

The Worry Free Wealth Guide To Stock Market Investing

How to Prosper in the Wall Street Jungle!

[UNDERGROUND EDITION]

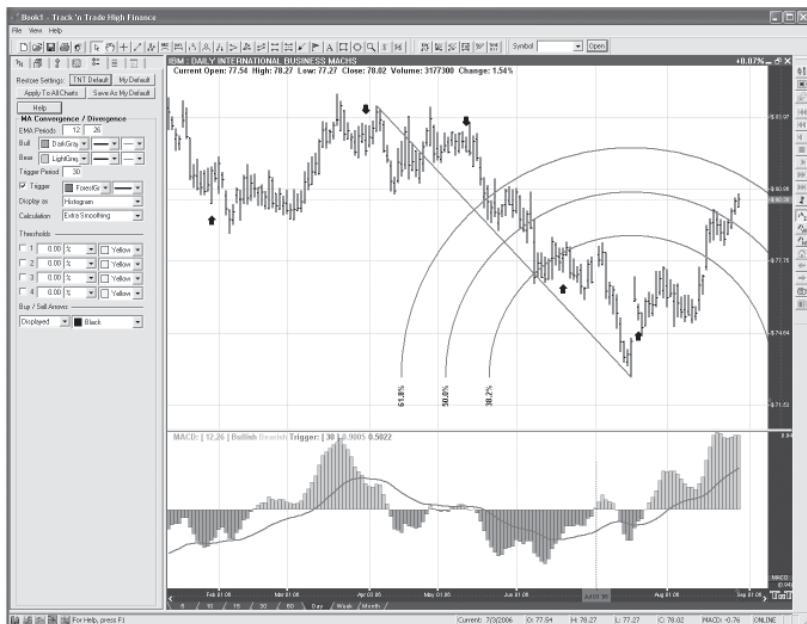
By Dr. Scott Brown, Ph.D.

"The Wallet Doctor"

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More Buzz about the Wallet Doctor...

“I was always terrified of the stock market because I had heard so many horror stories. I am a real estate broker in our community and I have always invested in what I know — real estate. When my husband, Rudy, started investing, I was concerned and asked him to not risk too much. He restricted his stock investing to \$900, so I forgot about it because I knew he was only playing with a few hundred dollars. I knew he needed a distraction, because many of our tenants just drive him absolutely crazy with stupid things they can fix for themselves (like leaky toilet valves) let alone the hassle of coercing them to pay their rent on time. About a year and a half later, he showed me our trading statements — he had also opened a Roth IRA for me, which he learned to do from Dr. Brown. I couldn’t believe what I saw. He had taken an investment of \$900 and increased it to over \$50,000! I decided that maybe there really was something to Dr. Brown’s approach to stock investing and decided to study the Bulletproof Stock Investing Home Study Course he had purchased from Dr. Brown. As I studied the course manual — which is incredibly easy to read and understand — I realized that I had been blind to the enormous opportunities in the stock market. I wish I had known what the Wallet Doctor has taught us back in the ‘80s when the time was ripe — like it is again today — to have entered the market. We are older, but at least I know our grandchildren will prosper from the Wallet Doctor’s investment secrets that are surprisingly common sense — that Dr. Brown teaches. He sure has made us both believers in the unlimited possibilities of intelligent, common sense, and through bulletproof stock investing!”

- Barbara Gallion, Fall River Mills, CA

“I first met Scott when he was a futures trader. He is an out-of-the-box thinker who wants everyone to succeed. One day Dr. Brown was complaining that there was no central place for grain futures information. He also reminded me that I am a world authority on the grains because of my work in the industry and my former positions as both a local and floor broker on the floor of the Chicago Board of Trade (CBOT) in the grain pits. He asked me to do something about the problem and really got me thinking. Because of his encouragement, I am now the creator and publisher of the leading worldwide information source on grain futures — the Grain Traders Almanac — and I help thousands of people become competent grain futures traders every year. The Wallet Doctor always helps me whenever I am in a bind, and he will also help you achieve your full potential in your finances.”

- Scott Barrie (www.grainguide.com — Free Trial), Portland, OR

“I am the personal assistant to the highly sought, behind-the-scenes marketing expert of top people in the information marketing industry — Stefanie Hartman. I make things happen behind the scenes for Miss Hartman’s clients and can really tell who is who. The key characteristic that I have observed about Dr. Scott Brown, Ph.D. — our Wallet Doctor — is rock solid reliability. Whenever we have a conference call or meeting of any kind, Scott is the one person I can count on to be punctual, laser focused, on topic, and always upbeat and cheerful!”

- Tania Van Druuten, Victoria, BC (www.StefanieHartman.com)

“Unless you are one of the modern day CEO-robber-barons Dr. Brown describes, a banker, a corrupt politician (most of them) or a Federal judge, the Wallet Doctor’s book is for you — the unprotected individual investor!!! Here in Europe, we have something called “uni-

versal banking”, which means that you go to your banker for loans, deposits, insurance, and stock brokering — really these are just more ways to get ripped off. I wish I had read his book, *The Wallet Doctor’s Survival Guide to the Stock Market*, before I lost my money in the stock market due to my European universal banker’s horribly misguided advice. Scott is one of those people that “you wish you would have met” a long time ago. Scott and I met because of my company, a publishing company that represents American authors in Europe, so I had the opportunity to pre-edit his book. As I read through the material, I was amazed at how he makes it easy for me to understand things about the market that every person should know before they make a decision to invest in stocks. Armed with this information, I am prepared to go back and do it right this time — amen, Scott!!”

- **Don-Alan Rekow** (www.nopowerinchaos.com), **Northern Spain,**
Author of

There is No Power in Chaos,
How to be Empowered and Eliminate Chaos from Your Life

“I have a master’s degree, and that was hard enough. A Doctorate is even more so. Dr. Brown has struggled through and beat adversity in his own finances and trading. He has put a lot of time into his Bulletproof Stock Investing course. Finally, he makes himself open and available to all of us through e-mail, telephone, and open calls. He draws people who are more inclined to be serious and have more money to invest, but he also works with people who are just starting out because that is how he began.”

- **Bruce H., Cincinnati, NY**

“The first thing I noticed about Scott, after registering for his course, is how frankly personal he really is. When I call his office and he is available, I get his full attention and I have become his friend. He really works hard to teach us what he knows. Through his teach-

ings, I have learned how to filter media information and how to identify the solid companies that are poised for big rises when the market heats up again — and I have learned from Scott that it most certainly will! If you really want to understand the stock market and position yourself for the kind of gains people experienced when they bought companies like Microsoft in the ‘80s, then Scott is the person to guide you.”

Joseph F., Forestville, NY

“Dr. Brown has the only system that works! He has created a stock investing system based on the high finance of the fact that what is really low today is usually really high a few years from today, and vice versa. The only ingredient you have to add is a little patience. It will be obvious to you that this works as long as you can keep patient and hang in through the shakeouts as Dr. Brown teaches. It’s simple. He makes it simple enough to where, in two or three days, you may not be an absolute expert in stock investing, but you will be long way down the road and will know what you need to know to make money in the stock market. It’s simple and it works, you just to have the patience to wait it out...no wave theory, stochastics, MACD or any of that complicated nonsense that just doesn’t work. It doesn’t take a genius to make this system work, and you don’t have to go through months of hard study to find out it doesn’t work. I’ve spent thousands of dollars on courses before, and none of them worked. This is something where, after a couple or three days, you can have an idea of what happens and what you gotta do to make it all work. These salesmen out there know more about marketing than they do about stock investing, and they just wanted into my wallet. Dr. Brown is the real deal and he gives you so much understanding that it just boggles your mind and doesn’t leave you confused like other courses do. This is a basic course for the stock market (Bulletproof Stock Investing) and not only will you know how to read a chart

when you finish reading his course, but you will also learn how to make a fortune – as long as you can wait the three to 10 years it takes for your positions in the stock market to take off!”

- Rudy Gallion, Fall River Mills, CA

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How to Prosper in the Wall Street Jungle!

Dr. Scott Brown, Ph.D.

The Delano Max Wealth Institute (DMWI), LLC.
Reno, Nevada

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To Marisol and Spinky, Barb and Rudy, Delano, Todd and Shandy,
Carly, Zack, Nacha and Brandon, Ernesto, Lydia, and Uco!

WELCOME!

FROM THE WALLET DOCTOR ADVISORY BOARD

I have gathered a coalition of experts who offer you a safe place to get vital information on your wealth building path. The concept of the Wallet Doctor Advisory Board grew from an awareness that there was no place to go and just listen to experts about what is really important — without getting bombarded by marketing pitches. There are so many self-proclaimed experts running around these days that it is very difficult to judge which is the best to learn from. The safe environment of the Wallet Doctor Advisory Board allows you to listen to audio interviews I have done with experts in various areas that directly impact your financial well being. These interviews are available as free gifts to you once you register on my website at www.bonanzabase.com/FreeGifts.htm.

As soon as you register online you will receive an e-mail from me explaining how you can access the audio files. As an additional bonus you will be automatically subscribed to the Wallet Doctor e-zine for free. These free gifts help you start off on the right foot. They have a retail value in excess of \$1,000, and I sure wish I could have listened to them when I started!

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Dr. Van K. Tharp, Ph.D.	Investing Psychology
Lan Turner	Technical Analysis

ACKNOWLEDGEMENTS

This book was not created in a vacuum. It took not only many years of work but also many years of questioning how the stock market actually works. I had to develop great fortitude to constantly go against the grain of public, professional, and academic “conventional reason” to come to the conclusions I lay out to you in this book.

The principal person in my family that was crazy enough to also truly want to understand the markets (even if it was totally against what the public is presented by the popular press) is my stepfather Rudy Gallion. We both shared a childlike disbelief of what Wall Street wanted us to believe regarding the “right” way to become wealthy as a stock investor.

In the beginning stages of my mental development as an investor I was gradually gathering information, analyzing, and forming conclusions. Everything was a seemingly chaotic mass of conjectures. The conjectures finally grew into conclusions and a systematic approach to stock investing I call base invading. In those days with no investments in the market and just a lot of suppositions Rudy was the only person I could turn to for meaningful conversations to bounce concepts off of. I had to be particularly careful during my doctoral studies because so much of what I teach today I had not yet grounded in agency theory. For this reason I kept my ideas concerning the stock market to myself during my work as a doctoral student in finance.

Another friendship critical to the creation of this book is with Professor Tim Koch, Ph.D. Tim is a prestigious professor of banking finance tenured at the University of South Carolina and is many years my senior in the field of finance. He became the chair of my

dissertation committee. At times I used to wait while he balanced his stock positions before we could discuss my research in market microstructure. The curiosity this raised gradually developed into informal conversations as I cautiously queried his beliefs about the markets. To my delight I found that he shared a healthy skepticism of many of the conventional academic theories regarding the stock market. These theories are hotly debated in doctoral finance seminars yet are simultaneously taught to university finance students who are simply expected to memorize and regurgitate without question. In particular Tim, despite a far greater breadth and depth of knowledge in conventional finance than I, does not subscribe to the notion of market efficiency. His friendship and moral support encouraged me to forge on in my endeavor to determine what really makes the stock market tick as I explain to you in this book.

During that period I was assigned to work with Professor Eric Powers, Ph.D. who had just completed his doctorate in finance at the Sloan School of Business of the Massachusetts Institute of Technology. Eric had just been recruited to the faculty of the University of South Carolina's School of Business because of his research in corporate finance. Eric taught me the nuances of empirical research. In particular he imparted in my mind a healthy skepticism of contemporary financial research arising from conventional data sets which are hand input by unskilled minimum wage data entry workers. Eric's background as a naval officer and computer programmer before his entrance to MIT give him both a wry wit and steady, calm approach to everything he does making him a great mentor for anyone lucky enough to work with him.

There were others who had an impact on this book. Professor Glen Harrison, Ph.D. taught me to never accept the results of economic and financial theories as ever being conclusively proven. He also encouraged me to be unique in my questioning as a researcher and to build my own data set. His transfer to the University of Central Florida was a major loss to the school of business at the University of South Carolina. Professor Scott Harrington, Ph.D.

taught me to assess each side of an academic financial argument unemotionally - seriously considering each side before tentatively concluding. Professors Gregory R. Niehaus, Ph.D. and Helen Doerpinghaus, Ph.D. encouraged me to take the complex theories that are impenetrable to the public and to break them down into a user friendly format for those who wish to learn to invest. Helen and Greg both showed me by example the enormous returns of teaching to students with warmth, understanding, and compassion such a difficult subject as finance. Drs. Dave Shrider, Ph.D., Vladimir Ivanov, Ph.D., Vladimir Zrodtsov, Ph.D., and Rajarishi Nahata, Ph.D. all provided a rich friendly environment of open discussion only fellow doctoral students can provide in the trench. Three women at the University of South Carolina supplied friendly assistance throughout my doctoral work; Barbara Covington, Pat Zimmer, and Dr. Ellen Moore, Ph.D. At the University of Puerto Rico at Rio Piedras I have also long enjoyed the support and friendship of Professors Eusebio Diaz Diaz, Ph.D., Arleen Hernandez, Ph.D., Paul LaTortue, Ph.D., Myra Perez, Ph.D., Carmen Espina, Ph.D., Alba Maldonado, and Luis Rivera Batiz, Ph.D.

Despite my deep understanding of the intricate details of the capital markets, I had no idea how to let you know I am here to teach you what you really need to know before you put your savings at risk. I know how much you desperately want to learn to invest correctly, because I felt the same way many years ago and had no one to turn to.

I knew I needed just the right marketing mentor when I decided to create an investing course and seminar business. I followed my inner guide and found Stefanie Hartman (www.StefanieHartman.com), a marketing genius who, in my opinion, is absolutely the best relationship marketing consultant alive today in the English-speaking world.

Stefanie taught me what is really required to create an information business based on my expertise in investing that can really help others. This has turned out to be a lot more work than I initially thought but the satisfaction of helping so many people learn to self direct their own money is well worth it. If you have special

knowledge that will help other people, I strongly recommend contacting her first to get off to the right start. Through her expert guidance, I have learned how to inject into my courses and seminars the friendly family-like environments I use in my university classes. My Bulletproof stock investing community is one place where you never need to be afraid of asking questions, and you will learn to invest correctly from the start.

Key in creating this book was Donna Caudill who is a professional editor in the English language. She has years of experience editing for magazines and offers her services freelance. I employ her repeatedly because I know I can count on her for a high standard of professional quality. Donna can be reached at writinguru@verizon.net. Donna's husband Tim Caudill, CPA is a corporate auditing accountant who gave a very favorable review of this book as well as useful comments. This is a substantial blessing from the community involved in creating fundamental financial statements you will learn of in this book.

The cover design and page layout is by Nisa Helen Berzeg of Wildfire, Inc. I hired Nisa because she is truly an artist. Many graphic artists today are so only by diploma. I find that many lack actual drawing, painting, other base skills all artists should have. Nisa's graphic design work displays the brilliant creativity of a true artist. She can be reached at www.Wildfire-Inc.com

I have also learned much about what is really important in investing through my long friendship with Dr. Van K. Tharp, Ph.D. (www.IITM.com), who is the world authority on applied behavioral finance. Van is teaching what is really important that supposed financial gurus just seem to fail to understand - the importance, in investing, of developing yourself into a fully self directed independent thinker in your own unique way. He also teaches you the prudence of how to seek out low-risk, yet potentially high-yielding, investment opportunities in the stock market as you rationally decide how much you can risk at any time. I fully and ardently agree with Van on these points, and you will see this reflected in my teachings as you prog-

ress. Dr. Tharp's Peak Performance course is a must-study in your progress as an investor.

Also, my dear friend Scott Barrie (www.GrainGuide.com) believed in my ideas enough to push through the industry to acquire the data I needed for my research in commodity futures. Scott is the only person teaching futures trading that combines both integrity and extensive experience in the industry. He combines years of actual work as a floor broker and local on both the Chicago Board of Trade and the Chicago Mercantile Exchange with a crisp and offbeat humor that can only come from his youth in the futures pits. If you are interested in futures trading then his "Grain Trader's Almanac" is a must have and his live seminars are a must for you to attend.

Lan Turner (www.GeckoSoftware.com) has shown me the nuts and bolts of how to produce and deliver courses that make meaningful changes in your life. I had the knowledge, but it was Lan who showed me how to package and deliver it. Lan is the most knowledgeable person alive today concerning all aspects of technical analysis. His software is the very best there is in the area of technical analysis of the stock market. You will learn more about Lan in the chapter on technical analysis and his software is the foundational learning platform to practice everything I teach. With his software you will be able to shave decades off of your learning curve.

Dr. Scott Brown, Ph.D.

San Juan, Puerto Rico, 2006

Foreword

**by Stefanie Hartman,
International Speaker, Trainer & Marketing Strategist**

Pulling up to a lavish office, writing a check, and handing it to a broker — this has pretty much been the extent of my stock investment experience. Oh, I forgot to mention all the silent wondering, hoping and praying that I am making the right choice as I hesitantly release my grip on the check and hand it over with blind faith to the grey-suited broker that I hardly know.

So, of course, when Dr. Scott Brown (also known as “the Wallet Doctor”) — a man with extensive financial knowledge and training, who has studied finance for years and has earned one of the rarest PhD’s in the social sciences from an AACSB-accredited state-side research university, a man who reviews the finance curriculum and is responsible for the structuring of the course content for the finance department and MBA program of the leading university in the Caribbean, a man who is on the cutting edge of doctoral research in finance — called upon me to write a foreword in his book, instead of the army of financial wizards and professional stock investors that were banging down his door hoping for the opportunity to be included in his book, my ego may have been the only one who thought...yes, that makes sense.

You may be thinking, “Why would he make such an unusual choice?” Well, you have to know Dr. Brown, the man, for that answer. You see, I suspect there is a method to his madness. From the first day I met Scott, I knew there was something very unique about him. He is a fiercely intense person who strives for excellence,

which is great for you as a reader and beginning investor, as he will go above and beyond what is expected to ensure you have the precise and absolute information you need to handle any present or future investment strategy.

The Wallet Doctor is known for being very blunt and candid with his information and comments but, like him or not, people have to admit he is one of those guys who is always right. After all, true experts are rare and they have earned the right to have strong opinions! Everything he teaches is backed by experience and intensive research and really, there's no one else you should want to have on your financial team than someone who is deeply committed to telling you only what will work for you rather than what you would like to hear.

The bottom line is that Dr. Brown is not one to be bullied by what people think he “should do” (like, for example, ask a financial expert to write his foreword). Dr. Brown does what he feels is right. He feels it is right to teach people how things really work in this industry and not be bullied by what professional investment clubs or gurus do and do not want the general public to know. He believes it is right to remove the knowledge barriers between the financial haves and have-nots. Dr. Brown remarked that, as I am often referred to as the “behind-the-scenes” marketing expert to many gurus, I strive to do something similar by leveling the playing field between budding entrepreneurs and successful multi-millionaires. Helping people get ahead is a passion we both share and why he asked me to write this foreword.

Also, as someone who trains experts and entrepreneurs to become known in their field and create million-dollar businesses, I know how important it is in this global consumer democracy to stand out based on your merits, knowledge, value and heart.

I can tell you that not only does Dr. Brown have the heart, but he is not just some guy who invested a little and then decided to throw up a guru shingle and write a book. He is offering something very different to the market in that he is teaching the public what most do not have access to because they simply didn't go to college and study finance. He has extensive practical experience as a highly profitable

investor — not a common trait found in many academics.

Dr. Brown's investing advice is not only supported by "high-finance" research but also is based on years of hands on investing of his own money. He is one of those rare experts who understands the financial markets so well that he can literally read a long term stock chart in the blink of an eye — just like those experts described in Malcolm Gladwell's bestselling book "Blink".

This book is no ordinary book. It can be a detailed instructional manual for the advanced investor, and for the millions of us out there who are just starting out, it provides a wealth of information and takes the mystery out of the industry.

His book delivers shortcuts with his "Tips & Traps" summaries that "cut the bull" and break down anything remotely complicated into easy to read sign posts.

You will discover the "how-to" in creating financial abundance with meagre beginnings. One story you are going to love is about the father who now has a \$1.6 million stock portfolio at the age of 78, who never earned anything greater than an average paycheck-to-paycheck salary — he just followed the advice of the Wallet Doctor while raising three sons!

You will gain vast amounts of financial knowledge while being entertained by the fascinating stories of real people in history. You'll meet colourful characters like the infamous Hetty Green, whose nickname was "the Witch of Wall Street", a woman who was first swindled out of her inheritance by a male dominated court system and then retaliated by becoming the world's richest woman, amassing wealth of over \$100,000,000. She did it all at a time when Wall Street was full of crooks and was totally unregulated. You will laugh and be stunned when you find out her "secret technique" for figuring out which stocks to buy, an attitude that could be adopted today.

If you have ever felt even a minor twinge of intimidation when it comes to investing, or you think "bulls" and "bears" are just animals, then this book is for you. Every single investment strategy and every important term used today is explained in simple language that any

novice can master. Dr. Brown breaks down which strategies actually work and which ones don't, as well as the all important WHY — so that you can carry this knowledge with you. Your own personal finance degree will grow with each new chapter you begin. It is fascinating to learn why Wall Street wants you to buy particular stocks at particular times and how the “insiders” actually make boat loads of money while you, the little guy, lose.

Most stockbrokers value their large accounts, so if you are an average investor, you often get shuffled off to a trainee or an assistant who really doesn't have the personal interest or experience to ensure that your investment succeeds. It is Dr. Brown's dream that anyone at any age and of any race can stand shoulder-to-shoulder with the very best in the investment field and feel total empowerment. What is exciting is that in this book, he obliterates all the fancy financial terms that professionals throw at you whenever you ask them hard questions like “Why did that last stock you suggested I invest in tank?” After all, why should you, the average investor, ask the professional silly questions about your money that you entrusted to him?

By the end of this book, there's no question that you will have equal if not greater knowledge than any slick grey-suited broker you may come across. In your hands right now, with this book, you are holding the power to really create the financial security and future you deserve.

Congratulations for picking up this book. After all, it is a fact that no one will ever care more about how well your investments do than you. Nor will anyone else get half as excited as YOU to receive large checks in the mail and see your new knowledge securing your own future. Well, okay, maybe Dr. Brown. You will soon figure out that he cares about your money and success as if it were his very own. He is determined to see you do well.

With the *The Worry Free Wealth Guide To Stock Market Investing*, you will not only survive in the Wall Street Jungle, you will THRIVE – and you will have a ton of fun doing it!

I don't know about you, but the next time a broker walks into

my office wanting me to invest with them, they had better watch out. There's a new tiger in the jungle — and that's me, and now you!

Enjoy!

~ Stefanie

Considered one of America's most influential entrepreneurial mentors to help you get clients, skyrocket sales, and become famous in your niche or field, Stefanie Hartman, is known as "The Expert's Expert". CEO of Centaur Strategies, she founded the entrepreneur's "Millionaires-in-Training Mentorship Program" that literally teaches you how to re-invent yourself, become a published expert and create a six- to seven-figure annual income from selling information you already have! Learn the "behind-the-scenes" marketing, business & profit secrets from the marketing expert to the gurus.

www.mitprogram.com

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Introduction

Wall Street is only seven blocks long, but is possibly the most important street on Earth. It has fueled some of the greatest economic expansions ever known and it has plunged millions into poverty and ruin. It is home to the oldest, largest and most respected stock exchange in America, the New York Stock Exchange. It is also home of some of the largest financial institutions led by the most cunning and ruthless money mongers in the world. This book is designed to educate you to give you a good shot at surviving the complex and confusing maze that Wall Street uses to extract a profit from the unsuspecting public.

Generations before us have fallen prey to the financial predators of Wall Street. I just finished watching the movie *Cinderella Man* where Russell Crowe portrays the true story of world champion boxer Jim Braddock. What I found fascinating was that both Braddock and his manager, Gould (not to be confused with Jay Gould, the notorious stock manipulator), invested all of their money in the stock market at the end of the 1920s just before the crash that precipitated the Great Depression. They, like many people who were attracted to the stock market at the wrong time, ended up broke. Braddock lost all of his money, a substantial sum, made as a champion boxer in the Roaring Twenties, and ended up living in bread lines and on the dole.

Both these men knew that the promoters behind the fights made all of the money in the boxing industry with the least risk financially and physically. Like most Americans, they lost in the stock market because they lacked the inside connections to the forces behind the scenes, or simply lacked the experience to know when to buy low and when to sell high with the insiders

and manipulators.¹ Neither of them stopped to think that perhaps there exists an industry of promotion driving the stock market that is not only based on hype, but also serves the agenda of powerful individuals in corporate America, the federal government and the equity capital industry also known as the stock market.

These two men who knew so much about boxing knew *nothing* about the stock market. Ironically, while these men suffered financially, a few individuals who were either experienced investors or “inside” and hence, “in the know”, sold out at the top after having bought low years earlier — then lived lives of luxury during the Depression. You don’t hear much about these successful investors, because they didn’t say much, and they certainly did not care to teach the public what they knew.

Times are no different today than when Braddock was struggling to raise a family. We have just witnessed an equities industry caught in scandals of inside trading, false corporate accounting records, and inside executives dumping their option-vested stock on an unsuspecting public as an insider-controlled network of stock brokerages, brokers, mutual funds and the media hyped up the “bull market of the century.” These are just a few of the savage beasts in the stock market jungle that will eat you alive financially if you don’t educate yourself and become savvy.

The recent stock market bust from 2000 to 2003 was just as severe as the crash from 1929 to 1932, except that this time the banking system did not collapse as well; people left their money in the banks and consumerism continued unabated. The settling out of the old crash was just the right time to buy back into the market.

Hopefully, this is the first book you read about the stock market. If so, you have not acquired the baggage of believing the misleading theories of the ivory tower of finance, nor the outright lies from

¹ An **insider** is a shareholder who owns more than 5% of a publicly traded corporation, or an officer or director of the company. I further class them as **visible insiders** if they have to report their trading to the SEC and **invisible insiders** who are manipulators that buy individually under the reporting requirements without reporting to the SEC yet control a large enough percentage of the float as a group to manipulate the price of the stock over a period of years.

Wall Street. This book teaches you the basics of what the stock market is, what drives it, and will separate myth from fact. The knowledge you will discover in this book is based on my many years of actual investing in the stock market, many years of doctoral-level research, and many years of searching for the answer to my personal question: who really runs things from behind the scenes. The basic information and general wisdom in this book is based on the hundreds of books and articles I have read on the subject; some so obscure that you would probably never know about them if it weren't for me teaching you. This book is the foundation of your stock investing education, and hopefully the first book you read on the subject. Don't ever forget that the stock market is stochastic a word that means unpredictable so if you want a guarantee, buy a toaster!

