Systems.

traded at their lows for prices that were, on average, approximately one-third of their 52-week highs. More importantly, these growing companies were purchased at an average price-earnings ratio of below 10 times trailing earnings. They have since rallied sharply but still trade well below their earlier highs. If we are confident that we (a) understand a business that historically earns high returns on shareholders' capital, (b) feel that its business model is stable enough for us to estimate its intrinsic worth, and (c) conclude that management is both competent and shareholder-oriented, falling prices play to the strength of our business analysis. In each case, our average cost is well below what we think the businesses are worth. If business conditions remain reasonably positive, five-year expected returns for the three companies could average better than 20 percent, compounded annually. Since the mailing list for this report extends beyond our clients, we are not mentioning the companies by name.

We admit to having an abiding interest in the great consumer-products franchises like Coca-Cola and Gillette (stock price performance shown in Figures 1.1 and 1.2), and we would purchase them and others of their ilk if, based on conservative terminal-price assumptions, five-year expected returns approach 15 percent. Based on our work, at current prices, they are likely to earn little more than the yields available on U.S. Treasury securities for the foreseeable future. That's not enough to get us off the dime.[2]

[2][2006, *Speculative Contagion*] We often talk about patience, but Coca-Cola and Gillette have tested our limits. After peaking around $90 per share in mid-1998,

Figure 1.2 Gillette Stock Price History
SOURCE: © FactSet Research Systems.

Patience and Persistence

Short-term market-price volatility is relatively high for mid- and smaller-sized companies found on the road less traveled. While the market prices of the companies we own eclipsed by some margin the performance of the popular averages (and most equity mutual funds) in 1996 and 1997, this past year was a different story. We don't want to appear indifferent to these shorter-term outcomes, be they positive or negative, but our focus remains on the ultimate rationality of markets over time. Today's investor pays a heavy premium for popular big-cap companies. We expect the earnings of the companies we own to grow at a rate no less than the earnings of the S&P 500 index, and yet we acquired them for one-third of the index's price-earnings ratio. To paraphrase Benjamin Graham, in the short run, it's popularity and outward appeal that help a girl win a fellow's attention, but in the long run, it's good cooking that helps her keep it.

We would be less than candid if we didn't admit to coveting the returns that the S&P 500 and Nasdaq 100 have earned during the past

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Coke began a long stair-stepped descent, hitting $37 in the spring of 2003 and recently traded for $42. In similar fashion, Gillette peaked at $63 at the same time that Coke was reaching for the stars. It hit a low of $27 in the spring of 2001. For whatever strategic reasons, Gillette agreed to surrender its independence (for an 18 percent premium to the prevailing market price) to Procter & Gamble and is currently selling at $55, pending consummation of the merger.

several years. We regret not being able to find ways to fully and prudently share in the explosion of financial wealth that has been created out of thin air. Furthermore, it's a near certainty that if present trends continue, we will lag even farther behind. The high-stakes game of musical chairs that Wall Street has been playing is neither one we understand nor one in which we have any demonstrated competence. In the final analysis, our respect for history's lessons (see "The Dean of Wall Street Revisited" later in this chapter) and our pledge to think and act rationally leave us no choice but to stay our carefully plotted wealth-preservation course.

We have an aversion to investment operations that may lead to permanent loss of capital. In our judgment, permanent loss can result from (a) investment in securities of issuers in which high confidence of their ability to survive particularly adverse economic circumstances is not warranted by the facts and/or (b) an investor becoming so despondent because of the decline in the market value of his or her portfolio that in a moment of all-consuming fear he or she forces the conversion of a paper (and perhaps temporary) loss into a permanent one. We go to great lengths to minimize the likelihood of the first eventuality, a course of action for us that is essentially devoid of emotional forces. The second is more problematic. There is little basis for us to determine in advance how an individual might respond under conditions of such high stress. It has been 25 years since tolerance for wealth-threatening market-price declines was tested in the crucible of high emotion, and there is little precedent, therefore, from which to make such judgments about what form that response might take today should the market fall long and hard. At considerable cost in temporary (if not permanent) loss of opportunity, we have managed portfolios to avoid subjecting our clients to that test.

As we wait (im)patiently for some semblance of order to be restored in equity valuations, the vast majority of the assets over which we have control are invested in the safest-harbor securities available. The money we manage, both yours and ours, that isn't committed to equities is squirreled away in the highest-grade fixed-income securities, including Aaa-rated pre-refunded or escrowed-to-maturity tax-exempt municipal bonds and U.S. Treasury bills and notes. To compromise on credit quality at this juncture in our economic history would be the equivalent of a boat's captain feigning preoccupation with safety as he snugs the vessel

alongside the pier. Only he knows that below the waterline the hull is riddled with leaks, and the junk (pun intended) will stay afloat only so long as the bilge pumps keep working. Higher portfolio returns, if they are to be achieved, will be the result of rising interest rates or expanded investment opportunities in equity securities, not compromising on credit quality in fixed-income securities.

Market interest rates fell during 1998. Because we have elected not to expose our clients to the market-price volatility inherent in long-duration bonds (made even longer by lower coupons) as I did in the early 1980s, falling interest rates are anathema to longer-term investors such as ourselves. While short-duration bond prices rise moderately, coupon interest is reinvested at lower rates. The "realized compounded yield," a bond-management term, suffers accordingly. Conveniently, the consumer price index is concurrently wallowing in low single digits, making the yields from fixed-income securities somewhat more palatable. Unfortunately, the bulk of the income and realized gains earned on the wealth we manage is not consumed but reinvested instead. We openly acknowledge the formidable task that lies ahead: We must cope intelligently, on the one hand, with a global deflation that has driven bond-market yields to the lowest levels in a number of years and, on the other, with a virulent price inflation that is sweeping through the U.S. equity markets like a raging inferno. Necessity (with due apologies to Aesop or a lesser-known Latin source) is not the mother of a sound portfolio policy; purchasing quality assets at or below what they are worth is. We can't change the game, but we can determine if and when to play. In all decisions, we pledge to conduct ourselves in a businesslike manner—to be, above all, rational and circumspect. As noted earlier, we will do our best to avoid being held hostage by greed, fear, or the mindless imitation of others.

Analysts, as if there's any doubt, are not always right—even when the logic of our reasoning is theoretically sound. As we ply our trade, modern communications technologies have given us fingertip access to vast amounts of economic, business, and financial information at a somewhat reasonable price. Most of it is reliable. Deliberate falsification, while often sensational, is relatively uncommon. A far more important source for errors is in making judgments about an always

uncertain future. Lacking anything more tangible, we feel compelled to proceed on the basis that the past is at least a rough guide to what tomorrow has in store. At times it isn't. Another handicap is the sometimes irrational behavior of market participants, seemingly playing in concert under the direction of a slightly mad imaginary maestro. We must rely on this market to ultimately vindicate our judgments. All too often it is painfully slow in adjusting to our way of thinking! As readers are acutely aware, our contention that there is little or no margin of safety in the current prices of many common stocks is of little relevance in a market where the players are rhapsodizing to an improvised tune, the tempo of which is wildly upbeat. Patience and persistence, we frequently remind ourselves, are virtues, even if they don't feel particularly noble at the time they are called into play. We know all too well why the head of the tortoise is held low until the hare is in sight.

The Fixed-Income Alternative

Forecasting interest rates is surely the most difficult and error-prone assignment that a manager who relies on fixed-income securities to function as portfolio workhorses must accept. Let's begin by examining the bond-yield forecast implicit in the yield curve. The bond market is huge, global, active, and therefore relatively efficient; it represents a good summary of what institutional fixed-income investors around the world think about U.S. interest rates. When we observe that the yield curve is relatively flat, as it is today, in nontechnical terms we mean that market yields for securities due in 30 years are not much higher than those due in just one year. For example, the spread between the 30-year and the one-year yields was 0.58 percent at year-end. Why, you might wonder, would investors lend money for 30 years for essentially the same annual amount of interest they can earn by lending it for one year? The only reasonable conclusion is that they must think that interest rates will fall and that their total return over time will be higher if they "lock in" the yields available on longer-term instruments. If they felt otherwise, surely they ands other investors of similar persuasion would sell longer-term bonds (at the margin, causing their prices to fall and their yields to advance) and purchase short-term bills or notes (resulting in their prices rising

and their yields falling), producing an upward-sloping yield curve that tends to be more understandable.[3]

We don't take exception with the yield curve's forecast. It is reflective of the popular deflationary scenario. However, there are two compelling reasons why we haven't ventured into long-dated bonds. First is the unanimity of bullishness that the yield curve implies. Implicit in bond prices (again assuming the market is quite efficient) is the expectation that prevailing inflation and economic winds will continue to be favorable to bond investors. Little provision is made in today's bond prices for the possibility of reflation, or that the euro will eventually displace the dollar as the world's reserve currency,[4] or any other plausible scenario that might result in rising bond yields.

Second is the matter of duration. *Duration* is a technical bond-management term that quantifies the market-price sensitivity of a fixed-income security to changes in market yields. It makes intuitive sense that the greater the number of years until a bond matures, the more volatile are price changes in response to a given change in market yields. What is less widely understood is that duration is also a function of the size of the bond-interest coupon. The smaller the coupon, holding all other factors constant, the greater the volatility. The roller-coaster amplitude of price fluctuations of zero-coupon bonds, therefore, makes

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[3][2006, *Speculative Contagion*] Five years later, the forecast implicit in the yield curve proved resoundingly correct. In June 2003 the 30-year Treasury bond yielded 4.17 percent and the five-year, 2.02 percent, while the Fed funds rate was 1 percent. As of June 30, 2005, short-term rates had rebounded from their lows, and the yield curve was nearly as flat as it was in 1998. Currently the 30-year Treasury bond yields 4.30 percent and the 5-year, 3.83 percent, while the Fed funds rate is 3.50 percent. Only time will tell if the bond market has adequately discounted future levels of inflation. [2010 update: Deflation has been a concern for some time now. The 30-year bond yield is 3.65 percent; the 5-year, 1.40 percent; and the Fed funds target rate is 0–0.25 percent.]

[4][2006, *Speculative Contagion*] After its debut on December 31, 1998, at $1.17 per euro, the euro exchange rate sank as low as $.82 in late 2000 and now has recovered and strengthened to $1.20 as of June 30, 2005. The dollar is also weak relative to the yen. The U.S. dollar still reigns supreme as the world's reserve currency, but complacency could eventually topple the mighty buck. [2010 update: At this writing the exchange rate is $1.30. More important, the trade-weighted and the U.S. dollar indexes are still relatively near their lows.]

them the most volatile of all types of fixed-income securities. Since the only cash payment made occurs when the bond is redeemed at par at maturity, duration and the number of years to maturity are one and the same. When I purchased long-term zero-coupon bonds in the early 1980s at market yields in excess of 13 percent, I welcomed the prospect of outsized volatility because I felt it would eventually work in my favor. Conversely, committing capital to 30-year 5.17 percent Treasury bonds today at par borders on speculation, unless it's the investor's intent to hold the security to maturity. If market yields were to increase by 200 points (two percentage points), the bond price would fall nearly 25 percent, in all likelihood foreclosing on the possibility of selling the bond in order to reinvest the proceeds more opportunistically in, say, common stocks.[5]

Finally, a word about bond quality is warranted. As you may not be aware, the yield differential between high- and low-quality bonds widened dramatically during the year when global economic concerns elbowed their way into the headlines. Russia, in particular, shocked selected domestic money-center banks and hedge funds when it effectively defaulted on its sovereign debt. Our stance regarding bond quality remains unchanged. Unless we can find opportunities in investment-grade bonds that compare favorably with those from investment in well-capitalized and reasonably priced common stocks, we will not compromise on credit quality. We feel confident that the creditworthiness of our clients' bond portfolios exceeds that of those managed by any of our regional competitors—by a wide margin.

Sometimes much can be learned by simply stepping back from the hectic pace of business life and asking the question, "Does all of this make sense?" This report, prepared late each year, affords the writer that opportunity. We make every effort to examine all asset classes through the aforementioned paradigm. The combination of OPEC and rising

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[5][2006, *Speculative Contagion*] While such a bet looked risky in light of historical yields (we have warned against rearview-mirror investing, in which we ourselves have been known to indulge), as noted in a footnote above, the shape of the yield curve indicated lower rates ahead. Committing assets to longer-duration bonds of the highest quality would have resulted in performance that handily beat the S&P 500 since then. Chapter 8 discusses the biases that infect all investors to one degree or another.

inflation sent crude oil prices from as low as $5 in late 1973 to almost $40 in 1980. As the U.S. economy moved from double-digit to low, single-digit inflation during the recession in the early 1980s, the price of a barrel of crude oil fell from its $40 peak to a recent low of around $10. Conversely, the price one must pay to purchase a dollar's worth of bond interest has risen just as sharply as oil prices have fallen. Bond yields, which exceeded 14 percent when oil was peaking, have since declined dramatically to 5 percent. (Bond prices move in the opposite direction of bond yields.) Those who believe that the longest peacetime economic expansion will eventually overheat should be as interested in investments that might benefit from rising oil prices as they are wary of long-term bonds with fixed coupons.[6] To be sure, the highest-quality fixed-income securities, with short durations, will likely remain as portfolio stalwarts so long as they meet our present and well-defined need for preservation of principal. When opportunities for growth in principal appear, without concurrently endangering its safety, the role of fixed-income securities will be greatly diminished. Who knows what will appear in their place?

The Dean of Wall Street Revisited

The reign of Antoninus is marked by the rare advantage of furnishing very few materials for history, which is indeed little more than the register of the crimes, follies, and misfortunes of mankind.

The Decline and Fall of the Roman Empire (1776) by Edward Gibbon (1737–1794)

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[6][2006, *Speculative Contagion*] In June 2005 the price of crude oil hit $55.58 per barrel, a handsome advance from the $10 at which it traded when the above comments were made. To be sure, capitalizing on the sixfold increase in the price of crude oil is much harder than participating in a rising stock market. It's difficult to share proportionally in the rising price of crude oil, except in the futures market, and using indirect methods can be problematic since the correlation between the price of crude oil and the stocks of major oil exploration and production companies can be surprisingly tenuous. [2010 update: Oil reached $145 per barrel in mid-2008, then fell to below $40 in early 2009 during the low point to date in the global recession. It now trades in the mid-$80s.]

Gibbon offers a curious reference in the opening quotation regarding the unremarkable reign of Roman Emperor Antoninus (Marcus Aurelius), who ruled in the middle of the second century A.D. It is noteworthy that the events that account for the decline and eventual fall of the Roman Empire, not an insignificant development in the course of world history, was, as noted by Gibbon, "little more than the register of the crimes, follies, and misfortunes of mankind." As you may recall, the book *Extraordinary Popular Delusions and the Madness of Crowds* was of similar persuasion, insofar as the subordination of the rule of law and the follies of man (i.e., often originating from periodic episodes when common sense is almost laughably deficient). With the insights gleaned from the 1934 edition of *Security Analysis* by Benjamin Graham and David Dodd, we should be able to gain a clearer appreciation for the origins of the *follies* of the late 1920s that led to the *unfortunate unintended consequences* (often presented as unexpected or unprovoked tragedy) in the 1930s. Our interest is, however, more than academic. To the extent that follies are as cyclical as human gullibility—in contrast to science, where knowledge is cumulative and where real progress is possible—perhaps we can put history's lessons to practical use to avoid some of the more costly logical consequences that ignorance of the past periodically teaches.

By way of introduction, Benjamin Graham died in 1976 at the age of 82; it wasn't until 1996 that his memoirs, written in his later years, were published. Graham had a prodigious intellect, graduating from Columbia University in two and a half years and having the distinction of being invited to teach in three departments (Literature, Philosophy, and Mathematics) at Columbia. Instead, Wall Street beckoned in 1915. During the 14 years leading up to 1929, young Graham tasted much success, first as an employee and then as a junior partner at a brokerage firm—and finally as head of his own business.