One last comment: a friend of mine, in reviewing my home study course, told me that I occasionally write very negative things about the stock market and that positive, happy writing and marketing is what really sells. Yet, my friend agreed with the dark portrayal of the forces behind the scenes of the stock market. I thought about this for awhile and decided that if I paint you a "fairytale" picture of these potentially treacherous markets, then that would be unfair to you. You have to know who out there on Wall Street wants to legally rob you of your money or you will never succeed as a stock investor. I am no slick salesman; I am a doctor of finance, a researcher and a seasoned veteran of these markets. Let's get started on this wicked tour of the

Throughout the book, you will see little icons such as:



TIPS: to help you make money!



TRAPS: that Wall Street uses to ensnare you!

FACT

FACTS: that are fun to know!



HUMOR: to carry you through!

equity markets that really can potentially make you rich! I am your guide – painfully frank, brutally honest and lacking in eloquence, but I *am* your friend in the trenches. I *am* on your side, not theirs, and the information in this book is what you really need to start investing in the stock market.

Here is what Tom Akin, M.I.M., a close friend of mine who is a financial wizard in New York, wants you to clearly understand:

“When I was invited to write about this book by my good friend Dr. Brown, at first I was hesitant to accept. I asked myself, “Who needs another book on stock market investing?” Almost immediately, I knew the answer: the general investing public.

Far from demystifying the ways of the markets, in recent years Wall Street has managed to complicate further the investing process for the average person. For example, as of this writing there are more than 9,000 different mutual funds available to the public — not to mention nearly as many hedge funds. Add to this a bunch of well-intentioned yet disorganized retirement savings legislation brought on by a failing Social Security system, and you have a recipe for disaster. Simply put: it is up to you as an individual to figure out how best to invest your money. If you do not know how or are too lazy to learn, you are in big trouble.

This is where Dr. Brown’s direct, yet eye-opening, view on the workings of the markets comes into play. Finally, I said to myself, here is a book which pulls no punches in describing the conflicts of interest, the existence of insider trading, and the many other traps and pitfalls

which await the unsuspecting investor entering the concrete jungle of Wall Street. At the same time, Dr. Brown explains the nuts and bolts of investing in a plain speaking, no-nonsense way.

You would do well to heed the advice within these pages by adopting the savings and investment techniques Dr. Brown recommends. Undoubtedly you will be the richer for it, both spiritually and financially. Read on and prosper!”

Chapter 1

A Brief History of Stock Investing

Frances was born and raised in a family of Swedish immigrants in a small town near Atlantic, Iowa. As a youth she had the striking good looks of a beauty queen and after her first husband died, she met and fell in love with Leonard, a gentle wealthy dentist, who personally attended to William Randolph Hearst's family. She was 75 when she very happily remarried. Tragically, Leonard died a short time later and Frances received an inheritance of \$85,000



TRAP: The history of investing teaches us that a few people in-the-know on the “inside” track do everything they can to buy shares of a company low when the public isn’t paying attention and then sell it back high after exciting optimistic rumors about the company have been leaked to the press!

in an account with a nationwide brokerage. The full service broker who managed her account was named Joe. He was known for pushing overpriced stocks on the elderly. Full service brokers have been caught doing this to get inside corporate executives out of large positions in stocks that they know are about to drop.

Frances grew concerned when she stopped getting her Pacific Power and Light dividends. When she called Joe, he reminded her that she had instructed him to sell it and buy Pacific Lighting. She replied, “You told me that you thought it was a good stock. I said I might buy it — not that I would buy it!” She didn’t realize that her casual conversation with a financial counselor she trusted — her full service broker — had given Joe the authorization to sell her good stock and buy bad stock. She called him because she didn’t know that

he had moved her out of Pacific Power and Light and into Pacific Lighting without her desire. She found out with an empty feeling in the pit of her stomach that he had allowed the stock to drop to nothing without ever calling her even though he had been aware of the problem the whole time. She just took his word for everything and eventually lost it all. A kind, serene and gentle old woman, she tried to complain, but Joe easily held her back. Her son, Del, died of cancer less than a year after Leonard. When Del's wife Barbara became aware of the problem, she had no idea what Frances' rights were, so the \$85,000 just disappeared under the guidance of a full service, Wall Street-endorsed thief. It was finally getting around the valley that Joe was recommending bad stock to other retirees, but since he was selective and targeted only the elderly who did not know their rights, he was never prosecuted.

If her grandson knew then what he knows today, things would be quite different — the Federal authorities don't take too kindly to full service brokers who swindle the elderly. It would still be an upward battle though. The National Association of Security Dealers (NASD) was created by the full service brokerages of Wall Street and is fully endorsed by the federal government. Every time you open an account at a full service brokerage you are forced to arbitrate through a three member NASD arbitration committee due to a mandatory clause in the account open contracts you have to sign to be able to invest in the stock market.

While arbitration is a good way to resolve disputes it should still be administered by neutral organizations, using neutral arbitrators. NASD exists to protect the full service brokerages that created it because they were terrified when the Security Exchange Commission (SEC) was formed in the thirties in the aftermath of severe abuses by full service brokerages. The current system obligates you to deal with a three member arbitration panel. One member, by federal law, has to be a mandatory industry arbitrator who is far from neutral.

There has been a dramatic increase in arbitrations filed with NASD over the past few years, growing from under 5,000 in 1998

to over 9,000 in 2004. Investor representatives have raised concerns about a lack of investor protections and criticized the NASD system for requiring at least one industry arbitrator on three-member arbitration panels. Nonetheless I am confident that Frances' grandson would have found a way to trample the mandatory industry arbitrator on the panel. The nationwide brokerage would have been forced to fully repay the little old woman all the money (and then some) that their licensed broker had swindled. This is because Frances was my grandmother, and a good part of the motivation that lead me to master my

understanding of money and earn a Ph.D. in finance.

WALLET DOCTOR SURVIVAL RULE #1

Do not use a full service broker under any conditions. Take full responsibility for your investing and self-direct your stock buys and sells through an online discount brokerage like tdamericatrade.com, or etrade.com!

One promise I make you is that, as my student, I will teach you how to invest in the stock market in such a way

that the full service thieves of Wall Street can never damage your account! Wall Street, however, is also a place that can make you rich. Here's its history:

Centuries ago, investing was utter chaos. The roots of investment trace back thousands of years to ancient **Greece**. Ship captains offered a share of their profits to those in society who were able and willing to share in the risk of financing a trading voyage to faraway lands across the sea. Investing was an "all or nothing" gamble of personal savings. The ship might return with riches (hence the saying "my ship came in") or might be lost at sea and not return at all.

The **Romans** sold stock as well in huge civic construction projects that were beyond the means of a single businessman. Stockholders made handsome profits by investing in companies that built roads and aqueducts for the Roman government. Investment was restricted to Roman citizens. The slaves that built the projects did not benefit.

It wasn't until the 1600s that investing took a giant leap forward when the first shares of stock in a corporation were created in the **Dutch East Indies Company** in Holland. Like

the Greek seafaring merchants before them, the Dutch needed capital for international trade. This investment, however, was different because people bought a stake in the trading company — not in a single ocean voyage or civic project. **Speculation** followed because investors could sell their shares to one another over time without waiting for the “ships to come in”.

The stock price could rise or fall on the faintest of rumors, spreading panic in the world’s first stock exchange. Rising markets created new riches and market crashes wiped investors out. Those who lost money were of the wealthy class of nobles and merchants. They blamed their losses on pushy stock brokers. When the inevitable crash came, the citizens of modest means were not affected because they had not been able to invest. The general attitude of the common citizen was that the upper class were merely wealthy gamblers who had gotten what they deserved — the eventual collapse of the Dutch East Indies Company did not cause panic among the general public.

Investors’ opinions of stock brokers sunk even lower in the 1700s. In Paris, an escaped murderer sold stock. There were also other spectacular instances of fraud in the French stock market. **John Law**, one of the first “executive insiders”, working secretly with stock brokers, swindled the public with worthless shares of stock in his **Company of the West** that he fictitiously claimed owned gold mines in the then French-owned Louisiana Territory. He guaranteed a 40% return and created one of the first recorded public con jobs known as a **Ponzi scheme**. The stock was bid up in a buying frenzy and then crashed, wiping out people who bought too late as the “house of paper” collapsed.

In London, stock brokers lured investors into a Ponzi scheme with stories of a secret device that turned chicken into sheep. Sheep at the time were worth more than chickens and the value of these stocks skyrocketed until people came to their senses and stopped bidding prices up. At astronomical prices the **inside manipulators** started to sell out and the price dropped a little. Inexperienced investors on the inside

track of the manipulation started to worry as they saw the price drop and noticed that, although no business activity had taken place yet, the stock price was still ridiculously high. Pretty soon everyone realized the rises were over but it was too late. Panic set in, and the whole thing fell apart. This is how a market crash occurred then, and still occurs today in a market manipulated by insiders. I explain all of this in greater detail later in this book once I have taught you the vocabulary and concepts you need to know to fully understand the process — understanding this is vital to your investing success.

WALL STREET

Despite unscrupulous brokers and numerous Ponzi schemes, stocks helped make Europe the colonial and economic powerhouse of the world. Stocks would do the same for the United States of America beginning on a short muddy footpath named Wall Street. **Wall Street** was so named when New York was a tiny colonial outpost. Pilgrims in 1653 built a wall to keep out Indians. About 100 years later, the wall was gone but the path that ran along side it had become the center of New York City's commerce and society. The heart of the young city already had a dark side. On Wall Street was the auction block to sell slaves and the pillory for public humiliation¹. **George Washington** was sworn in as the first U.S. president on Wall Street in 1789.

Wall Street was where merchants met underneath a buttonwood tree to auction off stocks, mainly in banks and mines, while collecting a commission on every sale. This informal open air stock market lasted until 1792, when 24 merchants signed a document called the "**Buttonwood Agreement**." The pact was intended to avoid government regulation of street auctions and it blocked newcomers from entering the stock brokering business.

¹ A pillory is a wooden framework erected on a post, with holes for securing the head and hands, formerly used to expose the offender to public derision. Today we have newspapers, radio and television media that serve much the same function when not promoting the inside interests of Wall Street!

This formed the **New York Stock Exchange Board**, where the brokers met inside the **Tontine Coffee House** for two informal stock auctions per day — the public was not allowed to participate. If you wanted to trade in stock, you had to hire a broker to do it. This made the stock market less open and caused the public to be less informed about what was going on inside. In the original open auction system, where everybody could hear everything, people knew a lot more. As is the case even today, what is good for Wall Street is frequently not good for you.

The new coffee house auctions were indoor sessions where auctioneers sold stocks one by one, allowing brokers to regulate themselves to prevent more flagrant forms of fraud and abuse that occurred regularly on the street outside. Only stocks of real companies were traded, and the sales were recorded. These procedures created a false air of respectability and stock brokering became perceived as a reputable profession.

During the auctions, prices for shares of stock were quoted in increments of an eighth of a dollar or just **eighths**. This practice can be traced back to a time when people carried Spanish milled dollars and cut them into pieces of eight. In the beginning, only 30 companies were traded inside the exchange — banks, cargo insurance companies and construction firms that built bridges and piers — yet only a handful of fearless investors dared buy them. The general public was afraid of the stock market because, unlike bonds, if the company went bankrupt the stockholders lost everything. Stocks were for two types of people; outright speculators or people trying to take control of the company.

The struggle for respectability on Wall Street brought only a short period of limited success to the brokers and auctioneers that controlled it. With time, the less reputable trading of stocks resumed out front on the street among the brokers who weren't allowed to join the exchange board. Disputes between these **curb trading** stock brokers were settled with fists.

In 1832, a new invention allowed news to flash across the

United States called the **telegraph**. In the world of finance, information is power and the telegraph was a godsend. The telegraph's inventor, **Samuel Morse**, opened a demonstration office near the stock exchange charging 25¢ to see his device — the equivalent of \$5.43 in 2006! It wasn't long before Wall Street was a tangle of telegraph wires. The telegraph turned New York into America's financial capital by eliminating the need for regional markets in other cities. The **stock ticker** was the next innovation created in 1867 by **Thomas Edison**. The ticker printed telegraph signals on a narrow paper tape — the **ticker tape** — that carried current prices to brokers throughout the nation. For the first time since the Buttonwood Agreement, people outside the exchange knew what was going on in the stock market. On Wall Street, “**bulls**” became the term for people who expect stock prices to rise. Alternatively, “**bears**” were those who anticipated drops in the market. Many bears used declines to outwit other investors.

The First Economic Expansion

America's westward expansion detonated an explosion of trading activity and technology that sped up the pace of business beyond anyone's wildest dreams. The markets were completely unregulated by the federal and state governments and Wall Street was (and still is) no place for amateurs. The bulls included colorful characters like **Hetty Green**. The woman's severe appearance and miserly character earned her the nickname “the witch of Wall Street.” Hetty, bitter from being swindled out of her inheritance by an insensitive male-dominated court system, eventually became the world's richest woman by making shrewd investments in railroads. Hetty Green amassed a fortune of \$100 million dollars by investing in railroad stocks and real estate. Throughout her life, she employed a crude system of investigation before making any investment. She personally went to persons known to be enemies of the company directors or sellers of real estate. A money-wise and tough woman, she learned every-

thing she could about the competition, then bluntly confronted the company directors or property sellers and waited for a reply.

America's railroads were among the most ambitious engineering projects in world history. **Railroad stocks** fueled a new frenzy on Wall Street. Until the railroads, corporations trading on Wall Street were little more than family concerns that didn't need a lot of capital.² When the country needed to build a trans-national railroad, it had to assemble a lot of cash. At that point the stock market became very important.

In the crowd on the floor of the exchange lurked ruthless insiders that moved stocks up and down to suit whatever schemes they had invented to fool the public out of its hard-earned money. The most notorious bear began as a store clerk and later became the most despised foe of New York high society.

Jay Gould was one of the most detested speculators on Wall Street. He was called the "Devil of Wall Street" because he was always looking out for number one and never cared about the best interests of the companies he acquired control of. He was a master inside manipulator. Gould was the king of the short-sell manipulation called the **long (bull) squeeze**, a technique to make money by driving the price of a stock down. Here is how this particular inside con job works.

Gould focused on companies with very high prices. He would persuade other investors to loan him their shares in return for a small rate of interest. He would do this in different ways so that investors could not tell who they were really loaning their shares to. He would then immediately sell the stock over the exchange for top dollar. Gould then published vicious rumors about the company in a



TIP: Learn to acquire stock of good companies at low prices as large corporate insiders do when the public is not paying attention. If you do this, you will most likely become one of the Wall Street success stories in the next bull market!

² Capital is any form of wealth that can be employed or is capable of being employed in the production of more wealth. Since stocks traded across an exchange must be purchased with money in the form of the currency of the country a stock exchange is located in, I am generally referring to money when you read the word capital in this book.

newspaper he owned in order to drive the stock price down where he would buy it back dirt cheap. He then returned the worthless stock to the investors and paid the small amount of interest that he owed. In this way he sold high then bought back low. This does not break the one golden rule on Wall Street — **“buy low and sell high.”** His profit was the difference between the price received when he initially sold the stock and the price he later paid to buy the stock back. The fact that a company and its shareholders were ruined in the process was of absolutely no concern to Gould.

The bulls had their inside manipulators, too. Large individual shareholders or small groups of speculators would corner a stock by purchasing almost all of the shares outstanding that could be bought (known as the **float**) when prices were low. This was known as **cornering a stock**. They would then spread rumors designed to create optimism about the company’s prospects. The share price skyrocketed because only a relatively few number of shares were left in the market to “float” in the public’s hands. Public investors had no idea that they were really trading with a limited group of people. This made the share price highly sensitive to increases in demand because supply was restricted by the inside manipulators in control of the corner. When the investors or group of investors who had the “inside scoop” on the manipulation sold their stock, the price plummeted as all of the shares flooded the market. This increased the floating supply of the stock. Since the supply of the shares of stock increased faster than the demand, the share price of the stock dropped. For this reason, investors or managers who have special inside information that can be used to get an unfair edge on the public are called **“insiders.”** One of the better known public figures known to have cornered a stock was Dutch immigrant **Cornelius Vanderbilt**, nicknamed the “Commodore” because he started with ferry boats and ocean liners.

July 8th, 1889 marked a milestone for Wall Street when the first financial newspaper, *The Wall Street Journal*, was published and sold at newsstands for the price of 2¢ per paper — 40¢ in 2006 money. **Charles Dow** and **Edward Jones** raised the standard of financial jour-

nalism with the new publication. The most popular feature was the daily index of twelve stocks known as the **Dow Jones Industrial Average (DJIA)**. By analyzing the performance of key companies in the economy at that time such as American Sugar, U.S. Rubber and General Electric, the DJIA index became the principal stock market barometer.

The DJIA made sense out of what was perceived as chaos. In the daily jumble of “up an eighth and down a quarter”, it was impossible to tell whether stock prices generally were moving up or down. With the industrial average you could keep an eye on the long-term trends and not be confused by the short-term static. The telegraph, the ticker and *The Wall Street Journal* were the most powerful tools that opened the world of stocks to the general public. The so-called “**curbstone brokers**” continued to make an alternative marketplace for stocks — outside on the street curb — until they formed the **American Stock Exchange (AMEX)** in the 1920s. The bull and bear struggle made Wall Street dangerous to the public’s financial health. Every 20 years or so, Wall Street would crowd with investors panicked over a crash in stock prices. Sometimes the exchange was forced to close for days on end. The outbreak of World War I closed the stock market for more than 4 months.

J.P Morgan

The most powerful man in America — the son of a prominent banker — made his mark in history as the undisputed king of corporate mergers. His name was **J.P. Morgan**. Morgan combined hundreds of companies into coast-to-coast monopolies. Morgan’s crowning achievement came in 1901 when nine companies joined forces to become U.S. Steel. The merger made **Andrew Carnegie** the richest man in the world. It was the world’s first billion-dollar corporation with stock so valuable that it boosted the DJIA by 500%! Andrew, who had arrived in America as a poor Scottish immigrant, used his wealth to create the U.S. public library and community college systems, single handedly

making education accessible to all. Some say Bill Gates is following Carnegie's example today.

J.P. Morgan was a stern, autocratic man who never gambled. He based his decisions on business fundamentals and a company's susceptibility to stock manipulation. To protect his favored customers, Morgan insisted on a role in managing every company he created. If he sold you a stock in a railroad company and the railroad company got into trouble, he would move in and try to improve the situation personally.

Morgan controlled 341 seats on the boards of more than a hundred different companies. Investors respected Morgan, yet the public did not. His railroad monopoly raised shipping prices, hurting farmers. He supported child labor and opposed labor unions. President **Teddy Roosevelt** created anti-trust regulations to bust up parts of Morgan's empire.

Morgan created no industries and produced very little economic wealth. He latched on to industries other men and women created and learned the trick of sharing that wealth with others he favored. J.P. Morgan was an adept inside manipulator. John Flynn in his book *Men of Wealth* describes how:

*“The House of Morgan when putting out an issue of stocks could allot a few hundred or a few thousand to exalted persons who were useful to them. Then, when the shares were listed and manipulated into good prices for distribution on the Exchange, these preferred persons would reap swift, handy and rich profits, usually without putting up a cent.”*³

3 The inside corner of a stock issue was well known by market participants to occur even prior to the great crash of 1929. The process of buying up a stock issue at a very low price from an unsuspecting public was known as “accumulating a stock” while dumping the same stock later on an eager public at frenzied high prices was referred to as “distribution of the stock.” Some members of the public learned to spot price activity on long-term charts that indicated that a corner was starting. I teach you this in my home study course. Today, inside corporate executives use stock options to achieve the same purpose as described in numerous publications including Maggie Mahar's book *Bull* and Arthur Levitt's book *Take on the Street*.

The scope of Morgan's monopoly was staggering. Justice Brandeis in his book *Other People's Money* describes it's inter linkages:

“J.P. Morgan (or a partner), a director of the New York, New Haven & Hartford Railroad, causes the company to sell J.P. Morgan & Co. an issue of bonds. J.P. Morgan & Co. borrows the money with which to pay for the bonds from the Guaranty & Trust Company, of which Mr. Morgan (or a partner) is a director. J.P. Morgan & Co. sells the bonds to the Penn Mutual Life Insurance, of which Mr. Morgan (or a partner) is a director. The New Haven spends the proceeds of the bonds in purchasing steel rails from the United States Steel Corporation, of which Mr. Morgan (or a partner) is a director. The United States Steel Corporation spends the proceeds of the rails in purchasing electrical supplies from the General Electric Company, of which Mr. Morgan (or a partner) is a director. The General Electric Company sells supplies to the Western Union Telegraph Company, a subsidiary of the American Telephone and Telegraph Company (AT&T); and in which either Mr. Morgan (or a partner) is a director. The American Telephone and Telegraph Company has an exclusive wire contract with the Reading Railroad, which Mr. Morgan (or a partner) is a director. The Reading Railroad buys its passenger cars from the Pullman Company, of which Mr. Morgan (or a partner) is a director. The Pullman Company buys (for local use) locomotives from the Baldwin Locomotive Company, of which Mr. Morgan (or a partner) is a director. The Reading, the General Electric, the Steel Corporation and the New Haven, like the Pullman, buy locomotives from the Baldwin Company. The

Steel Corporation, the Telegraph Company, the New Haven, the Reading, the Telephone, the Telegraph, and the General Electric companies, like the New Haven, buy steel products from the Steel Corporation. Each and every one of the companies named markets its securities through J.P. Morgan & Co.; each deposits its funds with J.P. Morgan & Co.; and with the funds of each, each firm enters upon further operations.”

When Morgan died in 1913, he received a funeral befitting of royalty. The stock exchange closed for two hours as his hearse slowly

FACT

FACT: In the early days of Wall Street, stock merchants kept a physical inventory of securities on hand which they sold “over-the-counter” like any other retail product. Even today, with fully electronic transactions, NYSE market makers and NASDAQ brokerages are said to “carry inventory.”

paraded by. News of the death made the front page of newspapers around the world, but editorials were polarized. Some eulogies glorified him while others vilified him. Some hated Morgan so intensely that his company became the target of a terrorist bombing seven years after his death.

On December 20th, 1920, a wagon loaded with explosives killed 30 people and injured more than 100. The entrances to the Morgan Company and the New York Stock Exchange across the street were littered with bodies. The crime was never solved, eventually forty would die and

was called the worst terrorist attack on US soil until the Oklahoma bombing devastation. Theories abound as to the reason for the bombing including to act as a ruse to steal gold bars from the nearby Sub-Treasury Building, which was next door to the new Assay Office, where the deadly wagon was parked. At the time of the explosion, workmen at the Treasury had just closed the side-entrance doors for lunch, possibly saving themselves as well as the gold.

The Second Economic Expansion

Wall Street quickly recovered from the 1929 crash but more shocks were ahead — the 1995 Oklahoma City bombing is just a continuation of such acts on U.S. soil. Unbeknownst to all, the biggest market boom in history was approaching as was the biggest crash. America had never seen anything like the roaring 1920s. The First World War ended in victory. Factories were booming and families had money to burn. By the 1920s the NYSE, a private institution, looked more architecturally impressive than government buildings. The exchange demolished the coffee house at the turn of the century to construct a larger structure that projected an image of strength and respectability. The new trading floor was gargantuan. Each stock was now traded at a special spot called a **post** scattered across the exchange floor. Steel stocks were clustered at one post, for instance, while rail stocks were at another.

The auctioneers, now called **specialists**, controlled the building, intermediating between brokers who represented buyers and sellers in the public. When a sale was made, **clerks** would rush the details of the transaction by pneumatic tube to the ticker tape room where typists hurriedly relayed the news to the world. In the post-war 1920s, the exchange was a place of glamour and wonder. Stocks became a national pastime in much the same way as they did in the 1990s.

The public was fascinated by new inventions that led to exciting new products that Americans marched into retailers in droves to buy. Americans bought millions of radios and shares in the company that made them. They reasoned that the popularity of the wireless would drive up the share price of the manufacturer — Radio Corporation of America (RCA). As cars became popular so did automobile stocks. The demand for auto stocks pushed prices through the roof. Between 1924 and 1929, the DJIA shot up more than 300%. The bull market also attracted people who knew nothing about stocks, but who thought they were going to make some very quick money. The naïve and inexperienced public un-

knowingly made a market for the insiders as they were efficiently ushered into the slaughterhouse by Wall Street.

The Great Depression

To experienced investors, the market was obviously overblown. Yet unscrupulous brokers made matters worse by pressuring inexperienced investors into buying questionable stocks at high prices. Even more dangerous, many investors bought stock on credit, known in the trade as “**buying on margin.**”

American banks were universal as they are in Europe today — offering a full menu of financial products including stocks. Stock brokerages competed directly with banks in those days. Bankers were allowed to represent their clients as stock brokers and looked at margin as they would any other loan. If you were a good client, you could buy a stock for as little as 10% margin. If you wanted to buy a share of a \$100 stock, you could put up \$10 and the stock itself became collateral for the loan of the other \$90.

The widespread use of credit and the tremendous rise of stock prices had experienced investors wondering how long the good times could last. Even the larger brokerage houses were growing concerned. In 1928, stockbroker **Charles Merrill** of the firm Merrill Lynch sent a clear warning to clients: “*Now is a good time to get out of debt. We do not urge that you sell securities indiscriminately, but we do urge in no uncertain terms that you take advantage of the present high prices and put your own financial house in order.*”

His sage concerns were prophetic. Disaster struck Wall Street in October of 1929. The buying frenzy quickly disappeared. Hypothetical economist musing of the causes included consumer spending and sales of big ticket items having hit a slump — this was thought to cause several key stocks to decline. Once these critical security prices began to fall, speculators specializing in shorting stocks called **plungers** stepped in and drove the market down even more.⁴ Short

4 Don't confuse a plunger like Jesse Livermore with a short squeeze manipulator like Gould.

is a term meaning **short selling**. This is the sale of a security made by an investor who does not actually own the stock. The **short sale** is made in expectation of a decline in the price of a stock. If the stock price drops, it allows the investor to buy the shares back at a lower price in order to deliver the stock earlier sold short.

More selling caused more price drops. The drop sparked a flood of **margin calls** where brokers and bankers demanded that investors put more cash into their stock investing accounts. This was the very real risk of buying stock on credit. When a stock shrinks in price it is no longer valuable enough to be collateral for the loan. Investors must put up more cash, called **margin**, to even the scales. If they don't feed more cash into their account it is liquidated. On **October 24th, 1929**, thousands of investors could not raise the necessary cash by the time their brokers entered the exchange. When the opening bell rang on the NYSE at 10:00 AM, the equity fire sale began.

FACT

FACT: The stock market crash did indeed spark the Great Depression, but the causes are thought by economists to be much broader. They include distressed key industries, an end to the real estate boom, and widespread bad loans leading to massive banking failures.

The public credit binge that had built up the market was suddenly eating through it like the plague. The preponderance of sellers and buyers pushed all stocks lower forcing margin calls on even more investors and additional account liquidations. So many shares were sold so quickly that the ticker ran four hours late. Thousands of investors rushed into the financial district desperate for news.

Suddenly there was hope. **Richard Whitney**, vice-president of the NYSE, met with top U.S. bankers and then marched onto the trading floor. He boldly bought 10,000 shares of U.S. Steel at \$200. Whitney bought \$20,000,000 worth of stock in just minutes. It was a powerful symbol, yet few knew that Richard Whitney was not trying to save the market but to fool it so that the banks could eventually

Livermore simply sold short lots of stock when he felt prices were excessive.

sell out at a better price. Once again, the unseen forces behind Wall Street showed their lack of concern for the small investor.

His triumphant stand stopped the panic temporarily but the sickening downward spiral of prices returned the following week with a bigger crash that continued for the next three years. The drop was staggering. General Electric tanked from \$1,612 per share in 1929 to \$154 in 1932. General Motors spiraled from \$1,075 in 1929 to \$40 in 1932. The Dow plummeted 89% and \$72 billion of investments were wiped out.

People lost their life savings on Wall Street. Leading economists of the day, including **Philip Fisher** of Yale, contended that the stock market crash alone did not induce the Great Depression that followed, but the public blamed Wall Street anyway. The panic terrified the public and as everyone stopped spending money the economy ground to a halt.

The crash revealed to economists major flaws in the United States' unregulated market for stocks. With the nation in financial ruin, the federal government began to impose radically far-reaching changes in the way the exchange did business. President **Franklin Roosevelt** was elected in 1932 as a reformer. In his very first speech in office, he blasted the stock market as he shouted, "*There must be a strict supervision of all banking and credit and investments. There must be an end to speculation with other people's money.*"

On his second day in office, the president closed the NYSE for a week. He then pushed through Congress the most sweeping set of financial reforms ever enacted in the United States of America. Banks could no longer gamble savers deposits on stocks. Brokers had to act responsibly by treating their customer's money as if it was their own. Corporations that offered stock to the public were forced to file annual financial reports with the federal government.

These controls were intended to lessen the public view that Wall Street was nothing more than a "den of thieves". The stock market came back as a popular form of investing. Now president of the NYSE, Richard Whitney spoke out forcefully against the new

regulations claiming that the stock market could police itself. Such inane rumblings from Wall Street did not halt the president's push for federal oversight.

Roosevelt created the **Securities and Exchange Commission (SEC)** to enforce nearly all of the new rules. The SEC's first chairman was **Joseph Kennedy**. The SEC would eventually indict more than 300 people, including **Jesse Livermore**, famous for his short selling "plunging" of the market, in an effort to clean up Wall Street, but the agency found it virtually impossible to win convictions. The only insider to do jail time would be Richard Whitney himself, convicted of embezzlement.

The man who led the market during its deepest crisis spent three years in **Sing Sing prison** before being released. The newly reformed market was a lackluster place in the 1930s and 1940s as a shell-shocked public stayed away. Thousands of Wall Street workers lost faith in the paper chase and quit their financial professions.



TRAP: Short selling of stock is extraordinarily risky. Jesse Livermore himself went from fortune to famine several times and died penniless on November 28, 1940 when he committed suicide. He was a major short seller in both the 1907 and 1929 stock market crashes. Lesson: Don't sell stock short!

The Third Economic Expansion

During World War II, it was not the stock market but the federal government that generated most of the money to reinvigorate U.S. industry. The stock market produced less than 20% of the capital needed to fuel the allied war machine and the federal government pitched in the rest. The war did, however, bring a historic milestone to Wall Street when women — until then restricted to only work in the back rooms — now appeared on the stock exchange floor, ending a male-only tradition that had lasted 150 years.

With victory over German and Japanese axis forces appeared the stock market's most unique contribution to the war effort

— mountains of ticker tape confetti welcoming home America's battle-weary troops. The baby boom years that followed World War II sparked the most recent major expansion of the U.S. economy. Unlike the 1920s, however, this boom was fueled by solid investing instead of speculation as the war torn world economy forgave, healed, and grew. Leading the charge was **Charles E. Merrill** who opened hundreds of new **Merrill Lynch** offices catering to a growing middle-class America in the suburbs. Merrill Lynch aggressively offered investment classes for women and placed a "How to Invest" exhibit in New York's central station. Commuters could check in to see if stocks were right for them. One of their innovations was to make analysts research reports they gave out free to Merrill Lynch clients as well as interested prospects.

The market fully recovered as American investors returned to stocks. In 1958 the Dow broke 300, the mark it had set 25 years



FACT: The price of a membership "seat" on the NYSE in 1817 was \$25. In 2000, it was over \$1 million!

earlier just before the 1929 crash. One of the most influential, albeit misguided, financial innovations of the '50s came not from Wall Street, but from a university campus 800 miles to the west of the trading floor. Economist **Harry Markowicz** at the University of Chicago developed the **theory of stock diversification** that became the rally cry for investment pools now called mutual funds.

Investors, he said, should remain continually invested in a wide range of stocks to reduce the risk of loss when a single company goes under. The concept of a diversified portfolio is a basic tenant of modern investment, legitimizing mutual funds that were notorious for fraud in the 1920s when they were called **investment pools**. This concept was so radical in the 1950s, however, that it eventually earned professor Markowicz the Nobel Prize in economics.

The financial mind that I most greatly respect, **Warren Buffet**, considers Markowicz's theory nothing more than, "*an excuse for not thinking.*" Specifically, he says, "*The strategy we've adopted pre-*

cludes our following standard diversification dogma. ‘Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.’⁵ At the height of the recent bull market, he said, “diversification is a substitute for thinking.” Warren Buffet also said, “Many in Wall Street - a community in which quality control is not prized - will sell investors anything they will buy.”⁶

Ignorant and blind adherence to portfolio diversification so forcefully preached by the ivory tower of finance and Wall Street today is disastrous to the public’s financial health, as the recent crash from 2000 to 2003 has shown. In the decades that followed, there were downturns in the stock market. In the 1960s, there were major slumps prompted by bad news during the President Kennedy years and setbacks during the **Vietnam War**. The **OPEC oil embargo** is thought by some to have hurt stock prices in the 1970s as Americans waited in line for a gallon of gas. The most dramatic event since the 1929 crash, however, was the introduction of the computer.

WALLET DOCTOR SURVIVAL RULE #2

Buy undervalued shares in good businesses when the market looks bad, then patiently hold on and sell after the eventual rise in stock price!

A different kind of crash hit Wall Street in the 1960s — a paper crash. The rise of pension plans and mutual funds pumped trading volume to 11 million shares per day, yet every transaction was still processed by hand. There were mounds and mounds of papers on desks with clerks just moving slips back and forth. When the stock market had a lot of trading volume it also had a paper crisis.

For brokerage companies, the paper crunch was devastating. Exhausted clerks were incapable of balancing the books each night. The New York Stock Exchange even had to close every Wednesday to

5 1993 Berkshire Hathaway Chairman’s Letter to Shareholders

6 2000 Berkshire Hathaway Letter to Shareholders

give the clerks a chance to catch up. The clerks would work around the clock, every so often going to a cot to sleep for an hour — sometimes they wouldn't go home for weeks.

In 1968, at its height, trading volume across the exchange touched off a **paper crunch** which forced nearly a hundred brokerage companies into insolvency. Computers soon solved the problem with their ability to document market transactions at the speed of light. Since the 1970s, computers have assisted brokers with every aspect of the securities profession.

Computers routed smaller transactions directly to the trading posts, ending the delay caused by hand delivering an order across the trading floor. Computers vastly improved the market's ability to handle the ever growing volume of stock market trades. Computerization, however, also has a dark side.

Computers are thought by some financial economists to be responsible for the single biggest one-day price drop in stock market history. On **October 19th, 1987**, the market began an out-of-control decline that came to be known as "**Black Monday**." Lightning fast computers had been programmed to instantly sell stocks when prices hit a pre-determined level.

The Dow plunged 508 points — a trading session drop of 23%. The precipitous drop with no unusual news foreshadowing the event taught stock traders a vital lesson that the market will crash when least expected. The stock exchange has since installed a series of so-called "circuit breaker" programs that restrict selling when the Dow fluctuates too rapidly to prevent such runaway disasters in the future.

A computer named **NASDAQ** in Connecticut brought the stock market to a historic crossroad in 1971. The NASDAQ system became a quick and inexpensive way to trade without the need for face-to-face interaction. NASDAQ links hundreds of brokerages worldwide. The NASDAQ system was the first network to allow people to trade electronically in smaller, generally "high technology" stocks.

The success of the NASDAQ system has led many financial

economists and industry practitioners to question the future of trading floors such as that of the New York Stock Exchange where shares of large, more established corporations are bought and sold in traditional weekday auctions. Some financial economists strongly believe that the days of face-to-face transactions are numbered. Officials of the New York Stock Exchange defensively maintain that there are advantages to their time-tested ways of doing business. Only time will tell.

Most important of these supposed advantages is the role of the 450 specialists on the floor of the exchange who act as referees between the 900 brokers. The specialist occasionally buys and sells stock out of his or her own inventory to insure that the market keeps functioning during periods of crisis. But they have their share of critics. Specialists have been accused of gouging an unfair profit from the public with their special inside knowledge of market direction.

Two other recent innovations transforming the stock marketplace are the internet and online discount stock brokerages. Investors now have round-the-clock access to the buying and selling of equity securities worldwide.

Past dramatic increases in stock prices have roughly mirrored economic expansions, initially from the development of the railroad and westward expansion of the country, then during two post-world war peace times.

Today in 2006, I firmly believe that we are experiencing the greatest economic expansion in history as we leap into the communication age. The recent fall of the **Soviet Union**, with the highest average level of education of any populace, has added over a quarter of a billion brilliant minds to the world economy. **China** is also undergoing integration into the world marketplace, albeit on its own terms. These recent factors foreshadow a fourth massive global eco-



TIP: Now is your time to enter the stock market — while shares of good companies are selling at dirt cheap prices after the recent sell-off from 2000 to 2003.

conomic expansion. I believe that this may well allow the Dow Jones Industrial Average to eventually trade at the **100,000** level by the year 2050.⁷ Stock trends now circle the globe 24 hours a day from the United States to Tokyo to Europe and back again. In the U.S., stocks generate tens of billions of dollars per year to get new corporations started and to help old ones expand. The stock market definitely puts the capital in capitalism and if you can learn to think independently and find what is uniquely yours, you can put it to work for you!

⁷ This is my OPINON! I want you to become an independent thinker and find your uniqueness — your “mojo”, as Austin Powers would say. Do not form your opinions based on my opinions. I want you to become self-reliant as a stock investor!

Chapter 2

What are Capital Markets & Why Are They So Important?

You just never know when you really need the helping hand of a friend. My brother and I grew up with a guy named John who was a year or two ahead of us in high school. My brother was a year behind me. When he graduated, the three of us decided to backpack throughout Europe. If you are in your 20s and reading this, I strongly recommend that you save some money, buy a backpack and a Eurail pass, and fly over for four to six months — it will be one of the best experiences of your life.

In six months, we visited over 40 countries, including Norway. At one point in our adventure, we were on a train that wound over the Norwegian mountains from Oslo and down to the scenic town of Bergen, which is situated inside a fjord. A fjord is a deep ocean inlet that is basically a submerged U-shaped valley carved out by glacial action. The fjord is characteristic of the coastal regions of Norway and they are spectacularly beautiful. The best way to understand a fjord is to imagine California's Yosemite Valley with the ocean filling the bottom.

The train tracks on the way down to Bergen are hacked out of the sheer granite walls of the fjord. To get a sense of the experience, imagine a train coming down the sheer vertical cliffs of the Yosemite Valley! I was sitting inside looking out the window at the impressive view when, suddenly, my brother sat down next to me. He was pale and trembling — an unusual state for my fearless brother. “*What’s wrong, Todd?*” I asked. What he recounted was both terrifying and heroic.

Todd and John decided to walk out onto one of the platforms that connected the train cars. A train's cars are designed to be disconnected from one another and because of this, the railings between them are not only flexible but also latched, not bolted, in place.



TIP: Understanding the herd behavior of the public can make you rich in the stock market!

Todd and John looked down into the valley over 500 feet below. The view was mesmerizing — like hanging off the middle of a cliff in Yosemite. As Todd relaxed and leaned on the flexible railing connecting the cars, it snapped off! My brother began to fall forward off the platform when he felt a strong tug on the back of his jacket. It was John who, with a cool

head, calmly grasped the door handle to one of the cars and quickly reached out and saved my brother's life! Don't forget John because I will discuss the rich stock investing background of his family at the beginning of the next chapter.

Capital markets make it easy for companies that need money to expand their production of consumer demanded goods and services. These markets help people in the public get their savings into investments that store their wealth. Hopefully, the public's investments grow bigger to create financial security over time. The process of transforming people's savings into investments creates the injection of money that corporations need to make more goods and offer more services that we all need.

For instance, I have a General Electric air conditioner here in my office as I write this. General Electric is such a big company that it is a Dow stock, which I will explain later in the book. General Electric offers bonds and shares of common stock for the public to buy through our capital markets. This allows some people in the public to save each month and buy GE stock or bonds. The money the company got from selling the stocks or bonds was used by GE to create the factory that produced the air conditioner that I bought at Costco and is now in my office.

When people retire or are short on cash, they can sell the

stock or bonds and use the money as they choose. Some people have done so well in the stock market from wise investments that they have been able to retire early because they no longer have to worry about money. In this way, there is a vital “**circular-flow**” of capital, goods and services between individuals, households and corporations that has created the vast abundance of conveniences we take for granted today.

I had the enormous good fortune to travel behind the Berlin wall on our Euro-adventure in 1981, before the Soviet Union collapsed. The food and beer were the best I have ever had, and cost only pennies. But at the same time, I observed a populace in fear for its life, struggling to get by. People would avert their gaze when police cars would drive by. For all of the glitz and glitter of East Berlin as a showplace to attempt to convince Westerners that a command economy worked, it was clear that everyone suffered except those at the top of the communist party.

The system in place at the time was a communist party ruled command economy based on the misguided writings of **Karl Marx**.¹ “Doctor” Marx was an aggressive, disheveled, lazy and slothful man. He was also an unremarkable thinker, an angry, egotistical anarchist with a big mouth. An arrogant and selfish hedonist who abused his family, cheated on his wife, and purchased his “economics doctorate degree” by mail from a German diploma mill.² The fact that some people take his confused ramblings seriously even today underscores the ease with which a socially savvy individual can manipulate the public with outright misrepresentations.

From this experience, I became obsessed to understand why



FACT: The bond market is far greater in size than the stock market! In 2003, the global bond market was worth \$43 trillion as compared to \$27 trillion in stock.

1 A command economy is an economy that is planned and controlled by a central administration, as in the former Soviet Union.

2 A diploma mill is an unaccredited institution that grants fraudulent higher education degrees for a nominal fee without ensuring that students are properly qualified.

some countries with high living standards in Western Europe, Asia and Northern America experienced abundance that allowed middle-class citizens to enjoy conveniences that medieval kings could not. I have long studied why command economies controlled by tyrannical political groups, churches or dictators force poverty on nearly all of its citizens.

I have since come to understand that healthy capital markets — like the U.S. stock and bond markets — are key to economic abundance in any country. Command economies do not have capital markets that allow individual citizens to participate in the economy as lenders (by buying bonds) or investors (by buying stock). This also means that there is no connection in command economies between what goods and services consumers really need and want and the existence of companies to provide those goods and services. Another grave flaw of a command economy is the odd psychological human quirk that unprotected commu-

FACT

FACT: Do not open a self-directed retirement account like a Standard IRA or a Roth IRA at a bank. They will try to force you to put your money into certificates of deposits (CDs) at a low rate of return so that they can lend it out at a high rate of return for their benefit, not yours. Open your IRA at an online stock brokerage such as Ameritrade.com.

nal property is not valued. The only system that works is one that allows workers to selectively invest in stocks, lend their savings in the form of bonds or even abstain from participation in the capital markets if they so choose. People must at least perceive that if they play their cards right they have a shot of making it big.

This is also why the Soviet Union had some parts of their economy that were competitive on a worldwide scale, but due to inefficient distribution of resources and low worker productivity, most sectors of their economy were so inefficient that the population suffered.³ Examples of exceptional product quality are AK-47 assault rifles pro-

³ Capital is defined as cash money or goods used to generate income either by investing in a business or income producing property.

duced by Russia, vaccines produced by Cuba and basic education in both. At the same time, however, the public in both countries suffered (or in the case of Cuba still suffers) from a lack of variety and distribution of even basic foodstuffs.

This is important to understand because, when you become a stock investor, you really are voting with your wallet. You are participating in markets that allow some countries in our world to experience standards of living unprecedented in recorded history. Some of the problems I discuss in this book, such as employee stock options and corporate insider special interest groups in Washington, undermine the integrity of our capital markets and need correction. Some of the quirky behavior of the public, on the other hand, like herd buying and selling, can make you rich if you know how to play the game as I teach you.

Banks, Bonds, and Stock

To understand the capital markets, including the stock market, you must understand how companies get money to get started. It all starts with someone who gets an idea for a product or service that nobody has thought of. Imagine that a woman has a brilliant new idea for a product that everyone needs. Let's say she dreams up a new bicycle seat that is more comfortable and safer than any before. These people are called **entrepreneurs**. An idea in itself is worth nothing because the entrepreneur needs capital to buy patents, build a factory, push the product through the wholesale or retail supply chain, and market it so that consumers know about it. All of this is very costly and exhaustingly time consuming without the stock market.

The first thing the entrepreneur could do is start a very small business with her savings and sell the bicycle seats locally. If they start to sell like hot cakes, she knows she can make a lot of money if she had a lot of bicycle seats. She has a problem because she needs more money to expand production to fulfill the demand for the bicycle seats.

The next step she will probably take is to go get a **bank loan**. The problem here is that banks are difficult to deal with. Bankers have a lot of rigid rules and require collateral and personal guarantees from the entrepreneur. In this way, she can grow her business, but the money has lots of strings attached to it.

There are two other ways for her to get the money she needs, assuming her company has enough years of successful selling and good payment records to the bank and suppliers. The first way she can raise money (capital) for her company is to sell bonds. The second is to issue stock.

When she sells bonds what she is really doing is buying money directly from public investors instead of buying public bank deposits through a banker. Bonds are just another type of loan, but the banker is cut out of the loop as the annoying middle man. The way bonds work is that she makes an interest payment to the people who buy her bonds instead of to a bank. The price of money, called **interest**, is based on the going interest rate in the market when she sells the bonds to the public.

You probably know that you can get a loan for different lengths of time. The same goes with bonds. Bonds are sold in different payback lengths called **maturities**. For example, bonds can have maturities of 1, 5, 10, or 15 years. During the time from issuance to maturity, those who invested in the bonds are paid interest, generally quarterly (every three months). The very last payment includes the original amount of the bond. If our bicycle seat lady sells bonds and her company fails, then the bondholders will take any value left in the business in repayment for the investment in the bonds. If for any reason she cannot pay the bondholders their interest payments, they can force her into bankruptcy. Even so, money a company raises from bonds has fewer strings attached than bank loans.

Financiers came up with an idea hundreds of years ago (remember the Dutch East India Company?) that allowed them to get money from investors and not be on the hook for any payments like they are with bonds and bank loans. The entrepreneur in this example can

issue shares of stock. She will get money from investors and give up some of her ownership, but as her company grows, so will her portion. If the company becomes really successful, then the stock will become very popular and go way up in price. The initial investors who bought a lot of stock get rich.

There are a lot of vocabulary and definitions in this book, but it is important for you to have a conceptual foundation in your mind. As a stock investor it is absolutely critical that you develop a strong vocabulary and understanding of the equity markets, including stocks, mutual funds, and options. I call this the language of stock investing. This tongue has three distinct dialects: the language of stocks, the language of mutual funds and the language of options. If you understand the key concepts and terminology of the equity markets, you will be setting yourself up for success as a stock investor and it will be easier for you to see through the lies on Wall Street!

Chapter 3

Learn the Language of Stocks!

Remember John who saved my brother's life in Norway? The reason John was able to take the time and had the spare money to take the trip with my brother and me was that his family was very successful in the stock market. John related to me: *"My grandfather was involved in Wall Street with his firm. During World War II my father was a pilot and went to work with my grandfather when the war ended. My grandfather later died in a plane crash, but my dad worked with him quite a bit in the investment banking business before the accident. This was back in the early '50s."*

I asked John, "So your grandfather was in the business of taking companies public through IPOs?"

John replied, *"Yes. My dad was involved in that business to a limited extent and then he moved to the West Coast and worked for a firm called David Skaggs, which was subsequently acquired by American Express. My dad traded stocks while he was involved with David Skaggs for a number of years. After my grandfather was killed in the plane crash, he didn't want to have anything more to do with the stock business because it reminded him of the loss of his father — my grandfather. My father's painful memory of the loss of his father made it difficult for him to carry on with the securities business. He decided to move to a remote mountain valley in Northern California and was no longer involved in the day-to-day activities of David Skaggs. He bought our elegant mountain river ranch to engage in his passion of fishing and hunting to forget and ease the pain of the loss of my grandfather."*

I asked John, “I know that your family became wealthy on Wall Street...didn’t the big money come later with a massive trade your dad made in WD-40?”

John replied, “*I don’t recall exactly how he became aware of the product — through active use of the product or through a tip from his contacts in the securities industry. I do know that he bought the stock shortly after it became public. All I know is that he bought the stock on the pink sheets at a very good price when it was on the OTC as a penny stock. He did really well with WD-40.*”

Well indeed, John’s grandfather and father did so well in the stock market that a trust fund now exists that is large enough to support not only their grandchildren, but their great-grandchildren in their lifestyle needs.

Equity security is the technical finance term meaning stock in a publicly traded company. When I write equity or equity security, it means exactly the same thing as stock. A **security** is defined in the dictionary as an evidence of debt (such as bonds) or evidence of property (such as stocks). **Equity** is defined in the dictionary as the monetary value of a property or business beyond any amounts owed on it in mortgages, claims, liens, etc. The **equity** in your home, for instance, is how much cash you would get if you sold your house.

When you sell a house, the buyer’s lender pays off your current mortgage and any associated closing fees; you get whatever is left over. That is your homeowner’s equity. Equity in a corporation is a similar concept because it is what the owners would get after all debts are paid. An equity security is evidence that you have a claim to whatever residual value would be left

WALLET DOCTOR SURVIVAL RULE #3

take the initiative to learn about money in the broad sense — asset protection, estate planning, tax reduction, risk management, investment psychology, and stock market mechanics to set your family up for the good life!



TIP: A strong stock market vocabulary will help you learn and grow into a strong stock investor!

in a company if it were liquidated and all of its debts and any associated fees were paid. An equity security is simply a share of stock in a publicly traded corporation. When I refer to the **equity market** in this book I am referring to the stock market. When I refer to equity securities or equities in this book I am referring to stocks.

Stock may take many forms, but here are the two basic kinds. As the name says, **common stock** makes you an “owner in common” of the corporation. Owners of common stock are called **common stockholders**. This is the most “common” type of stock people invest in because it offers the greatest probability that it will go up a lot in price. The term common stock is an equity security that has no special dividend rights and has the lowest priority claim in the event of bankruptcy. This means that common stockholders who own common stocks probably aren’t going to get a piece of the profit pie and are the last to get paid anything if the company goes belly up! As horrible as this sounds, I will show you in this book that buying common stock is one of the best ways to grow wealthy in the United States today.

The second type of stock is called **preferred stock**. Owners of preferred stock are known as the **preferred stockholders**, and they get treated differently by the corporation. They get preferred treatment when it comes to receiving dividends or a cash payout if the company goes broke. The bondholders and banks still get paid first if the company goes bust, but preferred stockholders get paid before common stockholders if the **inside corporate executives** decide to spread a little of the profits around in the form of dividends.

Convertible securities are weird things that you buy as one security and can later convert into another if you want. Most convertible securities are preferred stock or corporate bonds that are convertible into the firm’s

common stock.¹ You need to understand the characteristics of both common and preferred stocks if you are going to invest in the stock market.

Common Stock

Common stock makes you a part owner of a corporation, but the last in line to get paid out of day-to-day profits. A fancy way to say this is that **common stock** is a basic ownership claim against a corporation. Think of this as the investors who have put up investment capital to get things going. It's exactly the same as if you decided to invest in the creation of a business in the town or city that you live in. The most important thing about common stock is that it is what we financial economists call a **residual claim** against the corporation's cash flows or assets. In other words, if the inside corporate managers mess things up completely and the company goes down the tubes, then common stockholders have a legal right to stick their hands out for repayment in bankruptcy court along with all the other people and firms who got the shaft...but common stockholders are last in line!

If the company goes bust and has to be “sold off” — another way of saying liquidated — common stockholders (owners) can't be paid until what is owed to the employees (wages), the government (taxes), the courts (judgments), short- and long-term creditors (bank loans), bondholders (long-term debt), and preferred shareholders (other owners) are all paid off. After these prior debts are paid in full, the common stockholders get whatever is left over — the **residual value of the firm**. Common stockholders may directly share in the company's profits, but the inside corporate managers get to decide if any profits get paid out. The residual claim nature of common stock means that it is more

FACT

FACT: At least 8,000 people died the night of the Bhopal Disaster, and possibly many more than 30,000 total in the aftermath.

¹ Firm is another fancy way of saying company. A corporation is the most highly organized form of company and can issue shares on a stock exchange if it gets big enough. A firm is defined in the dictionary as a company, concern, business or house.

risky than a firm's bonds or preferred stock because these investors are last in line if something goes wrong.