At the quarter-century mark of 1925, the great bull market was under way, and Graham, then 31, developed what he later described as a "bad case of hubris." During an early-1929 conversation with business associate Bernard Baruch (about whom he disparagingly observed, "He had the vanity that attenuates the greatness of some men"), both agreed that the market had advanced to "inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinks, and that the whole thing would have to end up

one day in a major crash." Several years later he lamented, "What seems really strange now is that I could make a prediction of that kind in all seriousness, yet not have the sense to realize the dangers to which I continued to subject the Account's capital" (Benjamin Graham, *Benjamin Graham: The Memoirs of the Dean of Wall Street*, edited by Seymour Chapman [New York: McGraw-Hill, 1996], 259). In mid-1929, the equity in the "Account" was a proud $2,500,000; by the end of 1932, it had shrunk to a mere $375,000. The dismay and apprehension Graham experienced during those three long years he summarized by saying:

> The chief burden on my mind was not so much the actual shrinkage of my fortune as the lengthy attrition, the repeated disappointments after the tide had seemed to turn, the ultimate uncertainty about whether the Depression and the losses would ever come to an end. . . . Add to this the realization that I was responsible for the fortunes of many relatives and friends, that they were as apprehensive and distraught as I myself, and one may understand better the feeling of defeat and near-despair that almost overmastered me towards the end. (Ibid., 259)

What has deeply impressed me about the 1934 edition of *Security Analysis*, which Graham set to work on in 1932 (with publication in May 1934), was his uncanny ability to put mind over matter. He intellectually detached himself from the travails that were wracking his portfolio, his confidence, and his sense of stewardship. While there are a number of hints in the book that tie the author's travails to the text, they are most subtle.

The Rise and Fall of Security Analysis

In the introduction to the scope and limitations of security analysis, Graham described the preceding three decades as a period during which its prestige experienced both a "brilliant rise and an ignominious fall":

> But the "new era" commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its

> devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of imaginary values, and the second—after the crash—due to the disappearance of real values. (Benjamin Graham and David T. Dodd, *Security Analysis* [New York and London: Whittlesey House, McGraw-Hill, 1934], 3)

Even an analyst as well-grounded as Graham failed to account for the severe economic contraction that followed the crash. Its causes have been speculated about ever since. Today, concerns about the "reverse wealth effect," thought to be a force that exacerbated the Depression, are clearly on the minds of Alan Greenspan and other policymakers.

The New-Era Hypothesis

During the post-World War I period, and particularly during the latter stage of the bull market culminating in 1929, the public adopted a completely different paradigm toward the investment merits of common stocks. According to Graham, the new-era theory or principle may be reduced to one sentence: *"The value of a common stock depends entirely upon what it will earn in the future"* [emphasis added].

From this dictum, Graham drew the following corollaries:

1. That the dividend rate should have slight bearing upon the value.
2. That since no relationship apparently existed between assets and earning power, the asset value was entirely devoid of importance.
3. That past earnings were significant only to the extent that they indicated what changes in the earnings were likely to take place in the future.

This complete revolution in the philosophy of common-stock investment took place virtually without realization by the stock-buying public and with only the most superficial recognition by financial observers (ibid., 306–307).

Fast-forward 70 years, and a student of history might logically conclude that the investment landscape is eerily similar to that which Graham described in the late 1920s. The current dividend yield on the S&P 500, at 1.34 percent, is one-third the yield on U.S. Treasury bonds and is at its lowest ebb in modern history. When capital gains

are plentiful, who cares about dividends? After all, if the surveys are correct and the average mutual-fund investor really believes that stocks will provide total returns exceeding 20 percent annually for the next 10 years, today's minuscule dividends pale in comparison to what the investor must expect from capital appreciation. To be sure, the dividend yield would be higher, although not materially so, were the cash used to fund stock-repurchase programs paid out in dividends instead. In plain English, dividend yields are low because stock prices are high (and bond yields are slightly below their long-term average). The explanation is to be found in the denominator, not the numerator.

Likewise, the price-to-book-value ratio of 6.53 is off the charts. As with dividends, there are plausible explanations. Companies like Microsoft and Dell, S&P 500 heavyweights, are short on physical assets and long on intellectual property. In addition, as discussed elsewhere in the report, corporations have taken massive restructuring charges against shareholders' equity in recent years. The growth in book value has, accordingly, not kept pace with the growth in earnings per share. With regard to earnings, Wall Street has never been more dependent on forward thinking than it is today. And that's in spite of the longevity of the current expansion that has set peacetime records, plus the reality that Japan and various Asian and Latin American economies are groaning and creaking like the timbers of a wooden ship in stormy seas. Given the uncertainties that abound, we wonder whether Graham would characterize the heavy reliance today on future prospects as speculation and not investment.

While the exponential ascension in stock prices during the late 1920s was in large measure a self-fulfilling prophecy, it was not without scholarly explanation, however tenuous. *Common Stocks as Long Term Investments* by Edgar Lawrence Smith, published in 1924, was often cited as justification for the ownership of common stocks. Unfortunately, the sound premise was rendered unsound by dint of prices escalating to speculative levels in the late 1920s. In practical terms, Smith's supposition was as sensible at 10 times earnings as it was ill-advised at 30 times. Coincidentally, Professor Jeremy Siegel's book, carrying nearly an identical title, *Stocks for the Long Term*, is the contemporary version of the same phenomenon.

Graham asked the rhetorical question, "Why did the *investing* public turn its attention from dividends, from asset values, and from earnings,

to transfer it almost exclusively to the earnings *trend*, i.e., to the changes in earnings expected in the future?" He observed that the tempo of economic change made obsolete old standards. At one time, stability was thought to be a function of a business being long-established. Instead, corporations that had been profitable for a decade lost their edge. In their place, other enterprises "which had been small or unsuccessful or of doubtful repute, have just as quickly acquired size, impressive earnings, and the highest rating." The parallels with today are unmistakable. Think of IBM, AT&T, General Motors, Eastman Kodak, and Kellogg (to name a few)[7] and the restructuring charges that have revealed cracks in their heretofore impenetrable armor. On the other hand, we all have witnessed the spectacular ascent of technology stocks that has sent the Nasdaq price-earnings ratio soaring to over 100, as well as the flight of Internet stocks that have modest though rapidly growing sales and often no earnings (ibid., 307–308).

Forgetting to Read Menus from Right to Left

As for the analysis of individual businesses, Graham attached great importance to the purchase price, the only variable over which an investor has control (if he has the discipline to patiently wait, and sometimes forgo purchase altogether, so as to pay no more than a price that affords a satisfactory margin of safety). Graham distinguished between financial reasoning and business reasoning as they relate to purchase price:

> We have here the point that brings home more strikingly perhaps than any other the widened rift between financial thought and ordinary business thought. It is an almost unbelievable fact that Wall Street never asks, "How much is the business selling for?" Yet this should be the first question in considering a stock purchase. If a business man were offered a 5 percent interest in some concern for $10,000, his first mental process would be to multiply the asked price by 20 and thus establish a proposed value of $200,000 for the entire undertaking. The rest of his calculation would turn on the question whether the business was a "good buy" at $200,000. (Ibid., 492)

[7][2010] All but IBM are selling at lower prices 12 years later.

Figure 1.3 General Electric Stock Price History
SOURCE: © FactSet Research Systems.

This elementary and indispensable approach has been practically abandoned by those who purchase stocks. Of the thousands who "invested" in General Electric in 1929–1930 probably only an infinitesimal number had any idea that they were paying on the basis of two and three-quarter billions of dollars for the company, of which over two billions represented a premium above the money actually invested in the business (ibid., 493).

The market value of GE (stock price performance shown in Figure 1.3) has grown to $334.9 billion since then, compounding over the years at an average annual rate of 7.5 percent, plus dividends. The premium above the $37 billion actually invested in the business that an investor pays today is a tidy $298 billion.[8]

Long before modern portfolio theory (MPT) and its mathematical models took root in academia, Graham argued that it was unsound to think that the investment character of an issue was a constant:

> The price is frequently an essential element (of any investment operation), and so that a stock may have investment merit at one price level but not at another. The notion that the desirability

[8][2006, *Speculative Contagion*] At the time of this comment, General Electric was selling in the range of $30 (adjusted for a 3:1 stock split in May 2000). It subsequently rose to $60, revealing, as so often happens, investors' misguided affection with the currency equivalent of exchanging two nickels for a dime. Having backtracked to a low of $21 in early 2003, it has subsequently rallied back to a price of $34. Earnings per share were $.95 for 1998 and $1.61 in 2004.

> of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a . . . stock was selling at 35 times its maximum recorded earnings, instead of 10 times its average earnings, which was the preboom standard, the conclusion to be drawn was not that the stock was now too high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappear, not only upon the price at which a stock could sell, but even upon the price at which it would deserve to sell. An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy "good" stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, "Why work for a living when a fortune can be made in Wall Street without working?" The ensuing migration from business into the financial district resembled the famous gold rush to the Klondike, with the not unimportant difference that there really was gold in the Klondike. (Ibid., 310)

The Investor's Dilemma

In reflecting on the seven years preceding the publication of *Security Analysis*, Graham pointed out the investor's dilemma brought about by the boom-and-bust market cycles that were emblematic of the most turbulent financial and economic era in the twentieth century.