Legally, common stockholders enjoy **limited liability**, meaning that their losses are limited to the original amount of their investment in common stock. Here's an example: the **Bhopal Disaster** of 1984 is considered by authorities to be the worst industrial disaster in history. It was caused by the accidental release of 40 tons of **methyl isocyanides (MIC)** from a **Union Carbide India, Limited (UCIL)** pesticide plant located in the heart of the city of Bhopal in the Indian state of Madhya Pradesh. UCIL was a joint venture between Union Carbide and a consortium of Indian investors.

The accident, which occurred during the early hours of December 3, 1984, produced heavier-than-air toxic MIC gas which rolled along the ground through the surrounding streets, killing thousands almost instantly. The gas also injured anywhere from 150,000 to 600,000 people; at least 15,000 of these innocents later died. Heads rolled at the corporate level in the aftermath but none of the common or preferred shareholders stood to lose more than the initial investment they made when they purchased the company stock. This is what limited liability means.

Limited liability means that the personal assets of a shareholder cannot be taken away to satisfy the obligations of the corporation. In contrast, a **sole proprietor** who owns a gas station is personally liable for all of the debts and losses of the gas station he or she owns. Given the obvious benefits of limited liability, it is not surprising that most large firms in the United States are organized as corporations and not as sole proprietorships. If you are thinking about creating a business, DO NOT create it as a sole proprietorship. A corporation or a Limited Liability Company (LLC) is infinitely more favorable.

Common Stock Dividends

Inside managers, at their discretion, can make corporate payments of profits to the stockholders (the corporation's owners) in

the form of **dividends**. Common stock dividends are not guaranteed, and a corporation does not get driven into bankruptcy if they don't pay them. Residual dividends, if any, are paid out of the firm's after-tax cash flows. Dividend paying stocks are nicknamed **income stocks** because dividends give investors a steady flow of money.

Usually though, inside executives have money earmarked for other uses in the company. Those uses increase the creature comforts of the executives, either directly or indirectly reducing the wealth of the shareholder. Alternatively, executives tend to put money in projects that increase short-term cash flows to try to run up the stock price so they can dump their employee optioned stock on the public. Corporate managers are not on your side as a stock investor, even though they try to seem so in shareholder reports they send to you. Dividends are a problem for the company anyway, so don't worry about not receiving them. **Dividend income** is taxable for most investors. Because of this, corporate profits are double taxed — once when the company pays the corporate income tax on its profits and once more when investors pay their personal income taxes.

Double taxation is one of the major problems with dividends. The corporation gets taxed on its profits and then stock investors have to pay income tax on the dividend income. In this very real sense, a dollar of profit by the corporation gets taxed twice before the owner of the company, the stock investor, gets to use it. To avoid double taxation, a few investors buy **growth stocks**, companies that reinvest their accumulated earnings instead of paying dividends. The main point is that growth stocks don't pay dividends. The vast majority of investors buy growth stocks because they tend to go up in price a lot more and a lot faster than dividend paying “income” stocks. But double taxation is also a lame excuse for some corporate inside executives to hang on to company profits for their direct or indirect benefit.

Reinvestment of earnings allows the company to accumulate capital and grow faster than it otherwise might, hence the nickname “growth stock” for equity securities that don't pay dividends. As a firm's earnings grow, people expect its stock price to rise. Stockhold-

ers can, if they are right and the price increases, sell their stock and pay capital gains taxes on their profits. You have to be very careful in selecting a growth stock because earnings and stock price increases do not go hand in hand. Many people believe this Wall Street and ivory tower myth. The public believes that as a company makes more profit, its stock price must go up. But don't you believe it — reality is not so simple. Some excellent stocks primed for a rise may actually show losses on their income statement for reasons I will later explain in the chapter on fundamental analysis. For this reason, I have created a “Bulletproof” system that allows you to identify which growth companies are much more likely to have monster increases in stock prices.

FACT

CAPITAL GAIN TAX RATES

2006 Tax bracket	Short term rate	Long term rate
10%	10%	5%
15%	15%	5%
25%	25%	15%
28%	28%	15%
33%	33%	15%
35%	35%	15%

The **Tax Reduction Act of 1997** set a lower tax rate on **capital gains** than on dividends.² The maximum tax rate on assets held for more than 18 months was lowered from 28% to 20%, and later to 15%. Note also that taxes on capital gains are paid only on realization of the gain when you sell. You can reduce your tax bill by delaying the sale

of your stocks to postpone the realization of a capital gain. In other words, if you learn to invest for the long run, you will save a lot of money in taxes. For this reason patience is an investor's great virtue in the stock market. This is important because the very high short-term capital gains tax rates will literally suck all of the profit out of the best short-term trading system. Whenever you listen to a self-proclaimed expert tout his or her short-term stock investing or stock-option trading system (options, by their nature, are short-term and

² Capital gain is the amount by which an asset's selling price exceeds its initial purchase price. A realized capital gain is an investment that has been sold for a profit. An unrealized capital gain, also called a paper gain, is an investment that hasn't been sold yet but would result in a profit if sold. You do not pay taxes on paper gains. Capital gain is often used to mean realized capital gain. For most investments sold at a profit, including mutual funds, bonds, options, collectibles, homes, and businesses, the IRS is owed money called capital gains tax. A capital loss is just the opposite.

taxed at the highest rate), notice how the huckster never mentions the serious tax consequences of short-term trading. They won't like it if you ask about short-term capital gains during their sales pitch, either, because it's like turning a fire extinguisher on a weenie roast!

Common Stock Voting Rights

Even though stockholders own the corporation, they aren't managers of the business — they have no control over day-to-day business activities. They have no control over dividend payments even though they are the true owners of the firm. You would think they could simply say, “*Just pay me what is mine, Mr. inside executive manager!*” Today, control of the firm now rests firmly in the hands of inside corporate executives who are supposed to be concerned about the shareholder's financial welfare. The large number of corporate inside scandals that have hit the press since the beginning of the recent crash in 2000 has given many seasoned investors — including Warren Buffet — the distinct impression that they rarely are.

In his annual letter to Berkshire Hathaway shareholders, released in 2004, Warren Buffett reemphasized previous themes on the inadequacy of corporate governance structures among U.S. companies and mutual funds. “[If] Corporate America is serious about reforming itself, CEO pay remains the acid test,” Buffett said. “The results aren't encouraging.” Buffett criticized lavish pay packages and the “lapdog behavior” of directors, calling the situation an “epidemic of greed.” Some of his harshest words were reserved for mutual fund companies which you will learn about in detail ahead in this book. In 2003, “the world began to learn that many fund-management companies had followed



TRAP: Do not ever buy shares of stock because you are attracted to the company's product or some report about the quality of the company. Focus on buying stock in companies that, mysteriously, nobody seems to be paying attention to.

policies that hurt the owners of the funds they managed, while simultaneously boosting the fees of the managers,” he wrote. “Yet to swell profits further, they trampled on the interests of fund shareholders in an appalling manner.”

Shareholders exercise control over the firm’s daily operations indirectly through a corporate board of directors. They do this by electing people called **directors of the board** who the shareholders believe will best defend their interests. The election of a board of directors is through shareholder **voting rights**. It is the task of the **board of directors**, on behalf of the owner shareholders, to keep a watchful eye on the corporate inside executives. Shareholders elect directors by casting votes at an annual meeting. In reality, this has its share of problems, because most shareholders cannot actually attend the meeting. They have to instead vote by **proxy** through absentee ballot or by endorsing a representative. As a stock investor you will frequently receive proxies in the mail so late that the vote will have already taken place!

Here is how the all-important board of directors is supposed to be formed. There are two ways of electing directors: cumulative voting and straight voting. In **cumulative voting**, all directors are elected at the same time and the shareholders are granted a number of votes equal to the number of directors being elected times the number of shares owned. In most cumulative voting schemes, shareholders are permitted to distribute their votes for one director. The effect of cumulative voting is to give minority shareholders, those owning small proportions of the stock, a voice in the company’s decisions.

With cumulative voting, minority shareholders are guaranteed to elect the largest percentage of directors. This is less than the percentage of shares that minority shareholders control. For instance, if five directors are being elected and the minority shareholders control 42% of the shares, they are assured of being able to elect two directors because each director requires 20% of the total votes cast to be elected. However, if only three directors are being elected, then

the minority shareholders would be able to elect only one director because each director requires 33.3% of the total votes.

In **straight voting**, directors are elected one-by-one. Thus the maximum number of votes for each director equals the number of shares owned. Under this strategy, it is difficult for minority shareholders to obtain representation on the board of directors because any shareholder who owns even slightly less than 50% of the shares can elect the entire board of directors. It should be obvious why inside corporate executives just love straight voting — they get more control of the board of directors away from the shareholders.

Normally, one vote is attached to one share of stock, but there are exceptions called **dual-class firms**. During the 1980s, many firms recapitalized with two classes of common stock that have different voting rights. **Recapitalize** is a fancy word for re-organizing the financing of the company. By issuing stock with limited voting rights compared to existing shares, the managers of a firm can raise **equity capital** (money) by selling stock and still maintain control of the firm.

They are able to maintain control because investors that buy the new shares can't vote, leaving the inside corporate executives to do what they want. Needless to say, dual-class firms are controversial. Many financial economists like me view **dual-class recapitalizations** as attempts by some managers to entrench themselves (dig in like a tick, as they say in the south) so that they can unduly enrich themselves.

Corporate inside executives created dual class recapitalizations as a tool to chew more meat off of the bone than they deserve. Opponents of dual-class recapitalizations argue that managers of dual-class firms are insulated from the disciplining affects of the proxy or take-over process, through which ineffective managers can be replaced. Proponents — corporate lawyers on the payroll of insiders — say that managers of dual-class firms are free to pursue riskier, longer-term strategies that ultimately benefit shareholders without fear of reprisal if the short-term performance of the corporation suffers.

Excuse me? Say what? Aren't they the managers? Aren't they sup-

posed to be responsible for the performance of the company? They make us pay their exorbitant salaries (in 2004, the average CEO of a major company received \$9.84 million in total compensation, according to *The New York Times*). They also want us to give them stock for free (stock options) that we have to pay for — making them richer than European royalty. And we are supposed to hold them harmless as well? Ain't America great — for corporate inside managers!

2004 Top 10 Most Highly Paid CEOs

Yahoo Inc.	Terry S. Semel	\$109,301,385
Coach Inc.	Lew Frankfort	\$64,918,520
XTO Energy Inc.	Bob R. Simpson	\$62,141,981
United Health Group Inc.	William W. McGuire	\$58,784,102
Viacom Inc.	Summer M. Redstone	\$56,017,985
TXU Corp.	John C. Wilder	\$54,960,893
Countrywide Financial Corp.	Angelo R. Mozilo	\$52,993,637
Occidental Petroleum	Ray R. Irani	\$52,648,142
KB Home	Bruce Karatz	\$47,288,228
Gateway Inc.	Wayne R. Inouye	\$46,338,744

Source: Executive PayWatch

Corporate Governance

As I mentioned before, investors have different likes and dislikes — some people like growth stocks and other people like income stocks. A fancy way to say this is that investors have different **portfolio preferences**. Corporations have different growth opportunities depending on the age of the company, the industry and many other factors. Different corporations have different corporate strategies, for instance, deciding to emphasize growth by reinvesting profits or to pay profits out to the corporate owners by making dividend payments to the shareholders. The stock market is supposed to match investor desires with companies managed by likeminded strategizing corporate executives. If the executives don't do what they are supposed to because they are lazy or cheating then the shareholders as owners of the corporation legally have the power to fire or penalize them.

That is all fine and dandy, but in reality we have lots of **agency problems** in corporate America today where some inside executive managers are sucking away as much value in the business from stockholders as they can in the form of perquisites, profits and employee stock option gifts. **Perquisites**, commonly known as “perks”, are executive goodies that cost the corporation lots of money that should go to the shareholders. Lear jets, useless “business trips” in super expensive resorts even royalty can’t afford, and overpaid supermodel secretaries are all examples of perquisites. Over the years I have come to understand that it is corporate greed, stock price manipulation, news manipulation, and the public’s desperate hope for getting wealthy, as well as fear of losing it all, that really drives stock prices more than fancy economic theories such as efficiency.

Inside corporate executives throttle the companies they manage with **agency costs**. The doctoral-level finance literature describes two basic types of managerial inefficiencies that are both called **shirking** — a fancy way to say thievery and laziness. The first agency cost I want you to understand is **misfeasance**. The idea here is that if lazy inside corporate executives worked harder, were smarter, or were more careful they would earn more money for shareholders — if they hang out all of the time on the golf course they aren’t exactly taking care of business. The second agency cost is **malfeasance**. Here, the thieving inside corporate executives cheat the corporation through lavish perks on themselves. The history of American public business corporations are filled with examples of both forms of **shirking**, ranging from congenital unluckiness (executives just born unlucky but, unfortunately for shareholders, in control of the company), to incompetence and, most commonly, to outright theft.³ These agency problems are at the core of doctoral finance research in corporate governance.

FACT

FACT: CEOs exercising employee stock options drain millions of dollars each year from the capital needed to make American companies more competitive.

This leads us to an area of finance that is very important for stock investors called corporate governance. We have many problems today with corporate governance. According to Sir Adrian Cadbury “*Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals.*” The aim of corporate governance is to “*align as nearly as possible the interests of individuals, corporations and society.*”⁴ In other words, corporate governance is also the study of how to avoid a society where the rich get richer and the poor get poorer until the poor get fed up and revolt. The corporate governance framework is supposed to encourage the efficient use of resources and to require accountability for the **stewardship** of those resources.⁵

All of our problems in corporate governance come from the fact that our large modern day corporations are no longer under control of the owner-shareholder, yet these companies control most of the world’s wealth. The 30 companies that are in the Dow index control an enormous share of the world’s profitable industrial production and an even larger share of U.S. economy. Oppressive dictators around the world find themselves threatened by the U.S. federal government and military. Yet men who are able to climb to the top of corporate America and astute enough to control the board of directors can have a more profitable dictatorship without any fear of invasion. Our corporate dictators call the shots in our federal government to a large degree and have full support of a White House that projects the modern day corporate inside executive to be the poster person for the American Dream. Some executive managers know that even if they do a little jail time for inside trading or stock manipulation, they will still come out wealthier than most of today’s European royalty.

You may have noticed that I have been harsh on inside corporate executives. The reason for this is due to the severe problems in the United States in terms of shareholders having been stripped of

4 ‘Global Corporate Governance Forum’, World Bank, 2000

5 Stewardship is defined as the act of managing another’s property or affairs; administering anything as the agent of another or others.

voice or control of the firm. Imagine how you would feel if you paid for a McDonald's franchise with your hard-earned savings. You are the owner and the manager is your employee. Now imagine how you would feel if the manager of your hamburger restaurant, who is really your employee, got to take whatever cash, benefits, or do whatever they want without asking your opinion. How would you feel if you complained, pressed charges, or tried to fire them and found out your restaurant manager had the support of Congress and the Delaware Supreme Court? This is exactly what has happened in our current political economy of the United States. Don't get bitter, though, because knowing that this is how the system works can make you a lot of money in the stock market.

The fact that there have been a lot of corporate scandals in large and once-respected companies indicates that there is a lot of room for financial mischief inside U.S. corporations. Corporate inside executives have been caught in outright lies to shareholders and workers in such cases as **Enron** and **WorldCom**. The inside corporate executives at **America Online (AOL)**, for instance, are notorious in corporate America for "cooking" their accounting books.

The problem of being ripped off by the managers of a corporation is not new. Economist **Adam Smith** in 1776 wrote, "*The directors of [joint stock] companies, however being managers rather of other people's money than of their own, it cannot be expected that they should watch over it with the same anxious vigilance [as owners]... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.*" What Adam Smith so wisely said is that since the inside corporate executives get to control your hard-earned savings without risking a dime out of their pocket, they are going to waste your money on undeserved daily luxuries while stealing as much money as they can.

Here is how the inside corporate executives take control away from the shareholders. When a company is founded, the **balance of power** between shareholders and inside corporate executives is not a problem. This is because everyone in the small company clearly



HUMOR: A man walking in the countryside meets a shepherd and a big flock of sheep. The man tells the shepherd: "I will bet you 1000 against one of your sheep that I can tell you the exact number in this flock." The shepherd thinks it over; it's a big flock so he takes the bet. "857," says the man. The shepherd is amazed, because this is the exact number. Says "OK, I'm a man of my word, take a sheep." The man picks one up and starts walking away. "Wait," shouts the shepherd, "Let me have a chance to get even — double or nothing that I can guess your exact occupation!" Man says "OK." "You are an economist working for the government," says the shepherd. "Amazing!" responds the man, "You are exactly right! But tell me, how did you know?" "Well," says the shepherd, "put my dog down and I'll tell you!"

understands that the **shareholders** are the owners. Inside corporate executives clearly understand that they are employees and work happily on a fixed wage. **Directors** also clearly view themselves as representatives of the shareholders. They know that it is their job to hire and fire and set the wages of the inside executive managers. In the beginning, there are only a few owners who are shareholders. These are generally the founding family or partners who started the company. Examples include the Ford family of **Ford Motor Company** or the Disney family of **Walt Disney Company**.

To summarize, a properly operating corporation has a **chief executive officer (CEO)** who is the top manager (employee) of the company. The **board of directors'** job is to hire the CEO and other officers and set their wages. The **directors of the board** are selected by the shareholders by democratic vote. The **chairman of the board** presides over all board meetings and recommends members of the board to the shareholders. What happens when the company grows larger and makes lots of money?

As the company gets bigger, these relationships get all messed up and the perfect family becomes completely dysfunctional. Company growth is wonderful but requires more capital to keep it all going forward. The initial shareholders who are usually the founding family or partners have a limited amount of money they can put up and are normally tapped out from starting the company. They know that if they bring in other investors they can grow a lot more, so they sell shares to the

public. This means that the **shareholder base** becomes very diverse, as lots of different people become owner-shareholders in smaller and smaller chunks as more stock is issued and sold. This is called **shareholder pool dilution**.

At this point, the company can take a number of different paths. Either the original founders continue to control the company or they decide to enter high society and hire a professional manager, with an MBA from a big-name school, as CEO, while controlling him through the board of directors with a firm hand. Alternatively, the family can maintain managerial control of the company. In the case of the Ford Motor Company, the founding Ford family still controls the company. Family members are groomed for upper management and if a corporate executive becomes too powerful, the family simply throws him or her out on their butt. This is exactly what the Ford family did when **Lee Iacocca** became too powerful, arrogant, and self-interested for his own good. This turned out to be a wise move on the part of the Ford family. Lee Iacocca's ego-driven leadership allowed him to ransack Chrysler for his own greed and eventually drove it nearly into the ground. This happened because the Chrysler Company had no large shareholder or family in position to thwart Iacocca and he was able to garner union support from the beginning. Iacocca eventually ransacked the company.

Another potential outcome is that an ego driven inside corporate executive, through corporate gamesmanship, gets appointed to both the position of chairman of the board and chief executive officer. At this point, the fox lives in the henhouse because the highest ranking employee of the firm can now appoint directors who will vote according to their own desires. This is exactly what happened when **Michael Eisner** gained



TRAP: Do not hold on to a stock too long or buy after a long extended run up in share price. When insiders sell out, a stock is said to be “unsupported” and falls rapidly in price.

control of the Walt Disney Company as both CEO and board chairman and was able to completely lock the Disney family and all small shareholders out of the governance of the firm. Eisner ransacked the company for nearly \$1 billion.

The key point I want you to understand is that as the company expands and its financing needs grow, the average shareholder controls fewer and fewer shares of stock in the corporation. As this happens, corporate inside executives begin to look at shareholders as more and more irrelevant for input in managing the company on a daily basis. In short, since inside corporate executives can do what they want and can listen to shareholders less and less, the inside corporate executives become more and more arrogant. Again, this happens because shareholders have to agree to give up some of their ownership to allow the firm to continue to grow. In doing so, however, they lose the key to the henhouse.

The cost of **active monitoring** of the performance of inside corporate managers becomes too expensive compared to what the shareholder earns from his or her relatively small ownership in the company at this point. Shareholders stop attending annual meetings. They either just vote with management or throw the proxy in the wastebasket since they don't know enough to make an informed decision about who would be a good director. This is called **voluntary shareholder absenteeism** and, when combined with strong and arrogant corporate insiders who have gained control of the company as well as its board of directors, it creates a problem that is at the heart of today's severe **corporate governance crisis**.

The important historical lesson is that the absentee shareholder system breeds severe arrogance on the part of corporate inside executives. This point will be even more evident when you read the chapter of this book describing historical corners. The crisis I am referring to is that you, as part owner of the firm, no longer have any voice whatsoever in the hiring and firing of top inside managers or the composition of companies' boards of directors. The "little guy" has been completely cut out of the loop in American corporate

culture. It is not supposed to be this way, but it is, and it is supported at the highest levels of the federal government.

How is it that the top employee of the firm ends up controlling the very board of owners that is responsible for his or her hiring, firing and compensation? Corporate insiders argue that they should have input into the board of directors because the corporation has a “social responsibility” to groups other than the shareholders, which include debt holders and employees.

Another typical inside executive defense offered is that the board requires the CEO and other management input to make proper decisions. Insiders use this argument to get onto the board and drive a wedge between the different forces in the company. What corporate executive insiders never explain is why the CEO needs a vote on the board — let alone the chairmanship — in order to supply the board with his or her input. It takes strong will to stand up to the CEO-chairman even for fully independent directors who are not part of the insider’s web of cronies.⁶

In today’s system, the vast majority of directors sit on boards because the CEO recommended them. The owner shareholders never have any input in the decision at all. As cronyism erodes the board’s decision-making ability, the corporate executive insider is the clear winner. Michael Eisner was able to acquire nearly a billion dollars worth of stock in the Disney corporation by simply asking a board of directors composed of his cronies to gift him all of the **employee stock options** he wanted. Shareholders were completely powerless to stop him because they had been eliminated from the process.

What few U.S. investors stop to ponder is the fact that it is now common for the CEO to also occupy the post of board chairman. Only recently has there been any debate among academics questioning this American tradition. Institutional shareholders, primarily mutual funds, and other governance activists, mainly unions, recommend separation of the roles. In Europe, the tradition has been

⁶ Cronies are defined in the dictionary as close friends or companions; chums. Cronyism is where the inside chief executive officer who is also the chairman of the board appoints all of his buddies to the board of directors. The CEO can then pass whatever corporate rule they want, including the gifting of more employee stock options to him or herself.

not to place the CEO in the chair. In some countries of the **European Economic Union** this is enforced by statute.

The politically-driven widespread practice of placing insiders on boards appears to have started in 1976. Germany expanded its **co-determination law** from the political pressure of **worker unions**. The newly-expanded law required companies with more than 2,000 employees to give half of the supervisory board seats to employees. This created a precedent that inside corporate executives in the U.S. were able to point to.

The Poison Pill

A **takeover bid** is a corporate action where one company, the acquiring company, makes a “bid” to buy another company, the target company. If the target company is publicly traded, the acquiring company will make an offer for the outstanding float of shares. A welcomed takeover usually refers to a friendly takeover that the inside corporate executives of the target company approve of. **Friendly takeover bids** generally go smoothly because both companies welcome it. In contrast, an unwelcome or **hostile takeover bid** can get downright nasty. One of the biggest reasons these takeover attempts are unwelcome is because the inside corporate executives of the target company are afraid they will be thrown out of the new combined company! Famous MIT Nobel Laureate economist **Paul Samuelson**, in his

book *Economics*, explained, “*Takeovers, like bankruptcy, represent one of Nature’s methods of eliminating deadwood.*”

FACT

FACT: Less than 2% of corporations give stock options to all employees, not just to upper management

Source: Executive Compensation Report

In the case of a **hostile takeover bid**, which would replace corrupt or incompetent inside corporate executives (deadwood), those very same executives today sit on a board with the power to stop the takeover and ignore the shareholder’s best interests. United States courts have never

recognized this as a problem or tried to fix it. Instead the Supreme Court has, over the past two decades, granted inside corporate executives broad power to ignore the right of owner-shareholders to organize a hostile takeover bid to get rid of lazy or thieving insiders. As a result, insiders have even succeeded in blocking the rights of small shareholders who only want to sell their shares to someone else who is trying to accumulate a controlling block of the stock to do some managerial house cleaning.

A particularly effective inside corporate executive defense is the so-called “poison pill”. This is a clause in the corporate charter that is triggered if any investor accumulates a 15% share of the company they are trying to take over. When this happens, all shareholders except the 15% block holder get to purchase new shares for an arbitrarily low price, such as half market value. This is like asking the block owner who is trying to clean out the bad management to pay a dividend to all the other shareholders, financed out of the block holder’s personal wealth. Boards can even issue poison pills right after receiving a hostile bid (this is called a “**morning after pill**”).

An important 1983 decision was **Moran vs. Household International**, in which the **Supreme Court of Delaware** (where 60% of Fortune 500 companies are incorporated) upheld the inside controlled board’s right to refuse to remove a poison pill, even though there was an all-cash offer on the table and the majority of the company’s stockholders had already tendered their shares. The Supreme Court essentially said that the inside corporate executive employees had more rights than the owners of the company. With this decision, the federal government gave insider controlled boards, the vast majority of all U.S. corporations, the right to ignore lucrative offers that are beneficial to the owners but not to managers.

The poison pill has been the sharpest tool for the executive corporate insider to pirate the public of its hard earned savings. **Hostile takeovers** transformed lots of poorly managed and inefficient companies into well-oiled business machines from 1975 to 1985. The poison pill has completely stopped hostile takeovers in the United

States — not one has gone through since 1985. Nobody dares take on the insiders today because they have everybody by the gonads.

As a stock investor, you should be concerned. The poison pill is a symbol of state sanctioned theft by insiders of the fundamental shareholder right to sell your shares of stock to the highest bidder. Today, no takeover can proceed unless corporate insiders — who are the employees, not the owners of the firm — agree to remove the poison pill. Boards refuse to remove the poison pill because self interested inside executives know that they will lose their positions in the company and more importantly their excessive compensation.

To summarize, American executive corporate insiders (1) are excessively overpaid in terms of salary and employee stock options, (2) have control of the company that no employee should have, and (3) remain in control through the legislative support of the federal government that no government should provide. It is no wonder that the 1985 Delaware Supreme Court precedent has caused an era of governance decline into crisis in corporate America. The robber barons are back!

Institutional Activism

In the past three decades, the growth of pension funds and other investment pools such as mutual and hedge funds have grown massively as inside corporate executives have shifted workers' retirement funds into self-directed defined contribution plans like the 401(k). Investment funds now control 50% of household stock market savings. These funds are now so large that they normally control 2% to 3% of the total equity of a company in which they purchase stock for the mutual fund's investors.

A few of these large investment pools, those that are not in on the insider gravy train, are upset about the excessive state-sanctioned control that inside corporate executives enjoy over the boards they sit on. This has allowed the absentee shareholder to regain a voice on the board to some degree. Over the last ten years, a few have been

pushing for non-excessive executive compensation and the separation of the posts of CEO and board chairman.

For example, investors, with the Disney family in the lead, were able to force Michael Eisner to step down as chairman. The victory was bittersweet, however, because of the extensive ransacking that this insider had already done. Another example is the recent success of a shareholder resolution that led the drug giant Merck to refuse to offer Richard Clark, the new CEO, the chairmanship. Instead, the board took the unusual step of having a troika of directors acting as “chair.”⁷

The way the CEO-chairman gets his or her cronies on the board is through the current election system. The way it works now is that the company sends out the election ballot to all shareholders. When the shareholder receives the ballot, it has only two options, “yes” or “abstain”. If every single shareholder but one abstains, the CEO-chairman gets the crony director he or she wants. Of course, they also get the lock-hold on setting their salary as well as the gifting of employee stock options to themselves through their “good ol’ boy” board they have created. The SEC tried to change this by forcing corporations to allow shareholders to write in their candidates for directors.

Not surprisingly, the special interest lobbying group for American corporate executive insiders, the Business Roundtable, was able to buy support from congress and the SEC was forced by capital hill to abandon the proposal. Arthur Levitt, as former head of the SEC, fought for nearly a decade to force inside corporate executives to report the gifting of employee stock options as a cost on the accounting books. To Levitt’s bitter disappointment, the Business Roundtable succeeded in garnering support from Congress. Senator Joseph Lieberman, Al Gore’s Vice-Presidential running mate in the 2000 elections, spearheaded the defense of excessive insider compensation. For more about this read Arthur Levitt’s book *Take on the Street*.

Eisner’s Disney is a prime example of poor corporate governance. The board of directors included Eisner’s friends like actor

7

A troika is defined as an association or a group of three.

Sidney Poitier, architect Robert A.M. Stern, who has designed many Disney properties, and former Senator George Mitchell, who consults for Disney. The board's poor judgment was best seen in the obscene compensation packages it awarded him during his tenure as CEO. In the spring of 2001, *Forbes* concluded that in the previous five years, Eisner had made \$737 million. And this was during a period when profits fell and the company's stock had performed poorly.

Eisner made a lot of stupid business decisions, including a spat with Jeffrey Katzenberg, genius behind such movies as *Shrek*, who left, taking the big green ogre with him. He was also responsible for the hiring and firing of the grossly overcompensated Michael Ovitz, losing the Pixar deal (which went on to make a fortune), and triggering a revolt by Roy Disney and Stanley Gold. After Frank Wells died, there was nobody at Disney with the power or guts to say no to Eisner.⁸ In large part, this is because Eisner was so good at stocking the board with ceremonial directors and, even worse, personal cronies. The board included such "luminaries" as Eisner's personal lawyer, his architect, and the principal of the elementary school attended by one of his children.

In 2002, reforms at Disney included changes to the board that led to corporate governance improvements. Yet Eisner managed to turn even those reforms to his own advantage. Roy Disney, part of the original founding family and Walt Disney's nephew, was forced out by a mandatory retirement provision, which exempted former CEOs! The only other persistent Eisner critic on the board — Disney's ally Stanley Gold — was kept off key committees because his business dealings with the firm meant he did not qualify as an independent director under the 2002 reforms.

The long-term problem at Disney was that virtually every

⁸ Previously, Wells had worked for Warner Brothers as its vice president in 1969, then in 1973 as president and in 1977 as vice chairman until he left the company in 1982. Disney shareholders Roy E. Disney and Stanley Gold recruited Wells to become Disney's second-in-command, under Michael Eisner, in their bid to oust CEO/President Ron W. Miller. Over time, Wells became very outspoken against Eisner's bad management.

mechanism created to hold boards of directors accountable for their actions failed. Board of director independence to act failed because the board was comprised of nominally independent folks who in fact were cronies of Eisner or “know-nothing” ceremonial directors. Shareholder activism failed because voting never made a serious dent in the board’s complacency. Litigation failed because the board was willing to pay zillions to Ovitz, Katzenberg, and anyone else who sued. The Sarbanes-Oxley Act and other post-Enron reforms failed because Eisner was so good at boardroom politics that he was able to use even those reforms to further entrench himself in the company.⁹ Don’t forget, corporate inside executives don’t give a hoot about you!

WALLET DOCTOR SURVIVAL RULE #4

LEARN TO THINK FIERCELY INDEPENDENTLY!

Preferred Stock

Like common stock, **preferred stock** represents ownership interest in the corporation, but as the name implies, it receives “preferential” treatment over common stock with respect to dividend payments and a claim against the firm’s assets in the event of a bankruptcy or liquidation. In liquidation, preferred stockholders are entitled to the issue price of the preferred stock plus accumulated dividends after other creditors have been paid but before common stockholders are paid.

Preferred Stock Dividends

Preferred stock is usually sold in terms of the dollar amount of its dividend. This dividend is different than a common stock dividend.

⁹ The U.S. federal Sarbanes-Oxley Act (SOX) was created in 2002 to protect investors by supposedly improving the accuracy and reliability of corporate disclosures. The act covers such issues as establishing a public company accounting oversight board, auditor independence, corporate responsibility and enhanced financial disclosure. The act came in the aftermath of a series of corporate financial scandals, including those affecting Enron, Tyco International and WorldCom (now MCI).



TIP: The very best way to invest long-term in the stock market is through a Roth IRA using an on-line brokerage!

With a common stock dividend, corporate inside executives can change the amount or arbitrarily decide not to pay it. A preferred dividend is a fixed obligation of the firm — similar to the interest payments on corporate bonds which are also fixed payments.

Bonds are loans that the company has to pay back in principal and interest. The company makes a one lump repayment of the principal when the bond comes due and

has to make interest payments every so often as per the terms of the bond. The key thing to understand is that a bond is a loan to the corporation made by investors while stock is ownership. A corporation will go into default for not making an interest payment but not for passing on making a common stock dividend payment.

Most preferred stock is nonparticipating and cumulative. Let me explain: Preferred stock is **non-participating** in the sense that the preferred dividend remains constant regardless of any increase in the firm's earnings. Firms can decide, however, not to pay the dividends on preferred stock without going into default. Default is a fancy way of saying going bad on a loan. In other words, preferred dividends are not loan payments that corporations absolutely have to pay like they do when they sell bonds or go to a bank for money.

The **cumulative** feature of preferred stock means that the firm cannot pay a dividend on its common stock until it has paid the preferred stockholders the dividends in arrears. In other words, the dividends are supposed to be paid out quarterly, just like bond interest payments. If the company cannot make the preferred dividend payment, the company still owes the dividends to the preferred shareholders if they can make them in the future. The company has to pay the preferred shareholders before the common shareholders, and that is why they call them preferred. Some preferred stock is issued with adjustable rates. **Adjustable-rate preferred stock** became popular in the early 1980s, when interest rates were rapidly

changing. The dividends of adjustable rate preferred stocks adjusted periodically to changing market interest rates.

Preferred Stock Voting

Generally, preferred stockholders do not vote for the board of directors. Exceptions to this rule can occur when the corporation is in arrears on its preferred dividend payments.

Convertible Securities

Convertible securities are important for you to understand, because they affect the float of common stock — the total common shares outstanding available for public purchase. As you will learn later in this book, when the float increases it has a tendency to depress the price of a common stock. It can be very useful to know if there is a lot of convertible securities around that could be added quickly to the float of common stock. Sudden increases in the shares outstanding of a firm are one of the clues you will learn to look for that tell you insiders are bailing out at the top of a long extended upward price run — which should make you start to consider selling out as well.

Convertible preferred stock can be converted to common stock at a predetermined ratio (such as two shares of common stock for each share of preferred stock). By buying such a stock, you can get a good dividend return. If the common stock rises in price, your convertible preferred stock will



HUMOR: A mathematician, an accountant and a stock analyst apply for the same job. The interviewer calls in the mathematician and asks “What does two plus two equal?” The mathematician replies “Four.” The interviewer responds “Four, exactly?” The mathematician looks at the interviewer incredulously and says “Yes, four, exactly.” Then the interviewer calls in the accountant and asks the same question. The accountant says “On average, four - give or take ten percent, but on average, four.” Then the interviewer calls in the stock analyst and poses the same question “What does two plus two equal?” The stock analyst gets up, locks the door, closes the shade, sits down close to the interviewer and says “What would you like it to equal?”

increase in value because you can choose to convert your preferred stock into common stock if you want. If you do convert, however, you will not get any more preferred dividend payments.

Convertible bonds are bonds that can be exchanged for shares of common stock. Until it is converted, it is corporate debt. The bond interest and principal payments are contractual obligations of the corporation that must be paid, or the corporation will go into default (deadbeat status). Most convertible bonds are **subordinated debentures**, meaning that they get paid after other bonds are paid if cash is tight in the corporation.¹⁰ Investors who own convertible bonds have a lower ranking claim against corporate profits than most other debt holders, but their claim ranks higher than stockholders. Stockholders are at the bottom of the food chain when it comes to corporate profits, but are willing to take on this risk because of the possibility of potentially fantastic rises in stock prices. The increases in stock price in last century alone have made many average or even uneducated Americans rich. It is easier for you to get rich in stocks than it is in real estate if you understand how the equity markets really work.

Because convertible bonds increase in value with rising stock prices and provide the fixed income and security of bonds, they are popular with investors, who are usually willing to pay more to acquire convertible bonds over conventional bonds issued by the same corporation. From the corporation's point of view, convertible bonds provide a way for the corporation to issue debt in the form of bonds and later convert it to equity at a price per share that is more than the current per share price of the stock in the open equity market.¹¹ This feature is attractive because it allows the corporation to "sell" stock at a higher future price. In other words, if you convert your bonds to stock, then the company is off the hook in terms of repaying the initial loan you made to them when you bought the bond.

As an investor, I recommend that you focus on common stocks

¹⁰ Debentures are unsecured bonds that are only issued by creditworthy firms. Convertible bonds are almost always debentures and are also known as an unsecured junior bond.

¹¹ Equity market is fancy way to say stock market.

and avoid convertible bonds. You will hopefully become wealthier buying the right common stocks. When you have made so much money in stocks, the low but guaranteed interest return on Treasury bills could support your lifestyle needs. Then you can simply start investing in AAA corporate bonds or even Treasury bills, Treasury notes or Treasury bonds.

Equity Markets

The table below shows the distribution of stock ownership of equity securities in the United States in 1998. Households dominated the holding of equity securities, owning over 40% of outstanding corporate equities. Pension funds, both private and public, are the largest institutional holders of stock, followed by mutual funds and foreign investors. These investors come to own equity securities through either primary or secondary market transactions.

Households Dominate The Holdings of Equity Securities

Holder	Amount	Relative Amount
Households	\$5,349,000,000	41.9%
Pension Funds	\$3,059,000,000	24.0%
Mutual Funds	\$2,029,000,000	15.9%
Foreign Investors	\$934,000,000	7.3%
Insurance Companies	\$765,000,000	6.0%
Bank Personal Trusts	\$433,000,000	3.4%
Other	\$189,000,000	1.5%
Total	\$12,758, 000,000	100.0%

Source: Federal Reserve, Flow of Funds Account of the United States, Third Quarter 1998.

Primary Market

New issues of securities are called primary offerings. Stock purchases through primary offerings are called **primary market** transactions. The company can use the funds raised by the sale of securities in primary offerings to expand production, enter new markets, further research and enhance other aspects of the firm's operations.¹²

12 For the purpose of this book firm, company and corporation mean the same thing, and I



TRAP: Because of really low interest rates, many fixed income investors look for higher yielding, lower-quality bonds called “junk” bonds. Wall Street tries to make these double digit returns in the junk-bond market seem secure to suck investors in. Don’t make this mistake! Junk bonds carry enormous risk. In fact, they are really a form of fixed income gambling. Many of these issues go into default, becoming worthless. Without realizing it, these investors are purchasing sub-standard securities in the hope that nothing goes wrong.

If the company has never before offered a particular type of security to the public, meaning the security is not currently trading in the secondary market, the primary offering is called an **unseasoned offering** — also called an **initial public offering (IPO)**. Once a company has its shares of stocks publicly trading in the stock market, the inside corporate executives can tell how much money the public will pay if the firm issues more shares. This allows them to figure out if it is cheaper to get money through a bank loan (interest rates are low), sell bonds (interest rates are low and company has a good bond rating), or issue more stock and sell it to the public (share price or interest rates are high). To sell more shares of the same stock, the corporation uses the secondary market. In other words, if the firm has already issued similar equity securities (stocks) that are

trading in the secondary market, and is offering more of the same class of stock, this is known as a **seasoned offering**.

Here is what I mean. Wal-Mart “went public” in 1978, making its first IPO of common stock that immediately started trading on the New York Stock Exchange under the ticker symbol “WMT.” This was an unseasoned offering, because it had never issued public shares before. Once the stock has traded on the exchange, it is said to have “seasoned” like an aged wine. When WMT issued more shares of the same common stock, it was called a seasoned offering because it was just more of the same stock being pumped onto the market.

A **ticker symbol**, also simply called a **symbol**, is a system of letters used to uniquely identify a stock or mutual fund. Symbols with up to three letters are used for stocks which are listed and trade

use these words interchangeably.

on the NYSE. Symbols with four letters are used for NASDAQ stocks. Symbols with five letters are used for NASDAQ stocks that are not single issues of common stock. Symbols with five letters ending in X are used for mutual funds.

Companies raise money much more cheaply when the stock price increases significantly because they can sell seasoned offerings to the public. They don't have to pay principal and interest to bondholders or loan payments to banks when they capitalize (raise money) through seasoned offerings. A seasoned offering is what a company does to raise more money for operations. Alternatively, if the company's stock price drops a lot, then it becomes more expensive for the company to capitalize because they have to use more bond or bank financing. Note that a seasoned offering at high share prices also increases the float and tends to depress the share price, so it is not necessarily good for shareholders. This does not mean that insiders are selling out, so don't get too nervous when this happens.

All securities undergo a single primary offering of an IPO in which the issuer receives the proceeds of the offering and the investors receive equity securities. Thereafter, whenever the securities are bought or sold, the transaction occurs in the secondary market and money and shares are transferred between shareholders as they buy and sell the stock among themselves.

New issues of equity securities may be sold directly to investors by the issuing corporation, but are usually distributed by an **investment banker** in an underwritten offering, a private placement or a shelf registration. The most common distribution method is an **underwritten offering** in which the investment banker purchases the securities from the firm at a guaranteed amount known as the **net proceeds**, then resells the equity securities to public investors for a greater amount, called the **gross proceeds**. The difference between the net and the gross proceeds is called the **underwriter's spread**, which compensates the investment banker for the expenses and risks involved in the offering.

Also, some equity securities are distributed through **private place-**

FACT

FACT: In 2000, CEO Steven Jobs' crony-controlled board of directors at Apple Computer (AAPL) awarded him 20 million shares in employee stock options — a lot of shares that will one day bloat the float at the top of an upward price run and help crash the stock price. Today in 2006, those shares are worth over \$500,000,000!

ments in which the investment banker acts only as the company's agent and receives a commission for placing equity securities with investors. In addition, occasionally a company will place equity securities with its existing shareholders through a rights offering. In a **rights offering**, a company's existing stockholders are given the rights to purchase additional shares at a slightly below-market price in proportion to the current ownership in the company. Stockholders can exercise their rights to own the equity security offered or sell off their rights to another investor.

An important innovation in the sale of new corporate securities (equity and debt)

is shelf registration. **Shelf registration** permits a corporation to register a quantity of securities with the Securities and Exchange Commission (SEC) and sell them over time rather than all at once, thus the issuer is able to save time and money through a single registration. In addition, with shelf registration, securities can be brought to market with little notice — thereby providing the issuer with maximum flexibility in timing a seasoned offering to take advantage of favorable market conditions. For example, **Sirius Satellite Radio (SIRI)** filed a \$500 million shelf registration on July 5th, 2001 when the stock price was around \$10 per share. This shelf registration allows them to raise money cheaply and quickly if the stock price skyrockets in the future because they don't have to hassle with the SEC. They can issue a seasoned offering very quickly due to the shelf registration.

Factors Affecting Underwriter Spreads

The **gross proceeds** of an underwritten offering, you'll recall, is the total profit of selling the stock and the **net proceeds** are what is left over

after the investment banker takes his commissions and fees for helping the corporation make the offering. In an underwritten offering, the investment banker's profit, the **underwriter's spread**, is the difference between the gross proceeds and the net proceeds. Several factors affect the size of the spread.

First, the underwriter's spread is inversely related to the size of the offering. In other words, the larger the offering, the smaller the spread tends to be as a percentage of the amount of funds being raised by the company. Second, the more uncertain the investment bankers are concerning the market price of the equity securities being offered the larger the underwriter's spread tends to be. The reason for this is that in an underwritten offering, especially an unseasoned offering, the investment banker bears all of the price risk — the investment banker could lose money if the price of the stock turns out to be lower than anticipated because the public doesn't want it. Third, shelf registrations tend to have lower spreads than ordinary offerings. This is due in part to the fact that larger, more well-known companies employ shelf registrations. The stock is already trading so there is less price risk to the underwriter.



HUMOR: Diversification is defined as, "things go wrong all at once, but go right gradually!"

Secondary Markets

Any trade of a security after its primary offering is called a **secondary market transaction**. When an investor buys 100 shares of IBM on the New York Stock Exchange, the proceeds of the sale do not go to IBM, but rather to the investor who sold the shares. In the United States, most secondary market equity trading is done either on organized exchanges, such as the New York Stock Exchange (NYSE), or in the **over-the-counter market (OTC)**.

From an investor's perspective, the function of secondary markets is to provide liquidity at fair prices. **Liquidity** is the speed at



HUMOR: The Pope and a full service stockbroker are on the elevator to heaven. When they arrive at the gates, there's a mad rush of angels, saints, and other holy people on their way to greet them. When they arrive, they pick the full service stockbroker up on their shoulders and carry him off cheering hysterically. The Pope is deeply saddened. St. Peter sees this and goes over to him and says, "Don't feel bad. We get Popes in here all the time; it's not every day we get a full service stockbroker!"

which an asset such as stock, bonds, or real estate can be converted into cash without a discount. Stocks and bonds, for instance are much more liquid than real estate. In other words, liquidity is how fast you can get in and out of the market at what you feel is a good price. An **asset** is any item of economic value owned by an individual or corporation, especially that which could be converted to cash.¹³

Investors want liquidity in the stock market for three reasons. *First*, they have new information about a particular stock of a company and want to buy or sell. *Second*, they want to save by setting aside money for retirement or a rainy day by buying securities or they need money now and un-save by selling securities. *Third*, their attitude towards risk changes and they wish to re-

structure the composition of their portfolio — like selling out at the top of a bull market when they begin to notice heavy corporate executive insider selling.

Liquidity exists if investors can trade large amounts of securities without affecting prices — a high volume of trading does not make the price bounce around much. Prices are said to be fair if they reflect the underlying value of the security correctly. The problem is that it is very hard to determine what the true value of a stock is, but there are some strong clues most people don't know how to recognize. You will learn more about these clues towards the end of this book. Keep reading, because there is a huge payoff — if you read this entire book

13 Examples are cash, securities, accounts receivable, inventory, office equipment, real estate, a car, and other property. On a balance sheet, assets are equal to the sum of liabilities, common stock, preferred stock, and retained earnings. From an accounting perspective, assets are divided into the following categories: current assets (cash and other liquid items), long-term assets (real estate, plant, equipment), prepaid and deferred assets (expenditures for future costs such as insurance, rent, interest), and intangible assets (trademarks, patents, copyrights, goodwill).

you will know more about the right way to invest in the stock market than nearly all of the “*professionals*.”

There are three liquidity-related characteristics of a secondary market that investors find desirable: depth, breadth, and resiliency. *First*, a secondary market is said to have **depth** if there are orders both above and below the price at which the security is currently trading — people are waiting on the sidelines at each price increment to enter the market if the price goes up or down. When a security trades in a deep market, temporary imbalances of purchase or sale orders (that would otherwise create substantial price changes) encounter offsetting, and hence stabilizing, sale or purchase orders reducing noisy price volatility. *Second*, a secondary market is said to have **breadth** if orders in large volume give its market depth — lots of people are waiting to enter the market at each price increment above and below the current trading price. The broader the market for a stock, the greater the potential for stabilization of temporary price changes that may arise from order imbalances. *Third*, a market is **resilient** if new orders pour in promptly in response to price changes that result from temporary order imbalances — investors act very quickly buying or selling when the stock price moves up or down. For a market to be resilient, investors must be able to quickly learn when stock price changes occur. However, what investors are most concerned with is having complete information concerning a security’s current price and where that price can be obtained.

There are four kinds of secondary market: direct search, brokered, dealer and auction. Each of these types of secondary markets differs according to the amount of information you get concerning prices. You need to know the nuances of these different markets as a stock investor.

Direct Search Secondary Markets

The secondary market that offers you the *least* complete price information — buyers and sellers have to search for one another di-

rectly — is the **direct search secondary market**. Because the full cost of locating and bargaining with a willing and capable trading partner is paid for by an individual investor, there is only a small incentive to conduct a thorough search among all possible trading partners in the market for the best possible price. Not searching because of high cost means that, at the time a trade is agreed upon by two investors, at least one of the participants could have gotten a better price if they were in contact with some participant they never found. Stocks that trade in direct search markets are ones that people buy and sell very infrequently. This means a third party, like a broker or a dealer, has no profit incentive to provide any kind of service to facilitate trading in direct search markets.

The common stock of small companies, especially small banks, trade in direct search markets. Buyers and sellers of those issues must rely on word-of-mouth communication to attract compatible trading partners to buy from or sell to. Very few trades means there is no economical way of broadcasting quotations or transaction prices, trades can occur at the same time at quite different prices, and transactions frequently occur away from the best possible price. My advice to you is to stay away from stocks that you have to buy and sell by direct search.



TIP: Online discount stock brokerages allow you to buy and sell in the convenience of your home at low cost with no human intervention. By trading directly online, Wall Street cannot brainwash you into bad investing! Examples: Ameritrade.com, E-trade.com, ScottTrade.com, and fidelity.com.

Brokered Secondary Markets

When trading in an issue (a specific stock) becomes sufficiently heavy, brokers begin to offer specialized search services to market participants. For a fee, called a **brokerage commission**, brokers help find compatible trading partners and negotiate acceptable transaction prices for their clients.

Brokers are more likely to be involved in the market when there are economies of scale in searching — when they can make

money because a lot of investors are in the market. If brokers can fill two customers' orders at a cost less than twice the cost of the direct search — that would otherwise be conducted by each of those customers — then brokers will offer their services. By charging a commission less than the cost of direct search, they give investors an incentive to make use of the broker's special information. This is important because they can profitably acquire the business of both investors by charging a commission somewhat less than the cost of a direct search.

Since brokers are frequently in contact with many market participants on a continuing basis, they are likely to know what a “fair” price is for a transaction. Brokers will usually know whether the offering price of a seller can easily be improved upon by looking elsewhere. They know whether it is closest to the lowest offer price likely to be offered by some other investor in the market. Brokers provide these trade matching services at a cheaper price than the investor's own cost of searching. Stockbrokers also arrange transactions closer to the best available price for the investor than is possible in a direct search market. Their extensive contacts provide them with a pool of price information that individual investors could not economically duplicate because it is too costly for an individual.

Dealer Secondary Markets

A brokered market is better than direct search, but has the disadvantage that it can't guarantee the investor's orders will be executed promptly. Uncertainty about the speed of execution creates price risk. While a broker is searching out a willing and able trading partner for a client, securities prices may change and the client may suffer a loss. However, if trading in a stock issue is active enough, some market participants may begin to maintain bid and offer quotations of their own. **Dealers** buy and sell their own inventory at their own quoted prices. Dealer secondary markets eliminate the need for time-con-

suming searches for trading partners because investors know they can buy or sell immediately at quotes given by the dealer.

Dealers earn a living (in part) by selling stocks at an asking price greater than the bid price they pay. Their **bid-ask spread** compensates them for providing liquidity of an immediately available market to occasional market participants — you buy and sell every now and then but they are there ready every day to help, for a price. The bid-ask spread also pays for the risk dealers incur when they position an issue in their inventory — the dealer may lose money on the stock he or she is holding in inventory to sell to you or buy from you when you come around every so often.

The bid-ask spread is really just two prices people are willing to pay or accept for their stock. The **bid price** is the highest price that someone is willing to pay to buy your shares of stock; this also means it is the highest price you can expect to get for your shares of stock when selling them. It is always lower than the ask price. The **ask price** is the lowest price you can pay for a stock; this is because it's the lowest price any seller is offering their shares of stock for. Although the ask price might be \$14, you might pay slightly higher if you put in a large order, because the dealer has to look around a lot to find other sellers to fill the order.

In most cases, dealers do not quote identical prices for a stock because they disagree about the value or because they have different inventory objectives — they may want to get rid of the stock they have or they are loading up. Even in a dealer market, investors have to search out the best prices for their trades. The expense of contacting several dealers to obtain comparative quotations is borne by investors. But since dealers have an incentive to advertise, their willingness to buy and sell their inventory will be well known and such contracts can usually be completed quickly. The ease of searching among dealers guarantees that those dealers quoting the best price will be most likely to do business with investors.

Although dealer markets provide investors with the opportunity for an immediate execution of their orders, and although

dealer markets can usually be searched more rapidly and cheaply than a direct search or brokered markets, they do have several disadvantages. No one can guarantee that the quotation of a particular dealer could be improved upon by contacting another dealer. This being the case, investors operating in dealer markets have to bear some cost of searching for the best price.

A second factor in dealer trading is the expense of a dealer's bid-ask spread. Suppose one investor is willing to sell a stock at \$99, and another is willing to buy the same stock at \$101. If they could meet, they might agree to trade at \$100, each doing better than his reservation (desired) price. Rather than incur the expense of searching each other out, however, they might both prefer to trade with a dealer bidding on the stock at $\$99\frac{1}{2}$ and offering the stock at $\$100\frac{1}{2}$. They would be giving up a half point each to the dealer's bid-ask spread to avoid the cost of the search, even though they could have done better if each investor had known the other was looking to trade. Although dealers stand ready to trade, it would be better for the investors if they could trade directly, inside the dealer's quotations, whenever possible.