> The wider the fluctuations of the market, and the longer they persist in one direction, the more difficult it is to preserve the investment viewpoint in dealing with common stocks. The attention is bound to be diverted from the investment question, which is whether the price is attractive or unattractive in relation to value, to the speculative question whether the market is near its low or its high point.
>
> This difficulty was so overshadowing in the years between 1927 and 1933 that common stock investment virtually ceased

> to have any sound practical significance during that period. If an investor had sold out his common-stocks early in 1927, because prices had outstripped values, he was almost certain to regret his actions during the ensuing two years of further spectacular advances. Similarly those who hailed the crash of 1929 as opportunity to buy common stocks at reasonable prices were to be confronted by appalling market losses as a result of the subsequent protracted decline. (Ibid., 321–322)

Despite obvious similarities to today, it is virtually impossible to forecast the likelihood that knowledge of history will be of relevance now. Furthermore, in attempting to determine the cause-and-effect correlation between two events, the association can be imaginary. Behavioral scientists call it "illusory correlation." Each reader will have his or her own opinion as to what extent the inferences above are imagined. Nonetheless, wealth management requires that we sacrifice opportunity when its downside, however remote, may be permanent loss of capital (defined in the section titled "The Year 1998 in Review"). The aforementioned conversation Graham had with Baruch, followed later by his words of contrition, are still ringing in our ears.

It's a Numbers Game

In examining the confluence of forces that culminated in the Crash of 1929, Benjamin Graham compared the late stages of the phenomenon with the Alaskan Gold Rush. The blurring of distinctions between Wall Street and Main Street that occurred in the last chimerical years of the 1920s became the fetid bog of exaggerated expectations in which an addictive Gold Rush mentality fermented. The cause-and-effect logic that had throughout history linked effort with reward was thought to be temporarily, if not permanently, suspended. Common-stock paper wealth, gold's modern-day gilt-edged substitute (and lots of it) was to be had by those who simply knew how and where to go to unlock its treasures. Visions of untold riches—made even more seductive because the payoff was far out of proportion to the labor expended to acquire it—transformed plodding and deliberate merchants and manufacturers into wild-eyed prospectors. In their frantic search for the theretofore elusive dream, they gladly swapped their dark suits and

conservative ways for a pick and shovel. They abandoned many of the rules of thought and conduct—including reason and common sense—that had governed their lives in what at the time must have seemed like a dull and uninspiring past.

Perhaps Graham's analogy may be applicable 65 years later? What we appear to be witnessing today is a near-universal rush for the gold that common stocks symbolize. A sense of urgency tied to the obsessive belief that the bounty is finite and that a drop-dead point looms out there somewhere has sustained the charge at a fanatical pace. Nowhere in this agitated plot is there a speaking part for the rational man—except as a quiet and skeptical spectator.[9]

The following section examines the lengths to which some corporate executives have gone to massage their corporation's finances and their own compensation programs to seize what they believe to be their share, if not more, of the spoils. All the schemes, however far they stretch credulity, seem to excite little resistance if they are packaged under the pretense of "enhancing shareholder value." The deportment of those who exhibit some or all of the symptoms of Gold Rush fever, when viewed through that fascinating and age-old prism, is made much

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[9][2006, *Speculative Contagion*] As yet another example of the repetitive nature of history, the eternal gullibility of the "madding (and sometimes mad) crowd," and the parasites who prey on its denizens (see elucidating insights from novelist Ayn Rand in Chapter 7), let's step back in time to the California Gold Rush, which preceded by about 50 years the longer-lived Klondike Gold Rush. It was on John Sutter's expansive property that James Marshall, Sutter's sawmill contractor, discovered gold nuggets in the American River in 1849. Sutter and Marshall suppressed the gold news so as not to cause interruptions with their real estate development. Not surprisingly, it was a San Francisco merchant and master of hype, Sam Brannan, who got wind of the seemingly well-kept secret and subsequently became the richest person in California—but Brannan never mined for gold. When he started racing through the streets yelling, "Gold, gold in the American River," he wasn't planning to dig for it. He was planning to sell shovels. And the first person who sold shovels got a lot more gold than the person who had to dig for it. The laws of supply and demand were not unfamiliar to Brannan. His wild run through San Francisco came just after he had purchased every pickax, pan, and shovel in the region. A metal pan that sold for 20 cents a few days earlier was now available from Brannan for 15 *dollars*. In just nine weeks, he made $36,000. *While there are many stellar exceptions, the sooner one learns that much of Wall Street is actually in the "picks and shovels" business, the better.*

more understandable. Observed under any other construct, such people must appear capricious.

Some years ago, I asked the CFO of a public company what he thought earnings would be for the year. His only somewhat facetious reply: "What would you like them to be?" I wouldn't ask that question today because I'm afraid of what the answer might be.

The Supremacy of Earnings

Somewhere along the road to riches the corporate balance sheet was discarded as having little nutritional value, like yesterday's half-eaten McDonald's hamburger and fries. In its place has arisen "earnings power" (more often than not with substantial justification) as the primary determinant of the intrinsic value of a business. Before we lay to rest this barbaric corporate relic—the balance sheet and in particular the shareholders' equity account—let's say a few kind words in its memory. Shareholders' equity (book value when expressed in per-share terms) represents the shareholders' investment in the business, carried on the corporate books at depreciated cost, after all liabilities have been satisfied. While book value represents a reasonable starting point if liquidation of assets is in prospect, it is otherwise a relatively poor measure of the value of a business. For example, the tangible assets of Coca-Cola and Gillette pale in comparison to the value of their brands. The earnings of both companies are derived more from the market dominance and power of their intangible property than from the physical and financial assets that appear on the balance sheet. Nonetheless, when purchasing a business at a premium price relative to its book value—invariably the case today and frequently with good cause—some awareness of the size of the gap is warranted.

The full measure of the premium is better appreciated when expressed in aggregate terms. Returning to our earlier examples, the market value of Coca-Cola is $171 billion and represents a premium of $164 billion over the $7 billion in net tangible assets. Unconsolidated bottlers are carried at cost on Coke's balance sheet. If the market value of the bottlers is used, the $7 billion would increase to something like $15 billion. The equivalent numbers for Gillette are $52.5 billion in

market value of the shareholders' equity and $2.5 billion in net tangible assets. (Excluded is the valuable goodwill associated with the purchase of Duracell.) These financial statistics give credence to the earlier observation that most of the market value of these two businesses is derived from corporate assets that are nowhere to be found on the balance sheet. The not-insignificant premiums that the shares of these companies command in the marketplace are more understandable than many less-established companies in vogue today. There is a possibility, however slim (given the lightning pace of change and the general instability in the Internet world), that Amazon.com and Yahoo! (Figures 1.4 and 1.5) will

Figure 1.4 Amazon.com Stock Price History
SOURCE: © FactSet Research Systems.

Figure 1.5 Yahoo! Stock Price History
SOURCE: © FactSet Research Systems.

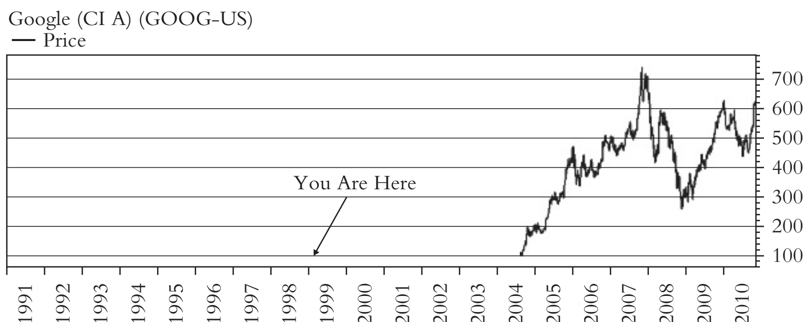

Figure 1.6 Google Stock Price History
SOURCE: © FactSet Research Systems.

dominate their respective markets 10 years hence. But there is relatively little doubt, conversely, that Coca-Cola and Gillette will reign supreme in theirs. He who doesn't understand the difference may ultimately be a victim, not a victor.[10]

Now we turn back to "earnings power." Even here a perfunctory note of caution is justified. Graham offers these thought-provoking observations:

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[10][2006, *Speculative Contagion*] (Note: All of the following stock prices have been adjusted for splits.) Amazon.com peaked at $110 in late 1999 and cratered at $5 in the fall of 2001, when the market capitalization was approximately $2 billion, which was down from the high of $38 billion. The stock has subsequently rallied back to $33 (a market capitalization of $14 billion) as of June 2005. Sales have grown to $6.9 billion in 2004, from just $600 million in 1998. In 2004 the company earned net income of $589 million. Likewise, Yahoo! skyrocketed to the same lofty price of $110 in early 2000, only to collapse to $4 by the fall of 2001. As of June 2005 it sold for $35. Revenues for 2004 were $3.5 billion, and profits $840 million, or $0.58 a share. The market capitalization as of June 30, 2005, was approximately $48 billion, down from approximately $117 billion at the peak, but still mind-boggling compared with current earnings. Forever chasing the latest great idea, speculators are now ogling Google (Figure 1.6). Amazon was the creation of a young fellow with an audacious idea, whereas Google is the brainchild of two bright young guys with an algorithm. We are addicted to Google as consumers of information, but not to the stock. As of June 30, 2005, its market capitalization was approximately $82 billion, with earnings for the last 12 months of about $1 billion. Seven years later, my skepticism remains unabated. Remember Darwin . . .