Auction Secondary Markets

Auction markets provide centralized procedures for the exposure of purchase and sale orders to all market participants simultaneously. In other words, an auction market is a place everyone who wants to buy and sell can go. This is important because auction markets virtually eliminate the expense of locating compatible partners and bargaining for a favorable price. The communication of price information in an auction market may be oral, if all participants are physically located in the same place, or the information can be transmitted electronically.

Factors Affecting the Size of Bid Ask Spreads

Spreads between dealers' bid and ask prices are not the same for all equity securities. They range from as low as $\frac{1}{32}$ of a dollar on fre-



HUMOR: Three stock analysts went out hunting, and came across a large bear. The first analyst fired, but missed, by a meter to the left. The second one fired, but also missed, by a meter to the right. The third analyst didn't fire, but shouted in triumph, "We got it! We got it!"

quently traded issues to several dollars on securities that hardly ever trade. The wide range of spread sizes exist because of differences in the trading costs of various securities. These trading costs are a function of issue characteristics of the stock and its trading patterns. In particular, the factors affecting the size of the bid-ask spread for equity securities include the price of the stock, the size of the transaction, the frequency of transactions, and the presence in the market of investors trading on inside information.

Other things being the same, the bid-ask spread for a stock should be proportional to

its price. That is, higher priced stocks tend to have larger absolute spreads. However, due to some fixed transactions costs, higher priced stocks tend to have lower bid-ask spreads in percentage terms.

Extremely small transactions and extremely large transactions tend to have larger bid ask spreads in percentage terms, because they are a pain in the rear for the broker. Small transactions generate larger spreads because of the hassle of filling small orders in less than a **round lot** of 100 shares. For larger transactions, the spread between bid and ask prices is larger because the dealer is providing more of a liquidity service than would be the case for a normal-size trade — large orders require a lot of smaller buyers that the broker has to find.

The frequency of trades for a particular stock also impacts the bid-ask spread. Since the dealer is providing liquidity service, the more frequently a stock is traded, the less costly it is for the dealer to provide investors with liquidity so that their orders clear. In other words, if there are a lot of people who are buying and selling the stock right now, it is a lot easier for the dealer to find buyers and sellers. This is because the dealer can hold a smaller inventory of the stock when trading is more frequent, decreasing inventory costs.

The presence of **short-term insiders**, traders who have short-term inside information the public doesn't about the short-term value of a stock, will cause dealers to widen the bid-ask spread. This is important to understand because dealers may lose in transactions with better-informed traders in the short run. Traders who have **short-term inside information** will sell when the current price is too high because they know the price will quickly drop. An example of short-term inside information would be a corporate secretary secretly photocopying a confidential report about an upcoming merger and then giving it to her husband. In this case, the couple would know that the stock price would go up or down the day the news of the merger is released.

Dealers who transact with inside traders end up paying a price that is too high when the short-term inside information is bad news about the stock. Alternatively, dealers will end up selling at too low of a price when the short-term inside information is favorable and short-term insiders know that the stock is going to quickly rise. Unfortunately, dealers find it difficult to separate traders acting on short-term inside information from those traders without such information. Traders and investors without short-term inside information are known as **uninformed**. Dealers increase the spread to compensate for potential losses when they know that they are probably trading against investors with short-term inside information.

I want you to understand the short run dynamics of the stock market, but remember that everything is different in the long run. There is an entirely different type of insider that operates in the long run. In my home study course "*Bulletproof Stock Investing ... what the insiders don't want you to know!*", I teach you how to spot potential long-term inside trading using long-term price charts. Long-term insiders do not affect the bid-ask spread. I am the only person who teaches about long-term inside trading. Inside trading is illegal, but very loosely and ineffectively monitored by the SEC, especially long-term. Still, inside traders, both short- and long-

term, must keep their activities a secret for fear of prosecution by the SEC. For this reason, there is very little academic research on inside trading and none with data of quality.

Equity Trading

Several thousand stocks are listed and traded on organized stock exchanges, while there exist perhaps 30,000 other “unlisted” stock issues that the public can buy and sell but are not listed on any exchange. These “unlisted” stocks trade in the over-the-counter market, also called the **OTC** market.

Over-The-Counter and NASDAQ

Securities not sold on an organized exchange like the NYSE are said to be traded **over-the-counter (OTC)**. A stock may not be listed on an organized exchange for several reasons, including lack



TIP: Get started today setting aside whatever you can for investing. Many stock market millionaires started setting aside as little as \$5 or \$10 per week for the stock market. They sent it in monthly or let it build up and contributed every three to six months or so. Identifying a good stock and buying every chance you can is called dollar-cost averaging. If you don't start somewhere, you will never get anywhere!

of widespread investor interest, small issue size, or insufficient order flow. The OTC stock market is a dealer market. Since different OTC issues are not usually close substitutes for each other, a dealer with limited capital can make a successful market, even in a relatively narrow range of stocks, by carrying inventory of the stock. **Inventory** here is defined as securities, in this case stocks, bought and held by a broker or dealer for resale. As a result, there a large number of relatively small **OTC dealers**. OTC dealers, however, often concentrate their trading in particular industry groups or geographical areas, like the high-tech industry or companies located in California. At least 30,000 various types of equity secu-

rities are traded in the OTC market. However, only about 15,000 of these securities are actively traded.

When a customer places an order to buy or sell a stock in the OTC market, the broker or dealer contacts other dealers who have that particular stock for sale. Public orders for purchase or sale of stock are often executed by brokers acting as agents for their own customers. When handling a public order, a broker will contact several dealers to search out the best price. When a broker is satisfied with a dealer's quoted price, he or she will complete the buying or selling transaction with that dealer and charge his or her customer the same price, plus a commission for the brokerage services. Investors use brokers to locate the most favorable dealer because investors are usually unfamiliar with which dealers are making markets in specific stocks. Investors also use brokers because they can contact dealers at a lower cost. Brokers can capitalize on economies of scale in searching; it costs the broker a lot less money to search for an off-setting buyer or seller of stock than the investor.

When handling a customer's order, a broker has two problems to deal with. First, he has to figure out which dealers are market makers in the stock the investor is buying or selling. Second, he has to figure out which of these dealers is quoting the best price to you. Before 1971, the first problem was easily resolved by looking at the "**pink sheets**" compiled by the **National Quotation Bureau (NQB)**. These sheets, printed on pink paper, are still distributed daily to subscribing dealers. The pink sheets list bid and ask prices submitted by dealers to NQB the previous afternoon.

Because of the delay, pink sheet quotes are always "stale." Nearly a day passes between the submission of a quote to NQB and the distribution of the pink sheets to market participants, including your broker. More generally, a dealer could not be expected to sell a stock on Thursday morning at the offer price quoted Wednesday afternoon. Thus, the pink sheets are more a vehicle for advertising interest in an issue than for publishing firm price quotations. The pink sheets are of real value, however, for figuring out which dealers are active in a given issue.

After a broker has found out which firms are dealing in a stock, he or she must next locate the best price for you. Up to 1971, this search process was conducted exclusively by telephone or Teletype. A broker handling an order typically called several dealers, got hit with big telephone charges and wasted a lot of his or her time calling around. These costs reduced the desire of the broker to make a complete search of the OTC dealer market and often resulted in orders filled at bad prices — these are executions away from better (undiscovered) prices.

A major development of the OTC market occurred in 1971, when the **National Association of Securities Dealers (NASD)** introduced an automatic computer-based quotation system (**NASDAQ**). The system offers continuous bid and ask prices for the most actively traded OTC stocks. NASDAQ is basically an electronic pink sheet that significantly helped the existing structure of the OTC market. NASDAQ really accelerated the disclosure of price information and fundamentally altered the structure of the OTC market.

There are three levels of access to the NASDAQ system. **Level 3 NASDAQ terminals** are available only to dealers and allow them to enter bid and ask quotations for specific stocks directly into the system. These quotations, together with information identifying the stock and the dealer, appear within seconds on the terminals of other dealers and brokers. For this reason, the NASDAQ

never has stale prices like the pink sheets. **Level 2 NASDAQ terminals** display all dealer price bid and ask quotations for a given stock, but do not allow quotations to be changed on the terminal. These terminals are available to brokers and institutions. **Level 1 NASDAQ terminals** provide only the best bid and ask prices (called the **inside quote**) for a stock. These terminals are used by stockbrokers when quoting prices to their customers.



HUMOR: "I'm thinking of leaving my husband," complained the full service stockbroker's wife. "All he ever does is stand at the end of the bed and tell me how good things are going to be!"

NASDAQ's most important contribution to enhancing the OTC market was accelerating the disclosure of dealer quotations to brokers. NASDAQ did little to increase the identification of dealers beyond the reach of the pink sheets, but it did greatly increase the efficiency of a broker's search for the best bid and ask prices. NASDAQ greatly reduced the amount of trading away from the best available prices. Whereas investors were overpaying for stock they bought or underselling the stock they sold, with NASDAQ, more transactions were taking place at true market value.

Stock Exchanges

A stock exchange is actually two markets in one. First, it is a place where a new company can raise millions or billions of dollars overnight by offering ownership to hundreds or thousands of small investors. These pieces of ownership, as I mentioned before, are called "shares of stock." Secondly, the exchange is a place where people can sell their stock to someone else whenever they wish.

You can be in the airline business one day and then get out of it in the next and into the automobile industry. This ability to get in and out and get paid for your investment drives the success of stock exchanges worldwide. Forty percent of American families own stock in U.S. companies, either directly or through mutual funds and pension plans. The exchange lets these families know how they are doing financially by placing a value on their stock.

The **New York Stock Exchange (NYSE)**, the pre-eminent, largest and most organized stock exchange in the United States, is an example of an auction market. Other **regional stock exchanges** in the United States include the **American Stock Exchange (AMEX)** in New York, the Pacific Stock Exchange in both San Francisco and Los Angeles, the Chicago Stock Exchange (formerly the Midwest Stock Exchange), the Philadelphia Stock Exchange, the Boston Stock Exchange, and the Cincinnati Stock Exchange. The table below shows the trading volume on the major United States exchanges. The NASDAQ and

the NYSE account for the vast majority of stock trading while regional exchanges account for little of the total stock trading volume in the United States.

United States Trading Volume	
Exchange	Trading Volume*
NASDAQ	858.70
NYSE	737.14
AMEX	32.28

* Millions of shares

Source: The Wall Street Journal, February 26, 1999.

All transactions completed in a stock listed on the NYSE occur at a unique place on the floor of the exchange, called a **post**. There are three major sources of active bid prices and ask prices in a stock issue available at a post: (1) **floor brokers** executing customer stock orders, (2) **limit orders** for stock left with the specialist for execution and, (3) **specialists** in the stock buying and selling for his or her own account. Since trading is physically localized, the best available bid-and-offer quotes are very available. Competition and ease of communication among market participants gathered at a post ensure there is the right priority of execution and also fill bids above the lowest ask price or asks below the highest bid price for the stock.



TRAP: Most people who fail do so because they never start — they just dream and never take action. North American football legend Fran Tarkenton held the quarterback record of 3674 pass completions until 1995. The rest of the story is that he also held the record for number of passing failures — he threw more passes than anyone else! After retiring from football, he became a motivational speaker, teaching people the importance of taking action toward what they really want out of life.

Orders from the public are transmitted by Internet, telephone or telex from brokerage houses to brokers on the floor of the NYSE, who bring the orders to the appropriate posts for execution. Most of these orders are either market orders or limit orders.

A **market order** is an order to buy or sell at the best possible price available at the time the order reaches the post. The broker

carrying a market order to a post might execute the order immediately, or might hold back all or part of the order for a short time to see if a better price is available. He or she may also decide to quote a price on the transaction that is inside the current bid-and-ask prices. This gets the client's order in front of other orders at the post and reduces the amount of time the broker will have to wait until completing the trade.

A **limit order** is an order to buy or sell at a designated price, or better if possible. The designated price that the client requests is called the **limit price**. Investors place limit orders when they want to buy or sell at a price somewhere above or somewhere below the bid-ask spread. In other words, a limit order is actually a desired bid for stock when buying or ask when selling a stock. A floor broker handling a limit order to buy at or below a stated price, or to sell at or above a stated price, will usually stand by the post with his order if the limit price on the order is near the current market price, which is, of course, the current bid and ask prices.

When a limit order is at a price that is not very close to the current market prices (the bid and ask), the broker handling the order knows it is not likely that the order will be executed anytime soon. For example, a **buy limit order** at \$50 on a stock currently trading at \$55 may not be satisfied for days, and may never be satisfied. The broker presenting the order wants to make sure that the order is executed as soon as possible, but does not want to stand around tendering the order to the post forever. As an alternative to maintaining a physical presence at the post (tendering the order to the post), the broker can enter the limit order on the order book maintained by the specialist. Orders on the book are treated with other orders in terms of price priority. No trades can take place at a particular price unless all bids above and all asks below, that price have been cleared from the book. In other words, the market has to move up through all of the sell limit orders in the book to hit your **sell limit order**. Alternatively, the market has to move down through all other buy limit orders in the book between your buy limit order price at the bottom of the

inside spread before it is filled. Entering a limit order on a specialist's book gives a great alternative to floor brokers who would otherwise have to maintain a physical presence at a post to keep a limit buy or limit sell order active.

Specialists provide the third source of bids and offers in listed securities. On the NYSE, specialists are members of the exchange who are both dealers and order clerks. Specialists have to maintain both bid and ask price quotations at all times, good for at least one round lot of the issue in which they specialize. In this respect specialists act as dealers, trading for their own account and at their own risk. NYSE specialists also maintain the book of limit orders left by floor brokers, and in this way they act as order clerks.

Stocks that are heavily traded do not need specialists — specialist activities in these stocks have been criticized as opportunistic by people off the exchange. Trading on the floor of the NYSE in stocks that have sufficiently heavy trading volume ensures that there is always an active bid or ask available from either floor brokers or the limit order book. For heavily traded stocks, the specialist's dealer function of liquidity to get your orders filled really fast is not a big deal — a lot of people buying and selling a stock in itself creates liquidity. In many stocks, public trading interest is not as strong — it is more sporadic and infrequent. In these cases, the obligation of the specialist to provide liquidity service of immediate execution is really important. In fact, if the prices of the best purchase and sell orders on the specialist's book have a wide spread (which is common for infrequently traded stocks), the specialist may be the sole source of an economical market for immediate transaction because there is nobody out there that wants to buy the stock you are selling or sell you the stock you want to buy.

Global Stock Markets

The secondary markets for equity securities are becoming very competitive. Better communications and computer technology have

really reduced transaction costs, making it easier for other financial intermediaries to compete with securities firms. This has really kicked up heated competition among national exchanges, regional exchanges, over-the-counter markets and foreign exchanges. The trend of change of the exchanges is related to forces of technology and competition — the emergence of a so-called national market system, online discount trading, the move toward 24-hour trading of equity securities, and globalization of equity markets are making the investment world more interconnected.

The Securities Act Amendment of 1975 mandated that the Securities and Exchange Commission (SEC), the primary regulator of U.S. financial markets, move toward creating a national market system. In its ideal form, a national market system would have a huge computer system recording and reporting transactions, regardless of where they take place in the country. It would also be a system that allows investors to get price information from any exchange instantaneously, and to buy or sell stock at the best price regardless of location. Progress has been made toward electronically linking the national exchanges, regional exchanges and over-the-counter markets, but we are still many years away from a truly nationwide system.

There is competitive pressure to link international stock markets as well. Many U.S. firms are issuing stocks on overseas exchanges to take advantage of differences in tax laws, to increase their visibility and reputation worldwide, and to avoid driving down the company's stock price by flooding a local stock market. In 1986, the London Stock Exchange created a computer network similar to the NASDAQ system that permitted U.S. and Japanese investment firms to enter trades on the British system. This development was important because it created a virtual 24-hour global trading environment, given time differences between New York, London and Tokyo. For this reason, many U.S. companies are now listed on exchanges in all three locations. This has also increased interest in Europe for trading stocks of U.S. companies by European investors.

Stock exchanges in the United States are panicked about losing business to overseas stock markets. As a step toward increasing the global competitiveness of the U.S. financial markets, the SEC permitted after-hours trading on the NYSE. Previously, trading on the NYSE took place between 9:30 am and 4:00 pm Eastern time. The NYSE now has several after-hours trading sessions during which shares trade electronically at the day's closing price. The biggest beneficiaries of the NYSE's move toward globalization will be U.S. companies that expect to broaden the market for their securities. The flow of capital across international boundaries makes it easier for firms to raise money for overseas operations and will probably lower the cost of capital in the United States — this would be good news if it weren't for corporate inside executives ready and willing to siphon capital away!

American Depositary Receipts

Japan's Sony and Switzerland's Nestlé are two among many foreign corporations that have discovered the benefits of trading their stock in the United States. Unfamiliar market practices, confusing tax legislation, incomplete shareholder communications, and a total lack of effective avenues for legal recourse tend to discourage U.S. investors from buying shares in foreign stock markets. On the other hand, the disclosure and reporting requirements of the U.S. Securities and Exchange Commission are a pain in the rear end for foreign companies and have kept all but the largest foreign firms from directly listing their shares of stock on the New York Stock Exchange, the American Stock Exchange or the NASDAQ.

Many foreign companies overcome these road blocks and tap into the U.S. market by means of **American Depositary Receipts (ADR)**. ADRs are dollar-denominated claims issued by U.S. banks representing the ownership of shares of a foreign company's stock held on deposit in a U.S. bank for U.S. investors. ADRs can be either sponsored or unsponsored.

A **sponsored ADR** is one for which the issuing (foreign) company absorbs the legal and financial costs of creating and trading the security. An **unsponsored ADR** is one in which the issuing firm is not involved with the issue at all or may even oppose it. **Unsponsored ADRs** typically result from U.S. investor demand for shares of a particular foreign company. With over 1,600 ADRs from 63 countries trading in the United States, they are very popular with U.S. investors, at least in part because they allow U.S. investors to diversify internationally. However, they are still holding a claim that is covered by American securities laws that pay dividends that have to be paid in American dollars (dividends on the underlying shares are converted from local currency into U.S. dollars and then paid to U.S. investors). In other words, you avoid exchange rate risk when you buy ADRs.

Each ADR can represent either a fraction or a multiple of a share of the foreign company. This means that the price of the ADR is within the range of share prices for comparable companies traded in the United States. Because an ADR can be converted into ownership of underlying shares, arbitrage ensures a reasonable price on this claim against foreign-currency-denominated stock. **Arbitrage** is the purchase of stock in one market for immediate resale in another in order to profit from a price discrepancy. Arbitrage is important because it



HUMOR: Three NYSE market makers and three stock investors were going for a trip by train. Before the journey, the investors bought 3 tickets while the market makers only bought one. The investors were glad that the stupid market makers were going to pay a fine. To the investor's astonishment when the conductor was approaching their compartment, all three market makers crammed into the toilet. The conductor noticed that somebody was in the toilet and knocked on the door. In reply the conductor saw a hand with one ticket. He checked it and the market makers saved $\frac{2}{3}$ of the ticket price. The next day, the investors decided to use the same strategy as the market makers — they bought only one ticket. In their excitement they didn't notice that the market makers didn't buy any tickets at all! When the investors saw the conductor, they went straight for the toilet, and when they heard the knocking they handed in their one ticket. They didn't get it back. The market makers took the ticket and went to the other toilet!

keeps prices in line — IBM stock sells for the same price on the NYSE as it does on the AMEX as it does in London because of arbitrage.

For example, Gerdua S.A (“GGB”) established an American Depository Receipt program on the New York Stock Exchange on March 10, 1999. Gerdua is one of Brazil’s leading steel producers. Other foreign companies that have ADRs include Unilever, Royal Dutch Shell, British Airways, Toyota, Bayer, Gucci, De Beers and Siemens. JP Morgan, a large U.S. investment bank and the leading sponsor of ADRs, has established a web site (www.ADR.com) devoted to providing information on ADRs.

Regulation of Equity Markets

Trading in securities in the United States is regulated by several laws. The two major laws are the **Securities Act of 1933** and the **Securities Exchange Act of 1934**. The 1933 act requires full disclosure of relevant in-



TIP: Stock prices have been and still are manipulated on every stock exchange in the world. For that reason, you may succeed investing in bonanza bases — that you will learn about at the end of this book — in every market in the world!

formation relating to the issue of new stock in the primary market. This is the act that requires full registration of an IPO and the issuance of a prospectus that details the recent financial history of the company. SEC acceptance of a prospectus or financial report does not mean that it views the security as a good investment! The SEC is only concerned that the relevant facts are disclosed to investors — you have to make your own evaluation of the stock’s value. The 1934 act established the **Securities and Exchange Commission (SEC)** to administer the provisions of the 1933 act. It also extended

the disclosure of the 1933 act by requiring firms with outstanding stocks — seasoned equities — on secondary exchanges to periodically disclose relevant financial information.

The 1934 act also allowed the SEC to register and regulate securities exchanges, over-the-counter (OTC) trading, brokers

and dealers. The 1934 act established the SEC as the administrative agency responsible for broad oversight of all U.S. secondary markets. In addition to federal regulations, security trading is also subject to state laws. The laws providing for state regulation of securities activities are generally known as “**blue sky**” laws because they prevent the false promotion of securities by fraudsters backed by nothing more than blue sky.

Equity Valuation Basics

Stock valuation is a tricky matter and a subject you must understand as a stock investor. You will hear and read many people in the markets discuss the value of a stock. The question is vitally important, because what you really want to know is if the stock is going to go up or down in price after you buy or sell it. To understand stock value, you need to know what market capitalization, book value, fundamental analysis and technical analysis are.

Market capitalization is simply the total value of all outstanding shares of a company — also called **market cap**. To calculate market capitalization, simply multiply the total number of shares outstanding — of each class of common and preferred stock that the company has trading in the market — times its corresponding share price. Assume, for instance, that a company has 1,000,000 shares of common stock outstanding trading at \$15 per share and 2,000,000 shares of preferred stock trading at \$10 per share. The market capitalization of the company is:

$$\text{Market Cap} = (1,000,000 \text{ Shares}) \left(\frac{\$15}{\text{share}} \right) + (2,000,000 \text{ Shares}) \left(\frac{\$10}{\text{share}} \right) = \$35,000,000$$

Book value is the value of the company as shown on the firm’s balance sheet. This is the value of everything the company owns,



HUMOR: A full service stockbroker is a man who is always ready, willing, and able to lay down your money for his own profit!

less everything it owes. This is very simple in concept, but very difficult to actually calculate. There are many areas of accounting standards promoted by the **Financial Accounting Standards Board (FASB)** where wide latitude in interpretation makes it possible for the balance sheet to not necessarily reflect the true value of the firm. It may actually be impossible to tell what the firm is really worth, because inside corporate executives have generated financial statements to reflect their own agenda. This agenda may have nothing to do with informing the public as to the true accounting value of the firm.

Fundamental analysis focuses on the company's financial information and uses not only the company balance sheet, but also the income statement and cash flow statement. The primary concept here is that increased earnings and cash flow increases the value of the firm. Since the shareholders are the owners of the firm, the idea is that increased corporate profits increase the share price of the company's stock and vice versa as shareholders somehow recognize that they are wealthier.

The problem is that inside corporate executives do not have to give the shareholders a dime of the profit. In fact, the only way for them to do so is by issuing dividends. Since few companies issue dividends, it is difficult to understand how investors could possibly value increased earnings, at least on a personal level. Market price bubbles indicate that fundamental analysis does not capture the essence of price fluctuations — you will learn a lot more about this toward the end of this book when you read about stock manipulation. You should understand fundamental analysis, but I recommend that you also use technical analysis for your investment decisions. You will learn more in the chapter ahead on fundamental analysis.

Technical analysis attempts to predict the future direction of stock price movements based on two major types of information: (1) historical price and volume behavior and (2) investor sentiment (another way to say investor attitudes). Technical analysis tech-

niques are centuries old, and their number is enormous. You will learn more about this in the chapter ahead on technical analysis.

Stock Market Indexes

Stock market indexes provide a useful tool to summarize the vast array of information generated by the continuous buying and selling of stocks. At the same time, the use of market indexes presents two problems. First, many different indexes compete for our attention. Second, indexes differ in their composition and can give contradictory information regarding general price movements in the stock market.

When constructing a stock market index, the base index value and the starting date have to be selected. The choice is completely arbitrary, since absolute index values are meaningless. Only the relative changes in the index values give you useful information. For example, knowing only that a particular stock market index finished the year at a level of 354.7 is of no value to you. However, if you also know that the same index finished the previous year at a level of 331.5, then you can calculate that the general change in the stock market — as measured by this particular index — rose approximately 7% over the past year.

The next decision is which stocks should be included in the index. There are three methods for deciding stock index composition: (1) *the index can represent a stock exchange and include all the stocks traded on the exchange*, (2) *the organization producing the index can subjectively select the stocks to be included*, or (3) *the stocks to be included can be selected based on some objective measure such as market value, which is simply the number of shares outstanding times the price per share*. Often, the stocks in an index are divided into groups so that the index represents the performance of various industry segments such as industrial, transportation or utility com-



FACT: It is vital to your success as an investor that you select analysis techniques that are harmonious with your personality!

panies. Regardless of the method chosen for selecting the stocks, the composition of an index can change whenever companies merge or are de-listed from an exchange.

Once the stocks to be included in an index are selected, the stocks must be combined in certain proportions to construct the index. Each stock, therefore, must be assigned some relative weight. One of two approaches typically is used to assign relative weights when calculating stock market indexes: (1) by the price of the company's stock or (2) by the market value index of the company, market value meaning the same thing as market capitalization.

Price-Weighted Indexes

A **price-weighted index** is first computed by summing the prices of the individual stocks composing the index. The sum of the prices is divided by a "divisor" to yield the chosen base index value. Thereafter, as stock prices change, the divisor remains constant unless there is an event like a stock split,¹⁴ a stock dividend,¹⁵ or a change in index composition. If this happens, then the divisor is adjusted so that the index value is not affected by the event in question.

For example, if the price per share of stocks A, B, and C in a price-weighted index were \$20, \$10, and \$50, then the prices would sum to \$80. If the base index value is to be 100, then the initial divisor would be:

$$0.8 \text{ because } 100 = \frac{80}{0.8}$$

¹⁴ A **stock split** is an increase in the number of outstanding shares of a company's stock, such that the proportionate equity of each shareholder remains the same. This requires approval from the board of directors and shareholders. A corporation whose stock is performing well may choose to split its shares, distributing additional shares to existing shareholders. The most common stock split is two-for-one, in which each share becomes two shares. The price per share immediately adjusts to reflect the stock split, since buyers and sellers of the stock all know about the stock split (in this example, the share price would be cut in half). Some companies decide to split their stock if the price of the stock rises significantly and is perceived to be too expensive for small investors to afford.

¹⁵ A **stock dividend** is a dividend paid as additional shares of stock rather than as cash. If dividends paid are in the form of cash, those dividends are taxable. When a company issues a stock dividend, rather than cash, there usually are not tax consequences until the shares are sold.

On the next trading day, say prices per share of the stocks change to \$25, \$10, and \$40. Now the new sum of share prices would be \$75 and the price weighted index value would be

$$\frac{75}{0.8} = 93.75$$

or 6.25% lower.

Now assume that stock C undergoes a two-for-one split after the market closes on the second day such that its price per share declines to \$20 because

$$\frac{\$40}{2} = \$20$$

The sum of the three prices is now only \$55, but the index should remain the same because the market value of the company did not change. The market value of the company did not change because, even though the price dropped by half, the shares outstanding of the firm doubled. The new divisor must be adjusted so that the index stays at 93.75. The new divisor must be

$$\frac{55}{93.75} = 0.5867$$

and it would remain constant until it had to again be adjusted for an event like another split.

Market Value Weighted Indexes

A **market value-weighted index** is computed by calculating the total market value of the firms in the index and the total market value of those firms on the previous trading day. The percentage change in the total market value from one day to the next represents the change in the index. Market-value weighted indexes do



HUMOR: A man was strolling down a street. As he passed a large building with a fence around it, he heard a group of people chanting "Thirteen, thirteen, thirteen" over and over and over again. Curious, he tried to see over the fence, but couldn't. Then he spotted a knot in the wood, and put his eye to the hole. He just managed to spy some old people sitting in deck-chairs chanting, before a finger came out of nowhere and poked him in the eye. As he staggered back, the old people started chanting, "Fourteen, fourteen, fourteen, fourteen..."

not require adjustments for stock splits and stock dividends because they do not affect market capitalization. However, market-value weighted indexes do require adjustment when the composition of the index changes. Market-value weighted indexes are better because they account for price and firm size at the same time.

For example, if stocks A, B, and C described in the example above had outstanding shares of 100 million, 200 million and 10 million, then the total market value for the three stocks on the first day would be \$4.5 billion. The total market value on the second day would be \$4.9 billion, for an increase of 8.8%. If the market value-weighted index began with a base index value of 10 on the first day, then its value on the second day would be 10.88, or 8.8% higher.

If stock C undergoes a two-for-one split after the market closes on the second day so that its price per share declines to \$20, then there is no impact on the market value-weighted index. This is because the number of shares outstanding will double to 20 million and company C's market value will remain at \$400 million. This means that the total market value of the three stocks in the market value-weighted index continues to be \$4.9 billion on the second day and the index will remain at 10.88.

Notice how you arrive at two very different conclusions concerning the general stock market performance using the price-weighted and market value-weighted indexes in the above examples. Both indexes used the same stocks and the same price changes. However, the price weighted index dropped 6.25% while the market value-weighted index rose 8.8%. This example clearly shows that both the composition of an index and its weighting scheme can have a signifi-

cant impact on its results. You need to understand how an index is created for you to understand what it tells you — I personally watch multiple indexes that measure different aspects of the stock market.

Both market value-weighted and price weighted indexes reflect the returns to buy-and-hold investment strategies. If you were to buy each share in an index in proportion to its outstanding market value, the market-value weighted index would perfectly track capital gains on the underlying index (but the return from dividends would not be included). A **capital gain** is another way of saying your profit from buying at a lower price than the price at which you end up selling the stock. Similarly, a price-weighted index tracks the returns on a portfolio composed of equal shares of each company.¹⁶ Now that you know exactly what a stock market index is, it is important for you to understand what the major stock market indexes are and how they are created.

FACT

FACT: It is vital to your success as an investor that you select analysis techniques that are harmonious with your personality!

The Dow Jones Averages

The most widely cited stock market index is the **Dow Jones Industrial Average (DJIA)**, which was first published in 1896. The DJIA is a price-weighted index that originally consisted of 20 company common stocks with a divisor of 20; this means that the value of the index was simply the average price of the original 20 stocks. In 1928, the DJIA was enlarged to encompass 30 of the largest U.S. industrial stocks and today includes such companies as Verizon, DuPont and Merck. Dow Jones also publishes a price-weighted index of 20 transportation companies, another index composed of 15 utility companies, and a composite index

¹⁶ A portfolio is a collection of investments all owned by the same individual or organization. These investments often include stocks, which are investments in individual businesses, bonds, which are investments in debt that are designed to earn interest, and mutual funds, which are essentially pools of money from many investors that are invested by professionals or according to indices.

that includes 65 companies making up the industrial, transportation and utility indexes.¹⁷

New York Stock Exchange Index

The New York Stock Exchange composite index, published since 1966, includes all of the common and preferred stocks listed on the NYSE. In addition to the composite index, the NYSE stocks are divided into four sub-indexes that track the performance of industrial, utility, finance, and transportation stocks. All the NYSE indexes are market-value weighted. The base index value for all five indexes was 50 on December 31, 1965.

Standard and Poor's Indexes

The Standard and Poor's (S&P) 500 Index is a market-value weighted index that consists of 500 of the largest U.S. stocks drawn from various industries. The stocks included in the S&P 500 track 80% of the market capitalization of all stocks listed on the NYSE, with a few NASDAQ issues thrown in. The base value for the S&P 500 Index was 10 in 1943. The index is computed on a continuous basis during the trading day. The S&P 500 is divided into two sub-indexes that follow the performance of industrial and utility companies.

The **S&P 400 MidCap Index** also is published by Standard and Poor's. It is market-value weighted and consists of 400 stocks with market values less than those of the stocks in the S&P 500. The S&P 400 MidCap index is useful for following the performance of medium-sized companies.

In addition, Standard and Poor's publishes a market value-weighted small-cap index that tracks 600 companies with market values less than those of the companies in its S&P MidCap 400 index called the **S&P SmallCap 600 index**.

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None of the Dow Jones indexes is adjusted for stock dividends of less than 10 percent.

The S&P 1500 index includes companies in the S&P 500, the MidCap 400 and the SmallCap 600.

NASDAQ Indexes

The **NASDAQ Composite index**, with a base year of 1970, has been compiled continuously since 1971. The index has three categories of companies — industrial, banks, and insurance. It consists of all of the stocks traded through the NASDAQ, including those traded in the **National Market System (NMS)** and those that are not. In 1984, the NASDAQ National Market System introduced two new indexes, the **NASDAQ/NMS Composite Index** and the **NASDAQ/NMS Industrial Index**. Both are weighted by market capitalization and have a base of 100.

Other Stock Indexes

The **American Stock Exchange composite index** includes all common stocks listed on the AMEX; it is a market-value weighted index. The **Russell 3000 stock index** encompasses the largest companies ranked by market capitalization, while the **Russell 1000 stock index** includes the largest 1,000 market capitalization companies. The **Russell 2000 stock index** includes the bottom 2,000 companies in the Russell 3000, so it loosely represents a small-capitalization market index.

The Stock Market as a Predictor of Economic Activity

After every minor and major stock market crash — like **Black Monday** in October of 1987 and the bear decline from 2000 through 2003 — there are always people who are terrified that a major recession or even a depression will follow! You have to ask yourself, “*How realistic are these fears?*” The hard evidence is that the very best time to buy into the stock market is after it has crashed and stock prices are really low.

When there are lots of Chicken Little characters in the popular press foretelling disaster, it can take real guts to buy back in, but you can learn to do it. These fears are based on people's memories of the 1929 stock market crash and the Great Depression that followed. Why do some economists and many investors believe that the stock market can predict economic recessions? They reason it all out as follows.

First, even if changes in stock prices really have no direct effect on the economy, lots of people think changes in stock prices cause recessions. They say that if everyone in the market agrees that a recession is about to happen, investors could, at least in theory, forecast lower corporate profits and stock prices should drop accordingly. Second, they also reason that stock price declines reduce the wealth of consumers and, theoretically, could lead to reduced consumption spending and a reduced national income (GNP or GDP). Third, if consumer confidence is adversely affected by stock price declines, consumption spending could decrease and lower stock prices could increase the cost of raising capital because companies get less money if they issue new shares; as a result, this could decrease business investment by corporations. Great, this is the way some economists and many laypeople in the industry think. But what really happens?

Empirical evidence by direct research indicates that the stock market is very poor at predicting economic activity. In other words, all of these Chicken Little folks are wrong. A study by the Federal Reserve Board of Kansas City showed that only 11 of the 27 recessions between 1900 and 1987 were predicted by stock market declines. The answer is, "Don't worry about it!"

Chapter 4

Learn the Language of Mutual Funds!

I have a family friend named Carol who shows all of us how powerful the unconventional wisdom is of “*pay yourself first.*” I was best friends with her sons, who lived in the same neighborhood where I grew up. There was a big difference in Carol and her husband Jeff’s income and my father and mother’s income. Carol’s husband was the local high school principal and she was a beautician. My father, on the other hand, was an optometrist with three highly productive practices. My mom owned and operated one of the most successful local real estate brokerages. My parents earned quite a few more multiples in income than Carol and Jeff — you would think that they retired modestly, but think again.

A few years ago I was skiing with Jeff and their youngest son Jim. It started snowing heavily and we packed it in to the warm bar for a few cold beers — one of those special joys of the ski slopes. I asked Jeff if it was pretty tough to live on the small salary of a retired principal. He gave me an odd look, laughed, then said, “*Hell no, Scott! Carol made us rich in the stock market! All those years we lived on my salary and once Carol learned about stocks, she shoveled all of her hair cutting money into the market at just the right time.*” Later I had the great pleasure of hearing the details from Carol. Here is how she did it.

Carol told me that a high school graduate from the area named Hugh came back from his college studies. He had taken a stock investing seminar and was asking people he knew in the local community to pool their money together. Carol had been saving money as a beautician and was looking for an investment opportunity, so

she threw in with the small pool. Hugh lost all of the money. Carol laughed and said, *“You know, Scott, I lost twice! Hugh is such a nice guy and when he came around a second time asking for money, I threw away even more money! I wasn’t about to allow it to happen a third time and started thinking that maybe I should have a go at it alone.”*

The loss was painful to her because both she and her husband lived a frugal lifestyle that revolved around their children. But once bitten by the bug, she developed the resolve to succeed as a stock investor. Providence works in strange ways. Carol was listening to the radio one day and ran across Bob Brinker’s radio show. Bob also has a mutual fund newsletter called MarketTimer (www.BobBrinker.com). Bob taught Carol two things that would change her financial life forever. The first was that she had to learn to “pay herself first.” The second lesson was the financial prudence of dollar cost averaging into no-load mutual funds indexed to the S&P, which I explain later in this chapter.

Carol was a quick student and every time the end of the month came around, she put as much money as she could into her trading account BEFORE she paid any thing else — bills, gifts, new televisions, etc. She said the one mistake that she made was that she did not sell out in 2000 at the top of the market even though Bob Brinker was advising his subscribers to do so.

Carol told me with barely contained excitement in her voice, *“Scott, I was looking at our account balances yesterday and I can’t believe how much we are worth!”* I asked, *“But didn’t you ride the market down through the worst bear market since the great depression?”* She responded, *“Yes, but before that I rode the market up through the biggest bull market in U.S. history!”* Despite the crash she was still able to retire a millionaire.

WALLET DOCTOR SURVIVAL RULE #5

LEARN TO PAY YOURSELF FIRST!

Today she enjoys an idyllic lifestyle. She redirected her artistic hair styling ability into painting and has made a name for herself as an exceptional artist. She still focuses on her children and, when I interviewed

her, had just returned from a delightful week in Cabo San Lucas with her sons and grandchildren. Carol and Jeff have traveled all over the world and don't have to worry about money in their retirement years because she was able to turn the tables on Wall Street by paying herself first.

If you don't want to actively buy and sell individual stocks on your own, you can invest in stocks, bonds, or other financial assets through a mutual fund. **Mutual funds** are nothing more than a way of combining or pooling together money of a large group of investors. The buy and sell decisions for the pool are made by a fund manager who is paid for operating the fund day-to-day.

Mutual funds provide indirect access to financial markets for individual investors; these funds are a form of **financial intermediary**. Mutual funds have a lot of power today because they are now the largest type of financial intermediary in the United States, followed by **commercial banks** and **life insurance companies**.

Because there are so many now on the market, it is very important that you understand mutual funds, even if you buy and sell stock for your own account and never invest in one. At the end of 2001, about 93 million Americans in 55 million households owned mutual funds, up from 5 million households in 1980 — this is a huge increase. Investors contributed \$505 billion to mutual funds in 2001, and, by the end of the year, mutual fund assets totaled \$7 trillion — yes, that's trillion with a "t." These are very big beasts of the Wall Street jungle and you don't want to get trampled by one!

One of the reasons for the explosion in number of mutual funds and fund types is that mutual funds have become, at a very basic level, consumer products. They are created and marketed to



TRAP: Academic studies and market statistics confirm that the typical investor acts in direct opposition to my wise advice — buy low and sell high. It's only after high returns are realized and reported that investors pour money into both stock and bond mutual funds. Lesson: learn to recognize when the general market and individual stocks are low.

the public in ways that are intended to promote buyer appeal. As every business student knows, product differentiation is a basic marketing tactic, and in recent years mutual funds have become increasingly adept at practicing this crude marketing technique. They will dupe you if you are not alert to their tactics. This is why it is so important to understand mutual funds. Even if you have never invested your money in one, someone in your family will be affected by a mutual fund and will need your guidance as you become an expert stock investor.



HUMOR: Full service stockbroker's creed: A man is a client until proven broke.

In fact, if you are not already a mutual fund investor, it is very likely that you will be in the near future. The reason has to do with a fundamental change in the way businesses of all types provide benefits for employees. It used to be that most large employers offered

pension plans. With such a plan, when you retire, your employer pays you a pension typically based on years of service and salary. The key is that the pension benefit you receive is based on a predefined formula, hence the name pension.

Defined benefit plans are rapidly being replaced by “**defined contribution plans.**” With a defined contribution plan, such as a 401(k), your employer will contribute money each pay period into a retirement account on your behalf, but you have to select the funds your plan picks. With this arrangement, the benefit you ultimately receive depends entirely on how your investments do; your employer only makes contributions. The security of your financial retirement is in no way guaranteed because the mutual funds you are now forced to select could lose your money — lots of it. You are now forced to choose from a group of mutual funds for your investments, so it is very important that you understand the different types of mutual funds, as well as their advantages and disadvantages.

Investment Companies and Fund Types

At the very most basic level, a company that pools funds obtained from individual investors and invests them is called an **investment company**. In other words, an investment company is a business that specializes in managing financial assets for individual investors. All **mutual funds** are investment companies, but not all investment companies are mutual funds.

Open-End Versus Closed-End Mutual Funds

There are two types of investment companies, open-end mutual funds and closed-end mutual funds. Whenever you invest in a mutual fund, you do so by buying shares in the fund. However, how your shares are bought and sold depends on which type of fund you are considering.

With an **open-end fund**, the fund itself will sell new shares to anyone wishing to buy and will redeem (another way to say buy back) shares from anyone who wants to sell. When an investor wants to buy open-end fund shares, the fund simply issues the shares and the fund manager invests the money received from the investor into equity securities. When someone wants to sell open-end fund shares, the fund sells some of its assets and uses the cash to redeem the shares. As a result, with an open-end fund, the number of shares outstanding fluctuates over time.

With a **closed-end fund**, the number of shares is fixed and never changes. If you want to buy shares, you must buy them from another investor. Similarly, if you wish to sell shares that you own, you must sell them to another investor.

The key difference between an open-end fund and a closed-end fund is that with a closed-end fund, the fund itself does not buy or sell shares. In fact, as I discuss below, shares in closed-end funds are listed on stock exchanges just like ordinary shares of stock, where the fund shares are bought and sold in the same way. Open-end funds

are more popular among investors than closed-end funds.

Strictly speaking, the term “mutual fund” actually refers strictly to an open-end investment company. Thus the phrase “closed-end” is an oxymoron, like “jumbo shrimp”, and the phrase “open-end mutual fund” is a redundancy, an unnecessary repetition or restatement, such as “past history”. Nonetheless, particularly in recent years, the term investment company has all but disappeared from common use, and investment companies are now generically called mutual funds.

Net Asset Value

A mutual fund’s **net asset value (NAV)** is important for you to understand. Net asset value is calculated by taking the total value of the assets held by the fund less any liabilities and then dividing by the number of outstanding shares. For example, suppose a mutual fund has \$105 million in assets and \$5 million in liabilities based on current market values and a total of 5 million shares outstanding. Based on the value of net assets held by the fund, \$100 million, each share has a value of :

$$\frac{\$100 \text{ million}}{5 \text{ million shares}} = \$20 \text{ per share} = \$20 \text{ NAV}$$

This \$20 is the fund’s net asset value, often abbreviated as **NAV**.

With one important exception, the net asset value of a mutual fund will change substantially every day, simply because the value of the stocks held by the fund go up and down every day. The one exception concerns money market funds, which I explain below.

An open-end fund will generally redeem shares at any time. The price you receive when you sell your mutual fund shares is the net asset value. In the example above, if you sell your shares back to the fund you will be paid \$20 per share. Because the fund stands ready to redeem shares at any time, shares in an open-end fund are always worth their net asset value. In contrast, because the shares of closed-end funds are bought and sold in the stock market, the share price at any point in time may or may not be equal to their

net asset values. This may seem confusing to you now, but don't worry, I will explain this in a bit.

Mutual Fund Operations

You need to understand how mutual funds are created, marketed, and taxed. Each of these topics affects your bottom line as an investor. My main focus below is on open-end funds, but much of this applies to closed-end funds as well.

Mutual Fund Organization and Creation

A mutual fund is simply a corporation. Like a corporation, a mutual fund is owned by its shareholders. The shareholders elect a board of directors. The board of directors is responsible for hiring a manager to oversee the fund's operations. Even though mutual funds often belong to a larger "family" of funds, every fund is a separate company owned by its mutual fund shareholders.

Most mutual funds are created by **investment advisory firms**, which are businesses that specialize in managing mutual funds. Investment advisory firms are also called mutual fund companies. Increasingly, such firms have additional operations such as discount brokerages and other financial services.

There are probably hundreds of investment advisory firms in the United States. The largest and best known is Fidelity Investments, with 150 mutual funds, more than \$800 billion in assets under management, and 19 million customers. Dreyfus,



TIP: Mutual funds should provide benefits to shareholders by hiring supposed "expert" stock pickers. The sad truth is that the vast majority of mutual funds under-perform the average return of the stock market. Over time, because of their costs, approximately 80% of mutual funds will under-perform the stock market's returns (indexes). If you must invest in mutual funds, play it safe with indexed funds like the Schwab 1000 Fund (SNXSX) or the Vanguard 500 fund (VFINX)!

Franklin, and Vanguard are some other well-known examples. Many big nationwide brokerage firms, such as Merrill Lynch and Charles Schwab, also have large investment advisory operations.

Investment advisory firms create mutual funds simply because they wish to manage them to earn fees. They really don't care about anything but the fee they earn. DON'T EVER FORGET THIS! Their marketing is oriented toward your benefits and how they strive to protect your interests but reality is far different. A typical management fee might be 0.75 percent of the total assets in the fund per year.

Here is how a fund is created. A fund with \$200 million in assets would not be especially large, but could nonetheless generate management fees of about \$1.5 million per year for the manager. It is not hard for you to see why mutual fund managers live in mansions. There is a significant economic incentive to create funds and attract investors to them. I believe that the 401(k) is an elaborate scheme by inside corporate executives and fund managers to force your money through mutual funds into specific stocks in which inside corporate executives hold large blocks of employee stock options — I suspect that the 401(k) is part of the largest pump and dump scheme in history. I have a solution to this problem that I will explain later.

A company like Fidelity might one day decide that there is a demand for a fund that buys stocks in companies to grow and process citrus fruits. Fidelity could form a mutual fund that specializes in such companies and call it something like the Fidelity Lemon Fund. A fund manager would be appointed, and shares in the fund would be offered to the public. As shares are sold, the money received is invested by buying shares of stock in the citrus fruit growing companies. If the fund is a success, a large amount of money will be attracted into the fund and Fidelity will benefit from the fees it earns. If the fund is not a success, the board can vote to liquidate it and return the shareholders' money — they never do — or merge it with another fund.

As this made up example shows you, an investment advisory firm such as Fidelity can (and often will) create new funds from time

to time. Through time, this process leads to a **family of funds** all managed by the same advisory firm. Each fund in the family will have its own fund manager, but the advisory firm will generally handle the record keeping, marketing, and much of the research that underlies the fund's investment decisions.

In principle, the directors of a mutual fund in a particular family, acting on behalf of the fund shareholders, could vote to fire the investment advisory firm and hire a different one. As a practical matter, this rarely, if ever, occurs. At least part of the reason is that the directors are originally appointed by the fund's founder, and are routinely reelected. Unhappy shareholders generally “vote with their feet” — that is, they sell their shares and invest elsewhere when they feel like they have been ripped off by the managers.

Taxation of Investment Companies

As long as an investment company meets certain rules set by the Internal Revenue Service, it is treated as a “**regulated investment company**” for tax purposes. This is important because a regulated investment company does not pay taxes on its investment income. Instead, the fund passes on these distributions to its shareholders as though they owned the stocks directly. Basically, the fund acts as a “**pass-through entity**” in terms of tax law, funneling capital gains and losses to the owners. This can cause problems for you because you can end up in a situation where you lose money in the mutual fund and have to pay taxes on capital gains of other investors who sold out their shares when the price was higher. Like I told you before, this beast can and will trample you if you don't understand it.

To qualify as a regulated investment company, the fund must follow three basic rules. The first rule is that it must in fact be an investment company holding all of its assets as investments in stocks, bonds, and other securities. The second rule limits the funds to 5% of its assets when acquiring a particular security. This is called the **five percent rule** of diversification. The third rule is that the fund



HUMOR: A minister dies & is waiting in line at the Pearly Gates. Ahead of him is a guy who's dressed in sunglasses, a loud shirt, leather jacket, and jeans. St. Peter addresses this guy, "Who are you, so that I may know whether or not to admit you to the Kingdom of Heaven?" The guy replies, "I'm Joe Smith, a managed mutual fund manager, of Noo Yawk City." St. Peter consults his list. He smiles and says to the fund manager, "Take this silken robe and golden staff and enter the Kingdom of Heaven." The fund manager goes into Heaven with his robe and staff, and it's the minister's turn. He stands erect and booms out, "I am Joseph Snow, pastor of Saint Mary's for the last forty-three years." St. Peter consults his list. He says to the minister, "Take this cotton robe and wooden staff and enter the Kingdom of Heaven." "Just a minute," says the minister. "That man was a fund manager — he gets a silken robe and golden staff but I, a minister, only get a cotton robe and wooden staff? How can this be?" "Up here, we work by results," says Saint Peter. "While you preached, people slept; his shareholders, they prayed!"

must pass through all realized investment income to fund shareholders.

The Mutual Fund Prospectus and Annual Report

Mutual funds are required by law to produce a document known as a **prospectus**. The prospectus must be supplied to any investor wishing to purchase shares. Mutual funds must also provide an annual report to their shareholders. The annual report and the prospectus, which are sometimes combined, contain financial statements along with specific information concerning the fund's expenses, gains and losses, holdings, objectives and management.

Mutual Fund Costs and Fees

I have explained how the inside corporate executive steals money from behind the scenes. Now that most Americans are virtually forced to put money in mutual funds through their 401(k), the mutual fund manager can steal from right out under your nose. Mutual funds charge outrageous fees upfront, more fees once you're invested, and again on the backend when you get frustrated and sell out. Managed mutual funds charge the highest fees they can get away with, and they charge these fees in the most confusing manner possible. They do this to suck money out of your pocket. There is a solution for all

these nasty fees – buy a no load index fund the same way Carol does. If you plan on entering the crazy and bizarre world of mutual funds beyond the index fund, make sure that you know exactly what fees you're paying — it really could cost you your retirement!

The Mutual Fund Expense Ratio

A mutual fund's **expense ratio** is the most important fee to understand. The expense ratio is made up of the following. The **investment advisory fee**, or **management fee**, is the money used to pay the salary of the manager(s) of the mutual fund. On average, this fee is about 0.5% to 1.0% of the fund's assets annually, and is necessary to make sure that the manager of your fund is able to afford a beach house in Malibu, ski chalet in Whistler, ranch in Montana, sports cars, Armani suits, Rolex watches and so forth.

Another piece of the expense ratio are **administrative costs**, which include things like recordkeeping, mailings, and maintaining a customer service line. These are all necessary costs, though they vary in size from fund to fund. The thriftiest funds can keep these costs below 0.2% of fund assets, while the ones who use engraved paper, colorful graphics, and phone attendants with fancy accents might fail to bring administrative costs below 0.4% of fund assets.

What should really annoy you if you are a mutual fund investor is the **12b-1 distribution fee**. This fee ranges from 0.25% of a fund's assets all the way up to 1.0% of the fund's assets. This fee is spent on marketing, advertising and distribution services. If you're in a fund with a 12b-1 fee, you're paying every year for the fund to run expensive commercials. How can this in any way help you? Do you enjoy seeing advertisements of your fund on television? Unless you really do, you should avoid funds that carry a 12b-1 fee.

Don't concern yourself with how the pieces of the expense ratio add up, just know what the total is. The most important question that you should always ask about any mutual fund is, "*How high is the expense ratio?*" And remember, for actively managed funds, the

average number is about 1.5%. Meanwhile, in the wonderful world of index funds, the expense ratio is six times smaller, around 0.25% and as low as 0.19% for the King Kong of all index funds — the Vanguard S&P 500 Index Fund (VFINX). The expense ratio for each and every publicly traded mutual fund can be found at www.morningstar.com. Try to identify the expense ratios of any mutual fund you own, or are thinking of owning. Don't forget that no-load indexed mutual funds are the only mutual funds my retired beautician friend Carol buys. I am now going to describe in detail all of the different kinds of non-indexed funds out there — so you can “Just Say No!”