> In recent years increasing importance has been laid upon the trend of earnings. Needless to say, a record of increasing profits is a favorable sign. Financial theory has gone further, however, and has sought to estimate future earnings by projecting the past trend into the future and then used this projection as the basis for valuing the business. Because figures are used in this process, people mistakenly believe that it is "mathematically sound." But while a trend shown in the past is a fact, a "future trend" is only an assumption. The factors that we mentioned previously as militating against the maintenance of abnormal prosperity or depression are equally opposed to the indefinite continuance of an upward or downward trend. By the time the trend has become clearly noticeable, conditions may well be ripe for a change. (Graham, *Security Analysis*, 36)

The Accountants Are Not to Blame

Accounting is under indictment, in all likelihood unfairly.[11] The task of reducing endless variations of actual business activities to standardized financial reports and protocol is at best not without significant real-life problems. No doubt part of the reason is that accounting is, as it always is destined to be, a step behind an ever-changing business world, the current expression of which is increasingly driven by technology and deal-making. In reality, the Securities & Exchange Commission (SEC) and public accountants are chasing a forever-moving target. It is out of practical necessity that the generally accepted accounting principles (GAAP) allows companies' chief financial officers and their bosses plenty of flexibility or, in Washington jargon, "wiggle room." The rules rely on honesty and integrity—behaviors that are ostensibly encouraged by the presence and watchful eyes of "independent" auditors—to ensure that financial presentations are both "transparent" and "reliable." Lawrence Revsine, a prominent accounting professor at Northwestern's Kellogg Graduate School of Management, sums up the current state of

[11][2006, *Speculative Contagion*] Sadly, some accountants and accounting firms succumbed to the temptations of the times. Independence became compromised when shekels trumped scruples. "He who writes my checks calls the tune I sing" is an old adage for an ageless reason.

SOURCE: Copyright © 1999 Bill Monroe.

affairs succinctly: "Accounting stinks." It always will, but through no fault of its own.

Let's face it: GAAP will never be a good match for those who are intent on finding a way around the sometimes flimsy roadblocks against misrepresentations and other abuses that the Financial Accounting Standards Board (FASB) erects. Besides, the seemingly ever-evolving boom in financial assets that dates all the way back to 1982 has put a premium on deception because, to put it bluntly, it pays so well. Which brings to mind the pungent pronouncement attributed to Mark Twain (loosely paraphrased) that there are liars, there are abominable liars, and then there are statisticians. The head of auditing at KPMG Peat Marwick, the fourth-largest accounting firm, observes: "There's probably more pressure to achieve results than at any time that I've seen." Earnings growth drives executive bonuses as well as stock options (which of late account for more than 50 percent of executive compensation), and the ability to make accretive acquisitions, raise money, or even survive as an independent entity. Robert Olstein, a fund manager and former

coauthor of the respected newsletter *Quality of Earnings Report*, lays part of the blame at the doorstep of security analysts. "Accounting tricks are always going on," he says. "What's changed is that companies are getting away with more now because analysts aren't paying any attention." We agree. Unfortunately, as is human nature, the longer the dry spell, the more likely it is that people will stop carrying umbrellas.

The investor's watchdog, the SEC, has begun to rattle its sabers. This past fall, SEC Chairman Arthur Levitt began a rare series of meetings with top corporate CEOs, accounting analysts from investment houses, the FASB, and the Big Five accounting firms, among others. Not only did the midyear stock market retreat prod normally unflappable Federal Reserve Board Chairman Alan Greenspan into action (reaction?), but the SEC's Levitt openly worried that if accounting problems continue, even more damage could be done to investor confidence. It is probably reasonable, although impolitic, to ask: "If the chairmen of both the SEC and the Federal Reserve take their cues from the stock market, why, pray tell, should the captains of industry do otherwise?" Reasoning further, it appears that people in high places sense that the speculative Bubble is inflated to near the bursting point, and no one wants to be remembered by history as the one holding the hatpin.

What's a Company to Do?

If companies aspire to take full advantage of the fruits that this grand and expansive bull run offers, they must demonstrate earnings momentum. Some, whose businesses are simply not up to the test, have relied instead on extraordinary measures, in desperation turning to "cookin' the books" (in most instances on low heat) in order to remain a player.

Earnings management is the unspoken buzzword among corporate managers as they seek to pull out all stops in responding to the Wall Street edict. For many senior officers of publicly traded companies, the fixation on reporting a steady upward progression in earnings per share is more than academic. The potential for millions of dollars of stock-option profits often hangs in the balance. It is paramount, therefore, that managers win and hold the favor of Wall Street analysts, whose thumbs-down reactions (if managers disappoint by missing their "guided" estimate for quarterly earnings per share by a cent or two) can trigger a flood of sell orders.

The "Big Bath" Restructuring Charge

Corporate America has finally discovered what the 42nd president, Bill Clinton, has long known. If you put the right spin on (corporate) sin, what was once unspeakable among estimable gentlemen seated in dark leather chairs around a heavy mahogany table is now an acceptable, if not actually fashionable, topic for conversation. Forgiveness for these sins of malinvestment comes freely from an ever-more-blasé investing public whose memories are short and who call for neither confession nor contrition. This state of unquestioned forbearance has not gone unnoticed in the corporate boardroom.

The naked truth is that restructuring charges (often announced in oxymoronic terms as "nonrecurring" charges) are management's public admission that earnings in past years were overstated. They are a confirmation that corporate resources had been committed to an investment or investments that ultimately failed to measure up to minimal expectations—and the time has come to stop the hemorrhaging. A charge or debit is made to shareholders' equity, and a liability reserve of equal size is established. Liquidation of unproductive assets and personnel severance costs are among those future expenses for which reserves are instituted. As costs are incurred in untangling yesterday's bright idea, the liability reserve is reduced accordingly. It is noteworthy that those costs do not appear as a line item on the income statement but rather are shuttled directly to the liability side of the balance sheet.

To be sure, humans, even CEOs, make mistakes. After all, investments are made in the present, but returns are subject to the vicissitudes of the future. A lot can happen between now and then. For example, how a customer, or a competitor, might respond to a new product is often little more than conjecture until the jury of the marketplace hands down its verdict. Good managers can reduce investment risk, but they can't eliminate it.

Strangely, it's apparent that investors rarely look back as stock prices often rise when restructuring charges are announced. The rationale? First, the operating-earnings drag of the miscue will cease, and thus future reported earnings, *ceteris paribus*, will increase by the amount of the expenses thereby avoided. Additionally, there is a more subtle gain to be had. As sometimes happens, managers will overestimate the costs to be incurred in the effort to right yesterday's wrong. In fact, since Wall Street is ostensibly impervious to the size of the charge

(within reason, of course) and, as noted previously, exacts no immediate market-price penalty, is it not better to be safe than sorry? That's how the so-called "big bath" charge came into being. Here's the benefit: After the damage has been repaired, still undepleted reserves can be used to offset future costs without having those costs leak onto the income statement. In Burger King terms, we think of the twin benefits as a "double whopper" for future earnings. No wonder Wall Street cheers! And it all began with the amputation of a leg or an arm from the body of shareholders' equity. I suppose if anyone ever looked at the restructuring charge for what it is from an accounting point of view—a reduction in assets for which shareholders lay claim—the drum roll announcing the event would be muffled. Main Street investors understand the absurdity of what Wall Street investors apparently thrive on. Think of it as emasculation of the corporate balance sheet; assets only count in liquidation, and who's worried about that?

It gets more troublesome. As hinted above, big charges can become addictive. And don't for a minute think that such chicanery is the exclusive plaything of corporate lowlifes. Such behavior can be found in the best of families. AT&T (Figure 1.7), the company whose sadistic, omnipresent telemarketers invade my home (seemingly once a week and, like clockwork, always at dinnertime), took multiple write-offs totaling $14.2 billion during the decade ending 1994. All the while, its earnings miraculously grew by 10 percent a year, from $1.21 to $3.13. Even magician David Copperfield would find that feat amazing. It was, after all, a financial elephant the size of the Empire State Building that

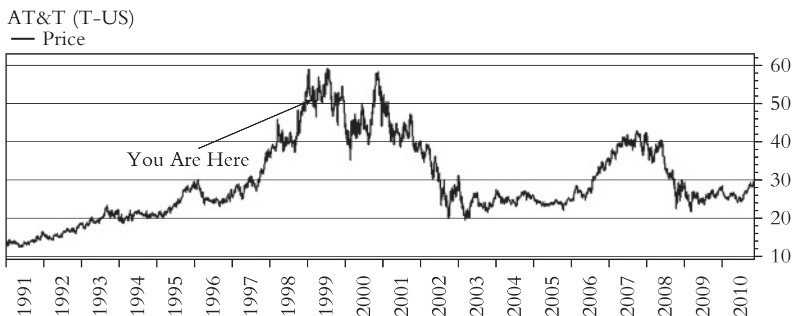

Figure 1.7 AT&T Stock Price History

SOURCE: © FactSet Research Systems.

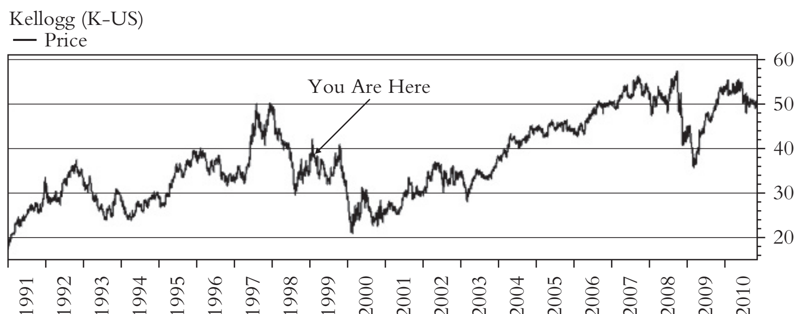

Figure 1.8 Kellogg Stock Price History
SOURCE: © FactSet Research Systems.

AT&T made to disappear in a cloud of accounting mumbo jumbo. The write-offs exceeded by almost $4 billion the $10.3 billion in earnings that the company actually reported. Sometimes it's helpful to compare the growth of a company's earnings over a period of time with the growth in shareholders' equity, before dividends are paid. Don't allow your children to do AT&T calculations unsupervised. We last wrote about AT&T's foibles in the 1995 annual report, and the beat goes on.[12]

Speaking of children, would they clamor for Frosted Flakes if they knew that Battle Creek-based Kellogg Company (Figure 1.8) has taken charges to "streamline operations" in nine of the last 11 quarters through year-end 1997? Real operating earnings for 1997 were more like $1.29 (down 24 percent from the year earlier), compared with

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[12][2006, *Speculative Contagion*] AT&T continues to be a "poster company" in the numbers game. Following earlier spin-offs of Lucent and NCR, it spun off AT&T Wireless (which was later bought by Cingular in 2004) and Liberty Media in 2001. It discarded AT&T Broadband in a transaction with Comcast in 2002 and announced in mid-2004 that it will be shifting focus from residential services to business services. After reaching $94 in early 1999, the stock fell to a low of $14 in late 2004. Because of the number of spin-offs, the decline in the stock price of AT&T overstates the loss in value for shareholders. In the latest chapter, in early 2005 SBC (one of the "baby Bells" born from the government breakup of AT&T) announced plans to acquire its former parent for $18 per share. But wait, there's more . . . While AT&T no longer exists as a stand-alone operating company, the bloodied but nonetheless venerable AT&T name is likely to survive. In a salute to the power of branding, SBC is considering renaming itself . . . AT&T!

the $1.70 reported. And the company still commands a price-earnings multiple of 31. At what point, it seems reasonable to ask, should such costs be recognized as recurring and thereafter appear as operating expenses in the income statement?[13]

A popular catchall technique, staying with descriptors familiar to children, is the "cookie jar reserve." Companies use unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses, or warranty costs. In effect, they stash accruals in cookie jars during the good times and reach into them when needed in bad times. This practice helps to smooth earnings rather than actually enhance them, as other schemes are able to do.

Some restructuring charges, we hasten to add, actually lead to increased earnings power, thereby enhancing the intrinsic value of the business by pruning dead branches. Our attention here is to the abuses.

Acquisition Reserves

While different in origin, reserves established as a result of acquisitions can serve much the same purpose. SEC Chairman Levitt calls the practice "merger magic." The number of acquisitions taking place each year has skyrocketed, making the issue increasingly relevant. In-process research-and-development write-offs, unknown a decade ago, have soared since IBM (Figure 1.9) used the technique to write off $1.8 billion of the cost of its 1995 acquisition of the spreadsheet creator, Lotus Development. The capitalized expenditure, in-process R&D, is obviously of indeterminate value to the acquirer. It is frequently written off after the acquisition as a "one-time" charge so as to reduce future earnings drag (which, under certain circumstances, we ignore).[14]

[13][2006, *Speculative Contagion*] The year 2002 was the first in the last five that Kellogg did not take a line-item restructuring charge. The stock peaked at $50 in early 1998, later falling to $20 in the winter of 2000. It currently sells for around $42, about 20 times earnings, and appears to have cleaned up its act.

[14][2006, *Speculative Contagion*] IBM traded at about $90 when the above comments were made and traded for $75 as of June 2005. It peaked at $135 in 1999 and sank as low as $54 in 2003. In 2002 the company recorded an after-tax charge of $1.8 billion for "extraordinary" items.

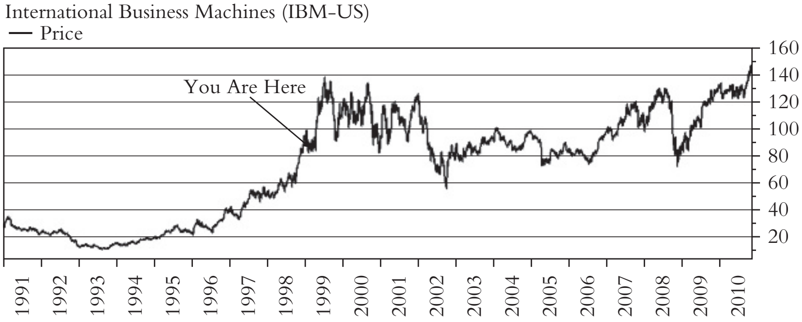

Figure 1.9 International Business Machines Stock Price History
SOURCE: © FactSet Research Systems.

Figure 1.10 WorldCom Stock Price History
SOURCE: © FactSet Research Systems.

WorldCom's $37 billion purchase of MCI Communications is another case in point. WorldCom estimated that at the time of the acquisition MCI had $6 billion to $7 billion in R&D under way but not ready for commercial application, making it the largest in-process R&D charge so far. Since it is possible that WorldCom (Figure 1.10) may never see any benefits from the MCI expenditures, accounting rules allow WorldCom to write them all off at once. Apart from the accounting practice, the Main Street business owner might well wonder why WorldCom paid so much for MCI if there is even a remote possibility that almost $7 billion of acquired assets are worthless. In reality, there is little doubt that WorldCom ascribes great value to MCI's R&D efforts. As WorldCom turns MCI's R&D efforts into salable products, the profits produced will be juicier without the drag

Figure 1.11 Walt Disney Stock Price History
SOURCE: © FactSet Research Systems.

of the amortization of capitalized R&D expenditures. In this instance, expenses and revenues are clearly not properly matched. With regard to the balance sheet, the charges effectively understate the amount of capital invested in the business.[15]

Equally troubling, according to the SEC's Levitt, is the creation of large liabilities for future operating expenses to hype future earnings—all under the guise of an acquisition. Walt Disney (Figure 1.11), in its 1995 purchase of Capital Cities/ABC, wrote off certain of ABC's programming costs at the time of the acquisition, thereby relieving its income statements of three or four years' worth of additional expenses. From this point forward, the company will have to show legitimate earnings growth, not the kind that comes from accounting machinations—unless it can engineer still more deals, as many banks have done.

Pooling versus Purchase Acquisition Accounting

Now we're getting a bit technical. At the risk of missing a subtlety or two, I'll attempt to keep the discussion at the lay level. In the case of an acquisition accounted for as a pooling of interests, the acquired company is absorbed into the parent company. The historical financial statements of the parent are recast so as to portray prior years as if the two had been

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[15][2006, *Speculative Contagion*] WorldCom filed for bankruptcy in July 2002. It was charged with overstating earnings by more than $11 billion in the largest accounting fraud scandal ever.

a family for a long time. Stringent tests must be passed for pooling to be used. On the other hand, purchase accounting, as the name implies, means that the revenues, expenses, and profits of the acquiree are aggregated with the parent company's income statements from the time of acquisition. If, as is almost always the case, the acquirer pays more than the market value of the net assets of the acquired company, the premium, an asset called "purchased goodwill," must be amortized against earnings for up to 40 years.

The advantage of pooling is that whatever purchase-price premium might have been paid, it is nowhere labeled as such and therefore is not subject to amortization. By way of an analogy, think of pooling as it might apply to a marriage between NBA clotheshorse Dennis Rodman and actress/model Carmen Electra that, hypothetically of course, lasted several years before irreconcilable differences (he never put the cover back on the lipstick) brought an end to the otherwise blissful union. On the date of consummation, Dennis—speaking exclusively in financial terms—may have paid a hefty premium for the 50 percent of his (and soon-to-be-their) marital estate that he effectively surrendered to the comely lass of *Baywatch* fame, if not fortune. (Assuming Nevada's laws on marriage dissolution are typical, Carmen's equity in the marital estate could approximate a shocking 50 percent on that sad day, presuming that the brief time between "Let's get married" and "I do" left no time for a prenuptial.) It is doubtful that their balance sheets or income statements were comparable at the time of the merger of unequals. Poor(er) Dennis surely suffered instantaneous dilution unless he was hedging against a possible seasonless NBA. Because he pooled, rather than purchased, the "goodwill" arising from his impulsiveness need not be officially amortized even though, in reality, a prudent man would do so. Bankers, Dennis should know, are sometimes prudent.

Unless accounting measures can be employed to reduce or eliminate the purchase price paid above the market value of net assets in a purchase transaction (as addressed elsewhere), the premium must be amortized against future earnings. The advantage of purchase accounting is that, depending on how the transaction is financed, a steady stream of acquisitions may result in earnings growth well above that which is organic. Cendant, one of the more celebrated failures of 1998, stumbled badly in executing its strategy of growth by acquisition. For the curious, it's a cautionary tale of a company that camouflaged slow

internal growth with a flurry of acquisitions, the last of which turned a formerly *as-cendant* trajectory into an almost fatally *des-cendant* one.[16]

At MCM, we don't quibble with purchased goodwill if it's readily apparent that the premium paid is equal to or less than the value received. As far as we're concerned, companies that go to great lengths to avoid amortization charges are squandering time and money. As a matter of practice, we add back amortization charges to earnings in our valuation work if the usefulness of the goodwill acquired is unlikely to decline over time. In this supercharged acquisition environment, however, we suspect that many acquisitors with voracious appetites have grossly overpaid. Paradoxically, one aftermath of the current binge must inevitably be another wave of aforementioned restructurings, including goodwill write-downs, as a result of overpriced mergers.[17]

With regard to the matter of acquisition accounting, in our financial modeling, we attempt to ferret out economic earnings. Accordingly, we make whatever adjustments we feel are justified—regardless of which method is used to account for an acquisition—to reveal economic

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[16][2006, *Speculative Contagion*] Within a six-month period during 1998, Cendant stock plunged from $42 to about $7. In the five years since, earnings have been irregular, as the company disgorged itself of hastily conceived acquisitions and reorganized as a global provider of complementary consumer and business services. The stock traded around $22 at the end of June 2005.

[17][2006, *Speculative Contagion*] Until 2002 FASB (Rule 142) mandated amortizing goodwill generally over a 40-year life. In 2002 FASB flip-flopped and relieved companies of the obligation to systematically amortize goodwill. Instead, it now requires that goodwill be reviewed annually for possible impairment in value. If impairment has occurred, the company takes an immediate charge. For the six years prior to the accounting change in 2002, cumulative goodwill amortized for the S&P 500 totaled $3.91 per share. From 2002 to 2004, goodwill-impairment charges totaled $10.36 per share, with $6.91 charged in 2002 alone. The vast majority of these write-offs were related to acquisitions that failed to live up to merger-frenzy expectations, and their carrying value had to be slashed in a more rational environment. To be sure, the old method of amortizing the carrying value of assets that often appreciated in value—and then charging that expense against earnings—made no economic sense. Under the new rule life is different, but not necessarily better. Large one-time impairment charges permit a company to sweep under the carpet prior dissipations of shareholder capital without typically evoking much of a response from Wall Street. Why? Because of the accounting treatment, the action has a salutary effect on earnings, return on equity, etc. . . .

realities. If the analyst community would do likewise, there would be far less use of smoke and mirrors in the practice of financial reporting.

Revenue Recognition

Although we don't encounter this misdemeanor often, in part because of the practical difficulties in identifying it, the SEC has served notice to companies that try to boost earnings by accelerating the recognition of revenue. Think about a bottle of fine wine. It isn't appropriate to pull the cork until the contents are properly aged. But some companies are removing the cork early, recognizing revenues before a sale is truly complete; before the product is delivered to the customer; or when the customer still has options to terminate, void, or delay the sale.

"Stealth Compensation"

The use of stock options as a key component of executive compensation has mushroomed. According to Richard Walker, named SEC director of enforcement last April, stock options outstanding have nearly doubled since 1989, accounting for 13.2 percent of shares outstanding. The *Wall Street Journal* calls them "the steroids that bulk up executive pay . . . the currency of an optimistic and opulent age." From 1992 to 1997, the value of option grants to CEOs and other executives of about 2,000 companies surveyed by Sanford C. Bernstein & Company quintupled to $45.6 billion from $8.9 billion. Also, according to the *Journal*, options-driven CEO compensation has climbed to 200 times the level of the average worker—a fivefold increase from the 1970s. That striking if not unsettling divergence draws little artillery fire during good times, yet the capitalist ideology itself could become the prime target if the cataclysm of serious recession sets in.

With more and more of an executive's pay linked to the upward movement of a company's stock price—in which historically he or she had little cause for direct interest—it's no longer uncommon to see a modern executive preoccupied with financially managing the business for the chief purpose of maximizing the stock price. Such practices may or may not be consistent with the goal of increasing intrinsic value. During a recent analyst conference on another hot topic, fair-value accounting, several participants expressed concern about any changes

Figure 1.12 Microsoft Stock Price History
SOURCE: © FactSet Research Systems.

that would increase earnings volatility. One analyst summed up the sad state of affairs when he said, "Any [managers] not concerned with smoothing earnings [are] not doing their job. You need to manage Wall Street—without being deceptive—while hiding information that could be used . . . by competitors."

For financial-reporting purposes, option grants are free money, because in their accounting treatment they are doubly blessed: Options granted do not appear as an expense on corporate income statements, yet they are deductible when exercised as a cost for the purpose of tax reporting.

Microsoft (Figure 1.12) has issued options equal to almost 45 percent of its shares outstanding. Shareholders, including Bill Gates, who before dilution owns approximately 20 percent of the company, will suffer massive dilution unless the stock falls to a fraction of its current price. If the company were to consider repurchasing the shares necessary to fund its options program, they would cost $49 billion at today's market price. Microsoft has $14 billion in cash. Cash flow for 1998 is estimated to be $9 billion. Under that hypothetical scenario, the total of outstanding shares would remain unchanged, but cash on hand and future cash flow would be depleted for years to come. Regardless of its name, options are synonymous with dilution.

In 1993, when FASB attempted to rule that the burgeoning use (and concealed cost) of options should be divulged on corporate income statements, the agency ran headlong into the lobbying steamroller driven by the Big Six auditing firms and much of corporate America. Dennis

Beresford, now a professor at the University of Georgia, served as chairman of FASB when the endeavor was flattened. "The argument was: Reduced earnings would translate to reduced stock prices," recalls the then-embattled professor. "People said to me, 'If we have to record a reduction in income by 40 percent, our stock will go down by 40 percent, our options would be worthless, we won't be able to keep employees. It would destroy all American business and Western civilization.'" *Forbes* magazine cynically concluded: "The bull market is more important than accurate financial reporting." Nobody, as noted previously, wants to be caught holding a hatpin should the bubble burst.

Beyond the absurdity of allowing options compensation to escape being treated like any other corporate expense and the possible backlash from eventual exposure of "stealth compensation" (that skews overall compensation in favor of the executive suite at the expense of the factory floor), we have other misgivings about the use of options. A widely cited argument for their use is that they cause managers to think like owners. As owners of the publicly traded shares of businesses, we find it difficult to understand exactly what it is that option holders have in common with us. When we make an investment, our first act is to write a large check. If the stock price subsequently falls—for any of a host of reasons—and we fess up to our mistake and sell, our loss is painfully tangible, and it represents far more than just the loss of an opportunity that the option holder endures. Ever-resourceful "optioneers" have found a remedy for the one downside of options—the opportunity that's lost when the share price heads south. It's increasingly fashionable to restrike options at lower prices should the stock go begging. Who said there wasn't opportunity in adversity?!

As for granting options to the rank and file, sometimes for the purpose of blunting internal criticism of megagrants on Executive Row, the practice is as widespread as it is unproductive in achieving its desired goals. According to a proxy-statement analysis by William M. Mercer, Inc., 35 percent of the 350 major companies tracked by the firm have stock-options programs for all or a majority of their workers. Another source advises that 50 percent of mid-level professionals at major companies receive options. Far from promoting an owner's frame of mind or even inspiring loyalty to the company, the vast majority of recipients treat this form of corporate beneficence as nothing more than a windfall. The Lotto mentality moves up and down the corporate ladder with

Figure 1.13 Citigroup Stock Price History
SOURCE: © FactSet Research Systems.

surprising ease. When Citicorp (Figure 1.13) Chairman John Reed was asked how he reacted when Traveler's Chairman Sanford Weill first proposed the colossal merger of their huge financial-services firms, he replied: "My instinct was to say, 'Why not?'" In the wake of the surprise announcement, both companies' stock prices surged, as in lockstep did stock-option paper profits for both Reed and Weill, whose one-day windfall was a cool $67 million and $248 million, respectively. Based on what has transpired subsequently, and presuming that Reed was not distracted by visions of sugarplums dancing in his head, "Why?" might have been a more reasoned and less instinctive retort. Boys will be boys, differentiated only by the size of their toys. Our other objections will be saved for another year.

Once again, we acknowledge that option programs have become nearly universal, particularly with technology companies. A company in Silicon Valley, for example, that stands on principle may find it practically impossible to recruit effectively.

In the meantime, rest assured that we comb the footnotes of 10-Ks and proxy statements of every company that we research to unearth stock-option or other abuses that may be tucked away there. Recognizing that stock options in this day and age are nigh unto ubiquitous (yes, rhymes with iniquitous), we don't object to companies that use options sparingly—and, in particular, to companies led by a dominant shareholder who doesn't personally participate in the options program. If the presumably knowledgeable insider is willing to suffer with us the cost of dilution at parity, we see no reason to take issue. As shareholders, we

find repricing proposals to be an even more outrageous example, fancy explanations notwithstanding, of options simply serving as off-income statement compensation. Apparently, FASB has reached the same conclusion. Early in 1998 it decided that companies repricing options should expense the difference between the lower-share price and subsequent increases. In the end our concerns may be of little consequence. If market participants of the future are like market participants of the past, and if the pendulum is freed again to swing, the next pervasive bear market will close the gap between effort and reward. Options, like stock prices, will fall—out of favor.

Stock Buybacks

Stock buybacks might well be more appropriately reviewed under a different banner. Many, if not most, programs evince a prudent use of shareholder cash. Boards that authorize share-repurchase initiatives at market prices below what the businesses are intrinsically worth per share (without forgoing investment in even more compelling growth opportunities and with due regard for the financial security of remaining shareholders) are clearly putting the shareholders' interests high on their priority list. While trying not to cast unnecessary aspersions on the purity of motives, we nonetheless find a curious circularity to the reasoning behind the calculation of the worth of the business. If the higher-earnings-per-share growth rate that results from the share buyback program in turn causes the board's determination of the worth of the business to be ratcheted up accordingly, where does one get off the merry-go-round?

Furthermore, and of no pressing concern, it also has occurred to us that share-repurchase programs are subject to finite limits. There is conceivably no ceiling on company growth, but a company can retire no more shares than are outstanding. If there are enough shareholders who don't comprehend the value of the business and are willing therefore to part with stock at prices well below intrinsic worth, someday there will be but one shareholder group remaining. That's what we call an MBO (management buyout)—on the installment plan.

Depending on how they're financed, stock buybacks have the effect of increasing earnings per share. If the numerator (after-tax earnings adjusted downward to account for additional interest expense when

money is borrowed to finance the purchase) falls less than the denominator (reduced by virtue of the shares acquired and retired), earnings per share will rise. In a catch-22 scenario, once a stock-repurchase program is instituted, discontinuing it becomes problematic. If the stock price surges in part because of the presumed higher rate of earnings growth, terminating the buyback plan will remove the growth catalyst that financial engineering provided, and the share price will likely register Wall Street's displeasure. Letting the air out of stock prices, as noted elsewhere, is anathema in modern-day boardrooms. To the extent that this section addresses techniques by which executives can "manage" earnings, share repurchases must be included. Such programs—many of which we applaud, and a few of which we think are blatant, flagrant, and systematic squanderings of shareholder assets—are nothing more than another arrow in the financial-engineering quiver. Their only income-statement appearances are through an increase in interest expense or a decrease in interest income, relating to the means by which they are financed—and a reduction in the denominator in the earnings-per-share calculation. They have no effect on operating profits.

As is often the case, the tax code ostensibly forces the corporate hand. It is reasoned that because dividends to individuals are taxable as income at rates approaching 40 percent, whereas gains on long-term capital transactions (including occasions when individual shareholders sell back to the issuing company) are subject to a maximum 20 percent tax, the latter distribution option is more tax-efficient.[18] The logic is not in all instances bulletproof. For starters, shareholders selling to other investors rather than directly to the company also avail themselves of the favorable tax rates on long-term capital transactions. The tax differential is admittedly of particular appeal to a taxable shareholder who sells enough stock each year to equate to a cash dividend, had one been paid. In effect, he or she creates a synthetic dividend that is taxed at no more than the 20 percent rate. Tax-exempt shareholders, including 401(k), pension, and other deferred-compensation plans, at least from a tax perspective, are obviously indifferent to the form of distribution, whether through dividends or share repurchases.

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[18][2006, *Speculative Contagion*] The tax on dividends for most shareholders was reduced to 15 percent as of May 5, 2003.

Finally, little is said about how a company's board of directors views its relationship with passive shareholders. In most instances, it is probably appropriate for the board to think of a shareholder's investment in the company as but one among many similar holdings that make up the shareholder's total portfolio. Such an attitude regarding any obligation that the board might feel toward its constituent shareholders is consistent with the doctrine that holds, "If you don't like what we're doing, you can always sell your stock." This almost universal and impersonal "portfolio of companies" paradigm runs counter to the "partnership" construct that Warren Buffett speaks of in his letters to Berkshire Hathaway shareholders. To be sure, Buffett's ownership structure is as refreshing as it is atypical. His 42 percent stake in Berkshire represents virtually all of his $30 billion net worth.[19] Likewise, for a considerable percentage of the company's outside shareholders, Berkshire also represents a large part of their wealth. Their Berkshire holding is not unlike a beloved lake cottage that becomes a family heirloom. It isn't surprising then that Buffett takes great pride in the low rate of turnover of Berkshire shares. If turnover were to increase appreciably, it might suggest that the lake is going dry.

Conclusion

The increased reliance of companies on accounting practices that are implemented to give the impression of often unwarranted growth, profitability, and stability is a sign of the times. For us, such hocus-pocus (with a bogus focus) simply mandates more thorough "due diligence." We spend extra time these days with financial-statement footnotes, proxy statements, and other disclosure documents. As noted above, when we attempt to determine the true earnings of a company, we often must recast financial statements to more fully reflect economic reality.

[19][2006, *Speculative Contagion*] Buffett's investment in Berkshire had appreciated to almost $42 billion as of June 30, 2005.