The Mutual Fund Load

The “**load**” is the sales charge many funds use to pay a stock broker for his or her “services” in selling a fund to an investor. This is loaded on in addition to the expense ratio. “**No-load**” funds are simply those funds that are sold directly to the investor, rather than through a middleman. A “**front-end load**” is a monster chunk of money that a broker or other adviser pays to himself or his company for telling you to buy the fund. Sometimes you will hear these called **A-class shares**. Front-end loads typically congregate around the 5% figure, but can go up to 8%. That means that if you were investing \$1000 in a 5% front load fund, \$50 is taken out of your investment account up front and put into the broker's pocket. Don't ever, under any circumstances, buy any front-loaded funds.

Deferred load or **contingent deferred sales load (CDSL)** funds (sometimes called **back-end loads**), often labeled **B-class shares**, are just as unnecessarily expensive (bad) as front-end load funds, but they're not as clearly labeled. These funds defer the sales fee until you sell out of the fund — the shark's last bite before it lets you swim away.

Level load funds, or **C-class shares**, are a load of trouble. These charge small front loads, and level loads every year thereafter. Although C-class shares might look like they aren't so bad to buy, they

end up being very, very expensive to hold because your account gets whacked every single year you own the fund.

Mutual Fund Turnover Rate and Taxes

A fund's **turnover rate** is the percentage of a fund's holdings that it changes every year as it buys then sells individual stocks or bonds. A managed mutual fund has an average turnover rate of approximately 85%, meaning that funds are selling most of their holdings of stocks or bonds every year. Buying and selling stocks costs money in the form of commissions and bid ask spreads, so a high turnover indicates higher costs (and lower shareholder returns) for the fund. Also, funds that have large turnover ratios will end up distributing short-term capital gains to their shareholders annually, even when the fund loses money. Shareholders will have to pay taxes on these gains, and paying these taxes can be a real killer. You can actually lose money in your mutual fund at the end of the year AND get a bill for capital gains tax. Keep a close eye on the turnover rate of any fund you own, and look to own funds with low (preferably no higher than 25%) turnover rates. Index fund turnover is around 5% at most, and frequently lower.

Load vs. No Load

Back in 1980 when I graduated from high school, investors could only buy directly through a stockbroker. That meant that all mutual funds were “load” funds. The advent of online discount brokerages made it really easy for mutual funds to sell directly to you the consumer — cutting out stock brokers as sales people. The stock brokerages started losing commissions to the online discount brokerages, so they teamed up with the mutual funds and invented A-, B-, and C-class share funds to confuse you and suck more money out of you. Index funds have the lowest expense ratios, so only buy an index fund in your 401(k) retirement account. If you have to buy a mutual fund, as you are forced to in a 401(k), just buy a no load index fund

with the very lowest expense ratio (the Vanguard 500 is a great one), unless your 401(k) or **403(b)** doesn't give you the option — which means that you have a cruddy 401(k) or 403(b) plan.¹ You don't need to pay any adviser to find a mutual fund for you.

Studies show that no-load funds perform as well as, and probably better than, load funds, so only buy no-load funds. If you're in a 401(k) or 403(b) plan, make sure you know whether the fund choices offered are load or no-load — that information may not be con-

tained in one-sheet summaries of fund choice performance. Take the list and go to www.morningstar.com and check the loads, fees and so forth.

WALLET DOCTOR SURVIVAL RULE #6

If your 401(K) Matches a Percentage of Your Salary When You Contribute, Only Buy A No-Load Indexed Stock Mutual fund!

Mutual Fund Morningstar Stars

Don't pay any attention whatsoever to the "stars" you see associated with mutual funds and their advertisements. The premier mutual fund data provider, Morningstar, assigns stars on the basis of subjectively assessed risk and return — attempting to compare one fund with other funds that have similar investment objectives. Morningstar's "star" rating system is totally worthless and meaningless. Morningstar's website, though, does list a lot of information about every mutual fund on their website — like the expense ratio of every fund in your 401(k).

Selecting Mutual Funds

Selecting the best fund is relatively easy — just buy a no load index fund. Index funds are available for international funds, growth

¹ A 403(b) is a retirement plan similar to a 401(k) plan, but is offered by non-profit organizations, such as universities and some charitable organizations, rather than corporations. There are several advantages to 403(b) plans: contributions and lower taxable income, larger contributions can be made to the account, earnings can grow tax-deferred, and some plans allow loans. Contributions can grow tax-deferred until withdrawal at which time the money is taxed as ordinary income (which is sometimes a disadvantage).

funds, mid-caps, small-caps, and just about anything else you can think of. My favorite for your 401(k), since you don't have to worry about taxes, is the Vanguard 500 fund (VFINX). If you are forced to buy a non-index fund, make sure that you understand all the costs and fees associated with buying and owning that fund. Make sure you understand what stocks the fund is buying and selling and check the long-term chart patterns on all of them — like I teach you at the end of this book.

Long-Term Funds

There are many different types of long-term mutual funds. Historically, mutual funds were classified as stock, bond or income funds. The rapid growth in mutual funds has made it increasingly difficult to place all funds into just these three categories. Also, providers of mutual fund information do not use the same classification schemes. Mutual funds have different goals, and a fund's objective is the major determinant of the fund type.

All mutual funds must state the fund's objective in the prospectus. For example, the “*Fidelity Independence Fund*” states:

“The fund’s objective is capital appreciation. Normally, the fund’s strategy is to invest primarily in common stocks of domestic and foreign issue. The fund strategy may result in the realization of capital gains without considering tax consequences to shareholders. Fidelity Management & Research Company (FMR) is not constrained by any particular investment style and may invest in “growth” stocks, “value” stocks, or both, at any given time.”

This fund says it invests in different types of stocks with the goal of capital appreciation. This is clearly a stock fund, and it might further be classified as a “capital appreciation” fund or an “aggressive



TRAP: Do not, under any circumstances, buy shares of your employer's company stock in your 401(k) plan — a no-load indexed fund is best. If the company goes bankrupt, you will lose your retirement — just like Enron and World-Com employees did!

growth” fund, depending on whose classification scheme is used.

Mutual fund objectives are an important consideration; unfortunately, the truth is that, like the Fidelity objective above, they are too vague to provide useful information. For example, it is very common that the objective reads something like this: “*The Big Bucks Fund seeks capital appreciation, income, and capital preservation.*” Translation: The fund seeks to (1) increase the value of its shares, (2) generate income for its shareholders, and (3) not lose money. Yeah, well, don't they all! More to the point, funds with

very similar sounding objectives can have very different portfolios and, hence, very different risks. As a result, it is a monster mistake to look only at a mutual fund's stated objective. Actual portfolio holdings speak louder than prospectus promises, which are really nothing more than hollow lies designed by marketing hacks to suck your money into the black hole of the mutual fund.

Stock Funds

Stock funds exist in great variety. I'll explain to you nine separate general types and some subtypes here. I'll also show you some new types that don't fit neatly into any category. Remember that you don't need to bother with any of this if you just buy a no-load indexed mutual fund.

The first four types of stock funds trade off capital appreciation with dividend income.

- 1. Capital appreciation stock mutual funds** seek maximum capital appreciation — a fancy way of saying that they try to sell higher than they buy. They generally invest in companies that have, in the opinion of the fund manager, the best pros-

pects for share price appreciation without regard to dividends, company size, or, for some funds, country of origin. Often this means investing in unproven companies or perceived out-of-favor companies.

2. **Growth stock mutual funds** seek capital appreciation, but tend to invest in large, more established companies. These funds may be somewhat less volatile as a result. Dividends are an important consideration for the mutual fund manager in purchasing a stock.
3. **Growth and income stock mutual funds** seek capital appreciation, but at least part of their focus is on dividend-paying companies.
4. **Equity income stock mutual funds** focus almost exclusively on stocks with relatively high dividend yields, thereby maximizing the current income on the stock portfolio.²

Among these four fund types, the greater the emphasis on growth, the greater the supposed risk, at least as a general rule. Again, these are only rough classifications. Equity income funds, for example, frequently invest heavily in public utility stocks, which suffered heavy losses at the beginning of the 1990s.

Company size-based stock mutual funds focus on companies in a particular size range.

1. **Small company stock mutual funds** focus on stocks in small companies where “small” refers to the total market value of the stock. Such funds are often called “small-cap” funds, where “cap”



HUMOR: A visitor from out of town came to a tour in Manhattan. At the end of the tour they took him to the financial district. When they arrived at Battery Park the guide showed him some incredible yachts anchoring there, and said, “Here are the yachts of our inside corporate executives, mutual fund managers, and full service stockbrokers.” The tour guide raised a quizzical eyebrow when the visitor asked, “And where are the yachts of the investors?”

² The **dividend yield** is the anticipated dividend divided by the present price of a share of stock.

is short for total market value, also called market capitalization. Small stocks have historically performed very well, at least over the long run, hence the demand for funds that specialize in such stocks. With small-company mutual funds, what constitutes small covers a wide range of companies from perhaps \$10 million up to \$1 billion or so in total market value, and some funds specialize in smaller companies than others. Since most small companies don't pay dividends, these funds by definition emphasize capital appreciation.

2. **Midcap stock mutual funds** specialize in stocks that are too small to be in the S&P 500 index, but too large to be considered small stocks. Hence, the stocks these mutual funds specialize in are considered to be middle- or medium-sized by market capitalization, also called midcap.

International stock mutual funds invest internationally. International funds have been among the most rapidly growing funds. However, that growth slowed sharply in the late 1990s.

1. **Global stock mutual funds** have substantial international holdings, but also maintain significant investments in U.S. stocks.
2. **International stock mutual funds** are just like global funds, except they focus on non-U.S. equities.

Among international funds, some specialize in specific regions of the world, such as Europe, the Pacific Rim or South America. Others specialize in individual countries. Today, there is at least one mutual fund specializing in essentially every country in the world that has a stock market, however small.

International funds that specialize in countries with small or recently established stock markets are often called **emerging market funds**. Almost all single-country funds, and especially emerging market funds, are not diversified and have historically had extremely volatile returns to investors — a lot of up and down surprise price movements. Make sure you understand the stock market of

the country these mutual funds are invested in. A good supplement to track the political economy of foreign markets is the *Christian Science Monitor*. Foreign economists at schools like Harvard University read it because it is the only newspaper left in the U.S. that is not biased by corporate or U.S. political interests.³

Many funds that are not classified as international funds may actually have substantial overseas investments, so this is one thing to watch out for. It is not unusual for a fund to call itself a “growth” fund and actually invest heavily outside the United States borders.

Other Stock Mutual Fund Types and Issues

There are three other types of stock mutual funds that don’t fit easily into a category.

- 1. Index stock mutual funds** simply buy and hold the stocks that make up a particular index in the same proportions as the index. The most important index funds are the **S&P 500 indexed stock mutual funds** which are intended to track the performance of the S&P 500 — one of the largest stock indexes. By their nature, index funds are passively managed, meaning that the fund manager uses a computer program to trade only as necessary to match the index. Such funds are appealing because of their low turnover and low operating expenses. Another reason index funds have grown so rapidly is that there is considerable debate over whether mutual fund managers can consistently beat the averages — empirical studies by top financial economists indicate that



TIP: Only contribute up to the maximum matching in your 401(k). After that, if you want to save more, put it into a Roth IRA. If you are worried about your financial stability then the Roth IRA is for you. You can withdraw the contribution in an emergency penalty free — you get heavily penalized for early withdrawals in a 401(k).

they can't. And if they can't, then why pay loads and management fees when it's much cheaper and much less risky to just buy the averages by indexing?

2. **Social conscience stock mutual funds** are a relatively new creation. They invest only in companies whose products, policies, or politics are considered to be socially desirable. Social objectives range from environmental issues to personnel policies. The **Parnassus Fund** is a great example because it avoids the alcoholic beverage, tobacco, gambling, weapons and nuclear power industries. Of course, general agreement on what is socially desirable or responsible is hard to find. In fact, there are so-called **sin stock mutual funds** (and sector funds) that specialize in what Parnassus fund shareholders would consider "sinful" industries!
3. **Tax-managed stock mutual funds** are managed with high regard for your tax liabilities as a mutual fund shareholder.

WALLET DOCTOR SURVIVAL RULE #7

If your 401(K) Matches a Percentage of Your Salary When You Contribute But Doesn't Offer a No-Load Indexed Stock Mutual fund, Then Buy a Fund With The Lowest Turnover and Expense Ratios — Never Buy Bond Funds!

Normally, fund managers focus on total pretax returns because this is what their performance bonus is normally based on. Recent research has shown that some very simple strategies can greatly improve your after-

tax returns and that focusing just on pretax returns is not a good idea for taxed investors. Tax-managed stock mutual funds try to hold turnover down to minimize realized short-term capital gains, and they try to match realized short-term gains with realized short-term losses (short term is a owning a stock for less than a year). These tax saving strategies work really well for index funds. For example, the **Schwab 1000 Fund** is a fund that tracks the Russell 1000 index, a widely followed 1,000-stock index. However, the fund will deviate from exactly following the index to avoid realizing short-term taxable gains. As a result, the fund holds turnover down to a minimum. Fund shareholders avoid short-term capital

gains taxes as a result. Funds promoting such tax saving strategies will become more common as investors become more aware of the tax consequences.

Taxable and Municipal Bond Mutual Funds

If you have a 401(k), you have probably been enticed to put part of your money into a bond fund to diversify. This is a very bad move right now because of the low interest rates. You would be much better off if you could just buy bonds outright because you could lock in the interest (yield) for the length of the maturity you want. But your 401(k) doesn't give you that choice. The big problem with a bond mutual fund in a rising interest rate market is that a bond is worth less as the interest rate rises. If you buy a bond at 5%, you will pay \$1,000 and get \$50 every year. If the interest rate rises to 6% and you want to sell your bond before maturity, you have a problem because someone with \$1,000 to invest in bonds will get \$60. This means that you will have to sell your bond for less than \$1,000 — your bonds lose value when interest rates rise. As bond mutual fund managers try to lock in higher and higher rates, they end up selling the bonds they bought in the past with your bond mutual fund contributions in your 401(k). This means that you will start to lose money as interest rates rise because you can't simply tell the bond mutual fund manager not to sell the bonds he bought with your money. Nonetheless, investors in bond funds were much better off in the stock market crash from 2000 to 2003 because they did not lose much while many stock mutual funds lost well over half their value. Do not buy bond funds unless you absolutely have to, such as when interest rates are high, the stock indexes are high and/or you cannot buy bonds directly (i.e., in a 401(k) plan).

Balanced mutual funds that buy both stocks and bonds are even worse. Two famous financial economists found that if a 401(k) plan offers a choice between a stock fund and a bond fund, most people simply put 50% into each fund, reasoning that the fixed income of



HUMOR: Fascism: You have two cows. The government takes both, hires you to take care of them, and sells you the milk.

bonds will offset the risk of unknown price changes in stocks — they think that they are diversifying. What is really a problem is that most 401(k) plans offer balanced funds which are composed of half stocks and half bonds already. Benartzi and Thaler found that people still put 50% in a stock mutual fund and 50% in a balanced mutual fund.⁴

Without realizing it, inexperienced public investors are putting 75% of their 401(k) investment in stock and 25% in bonds. I think that this is done intentionally by inside corporate executives to fool the public into pumping more money into stocks. I am not a fan of bond funds, but you may have a really bad 401(k) that doesn't give you any other option. If interest rates are relatively high and stable at the top of the next bull market — when you, along with corporate inside executives, will want to sell off all of your stock mutual funds — then you might buy bond funds — but only if you have no other choice. Treasury bills, bonds, and notes would probably still be better for you.

Most bond funds invest in domestic corporate and government securities. Some invest in foreign government and non-U.S. corporate bonds as well. As you will come to understand, there are not a lot of bond fund types. Here are the five characteristics that help you tell them apart:

1. **Maturity range.** Different funds hold bonds of different maturities, ranging from very short (2 years) to quite long (25-30 years).
2. **Credit quality.** Some bonds are much safer than others in terms of the possibility of default where payments to you stop (you get the shaft and the fund manager gets the gold mine). U.S. Treasury bonds have never defaulted in the history of the country and hence are considered risk-free. Another way

⁴ Benartzi, Shlomo, and Richard Thaler, "Naive Diversification Strategies in Retirement Saving Plans," *American Economic Review*, March 2001, Vol. 91.1, pp. 79-98.

to say this is that U.S. Treasury bonds don't have default risk. On the other hand, so-called junk bonds have lots of default risk. Since the payments on junk bonds may stop at any time, these bonds pay higher yields to compensate you for the high risk. Do not buy junk bonds!

3. **Taxability.** Municipal bond funds buy only bonds that are free from state and local income tax. Taxable bond funds buy only taxable issues.
4. **Type of bond.** Some funds specialize in particular types of fixed-income instruments such as mortgages.
5. **Country.** Most bond funds buy only domestic issues, but some buy foreign company and government bonds.

Short and intermediate-term bond mutual funds focus on a specific maturity range. Short-term maturities are generally bonds that make the last payment to you within five years from when you buy it. Intermediate-term bonds pay in full within 10 years. There are both taxable and municipal bond funds with these maturity targets.

One thing to be very careful about with this type of fund is that the credit quality of the bonds can vary from fund to fund. One fund could hold very risky intermediate term bonds while another might hold only U.S. government issues with similar maturities.

General bond mutual funds are a catch-all for bond funds that hold both taxable and municipal bonds. Funds in this category simply don't specialize in any way. Maturities can vary as well. My warning to you about the varied credit quality of the bonds in this funds means that you really have to beware as to what you are buying.

High-yield municipal and taxable bond mutual funds specialize in low-credit quality issues, like bonds sold by Orange



TIP: The Roth IRA is self-directed, judgment-proof, and probate-free. This means that you get to pick your own stock, don't lose it if someone sues you, and your kids don't have to cut it up with the government when you kick the bucket!

County in California that went bankrupt.⁵ These bond issues have higher yields because of the greater risk that you may not get paid. As a result, “*high-yield*” bond mutual funds can be very volatile. These are just as bad as junk bonds, so don’t buy these either!

Mortgage mutual funds specialize in mortgage backed securities such as the Government National Mortgage Association (GNMA also known as Ginny Mae) issues. There are no municipal mortgage-backed securities yet so these are all taxable bond funds.

World bond mutual funds invest worldwide and are few in number. Some specialize in only foreign government issues while others buy a variety of non-U.S. issues. These are all taxable funds.

Insured mutual bond funds are a type of municipal bond fund. Municipal bond issuers frequently purchase insurance that guarantees the bond’s payments will be made. Such bonds have very little possibility of default, so some funds specialize in them.

Single-state municipal bond funds specialize in issues from a single state. These are especially important in states like California that have high state and municipal tax rates. Confusingly, this classification refers only to long-term funds. Short and intermediate single-state funds are classified with other maturity-based municipal funds.

Stock and Bond Funds

This last major group includes a variety of funds. The only common feature is that these funds don’t invest exclusively in either stocks or bonds. For this reason, they are often called “**blended**” or “**hybrid**” funds.

Balanced stock and bond mutual funds maintain a relatively

⁵ In December 1994, Orange County stunned the markets by announcing that its investment pool had suffered a loss of \$1.6 billion. This was the largest loss ever recorded by a local government investment pool, and led to the bankruptcy of the county shortly thereafter. This loss was the result of the unsupervised investment activity of Bob Citron, the County Treasurer, who was entrusted with a \$7.5 billion portfolio belonging to county schools, cities, special districts and the county itself. In times of fiscal restraints, Citron was viewed as a wizard who could painlessly deliver greater returns to investors. Indeed, Citron delivered returns about 2% higher than the comparable State pool before this financial disaster was revealed. Lesson: don’t believe anybody who claims to be a “financial wizard” and learn to pick your own stocks!

fixed split between stocks and bonds. They emphasize relatively safe, high-quality investments. Such funds provide a kind of “one-stop shopping” for fund investors, particularly smaller investors, because they diversify into both stocks and bonds.

Asset allocation stock and bond mutual funds come in two flavors. The first is an extended version of a balanced fund that holds relatively fixed proportional investments in stocks, bonds, money market instruments, and perhaps real estate or some other investment class. The target proportions may be updated or modified periodically.

The other type of asset allocation fund is often called a **flexible portfolio fund**. Here, the fund manager may hold up to 100% in stocks, bonds, or money market instruments, depending on his or her views about the likely performance of these investments. These funds essentially try to time the market, guessing which general type of investment will do well (or less poorly) over the months ahead.

Convertible stock and bond mutual funds can be swapped for a fixed number of shares of stock at the option of the shareholder. Some mutual funds specialize in these bonds.

Income stock and bond funds emphasize generating dividend and coupon (bond interest) income on investments, so it would hold a variety of dividend-paying common, as well as preferred, stocks and bonds of various maturities.

The key that I want you to remember is that the mutual fund’s objective is not informative and should be ignored because it is just marketing hype. You should only look at the composition of the fund — what stock or bonds it actually holds in its portfolio.⁶ **Lipper, Inc.**



HUMOR: Feudalism: You have two cows. Your feudal lord takes some of the milk.

⁶ A portfolio is a collection of investments all owned by the same individual or organization. These investments often include stocks, which are investments in individual businesses; bonds, which are investments in debt that are designed to earn interest; and mutual funds, which are essentially pools of money from many investors that are invested by professionals or according to indices.

is a helpful company that tracks mutual fund composition. To check the portfolio composition of a mutual fund you are considering buying, go to *www.lipperweb.com*.

Mutual Fund Performance

Mutual fund performance is tracked very closely by a large number of organizations. If you look at performance ratings in the Wall Street Journal, you would wonder why anyone would buy a fund other than those mutual funds with the highest returns. This is a bad strategy because if the market has done well, the best ranked funds may actually be the riskiest. In a market downturn, the best ranked funds are most likely to become the worst ranked funds.



HUMOR: Communism: You have two cows. Your neighbors help take care of them and you share the milk.

There is an even more fundamental criterion. Ultimately, you don't care about historical performance; you should only care about your wealth. Many of the highest performing funds have the highest costs. These costs act as a constant drag on the mutual fund's performance and your bottom line, and have persistently poorer returns than otherwise similar funds. Now that you know all of this, just stick to no-load indexed mutual funds!

Money Market Funds

Some people use money market funds to park money, like in 2000 when the inside corporate executives were selling, the market was falling and interest rates were very low — you don't want to own a stock or bond mutual fund. A unique feature of **money market fund accounting** is that the net asset values are \$1 per share. This is purely an accounting trick to make the fund behave like a savings account at your local bank. A money market fund simply sets the

number of shares equal to the fund's assets. In other words, if the fund earns \$100 million in assets, then it has 100 million shares. As the fund earns interest on its investments, the fund owners are simply given more shares.

The reason that money market funds always maintain a \$1 net asset value is to make them resemble bank savings accounts. As long as a money market fund invests in very safe, interest-bearing, short-maturity assets, its net asset value will not drop below \$1 per share. However, there is no guarantee that this won't happen, and the term "**breaking the buck**" is used to describe the fund's share price dropping below \$1 in net asset value. This is a very rare situation, but, in 1994, several large money market funds experienced substantial losses because they purchased relatively risky derivative assets (stock options are a derivative asset, for example) and broke the buck — so it definitely can happen.

Money market funds are either taxable or tax-exempt. Taxable funds are more common; of the \$2.3 trillion in total money market fund assets in 2003, taxable funds accounted for about 87 percent. As a general rule, interest earned on state and local government securities (called "**municipal securities**") are exempt from federal income tax. Non-taxable money market funds, therefore, only buy these types of tax-exempt securities.

Some tax exempt securities go even further. Interest paid by one state is often subject to another state's taxes depending on where the mutual fund shareholder lives. Therefore, some tax-exempt funds buy only securities issued by a single state. For residents of that state, the interest earned is both federal and state tax-exempt. For beleaguered New York City residents, there are even **triple-tax-free money market funds** that only invest in New York City obligations,



TRAP: Do not buy bond funds when interest rates are low or rising — that is when they lose value!

thereby allowing the residents to escape federal, state and metropolitan income taxes on the interest earned.

Tax exempt money market instruments pay much lower **yield** (interest rate) because of their favorable tax treatment. For example, in mid 2003, taxable money market mutual funds offered about a 1.2% yield, whereas tax-exempt funds offered only 0.9%. Which is better depends on your individual tax bracket. If you're in a 40% bracket, then the taxable fund is paying only $(0.12)(1 - 0.40) = 0.0072 = 0.72\%$ yield after-tax — you're better off with the tax-exempt fund.

Money Market Deposit Accounts

Most banks offer what are called **money market deposit accounts (MMDAs)**, which are a lot like money market mutual funds. For example, both money market funds and money market deposit accounts generally have limited check writing privileges. There is a very important distinction between a bank-offered money market account and a money market fund. A **bank money market** account is a bank deposit offering FDIC protection,⁷ whereas a money market fund does not. A money market fund will generally offer SIPC protection,⁸ but this is a poor substitute for FDIC protection because it does not insure against investment losses, such as if an MMDA “breaks the buck” for mishandling the funds investment portfolio. Confusingly, some banks offer both money market accounts and, through a separate entity, money market funds. A money market account with FDIC protection is much, much better than a money market fund with only lousy SIPC protection!

7 The Federal Deposit Insurance Corporation (FDIC) is a federal agency that insures deposits in member banks and thrifts up to \$100,000.

8 The Securities Investor Protection Corporation (SIPC) is a non-profit membership corporation established by Congress which insures securities and cash in customer accounts up to \$500,000 (up to \$100,000 on cash) in the event of brokerage bankruptcy. The SIPC is funded by all of its member securities broker/dealers. While it insures the account in the event that a brokerage runs out of funds to cover its claims, it does not, however, insure against investment losses.

CLOSED-END FUNDS, EXCHANGE TRADED FUNDS, AND HEDGE FUNDS

Closed end funds have some weird things worth knowing.

Closed End funds

The major difference between a closed-end fund and an open-end fund, you'll remember, is that closed end funds don't buy and sell shares. Instead, there are a fixed number of shares in the fund, and these shares are bought and sold on the open market. About 450 closed-end funds have their shares traded on U.S. stock exchanges, which is far fewer than the approximately 7,000 long-term, open-end mutual funds available to investors today in 2006.



HUMOR: Militarism: You have two cows. The State takes both and drafts you.

The Closed-End Fund Discount Mystery

Wall Street has many unsolved puzzles, and one of the most famous and enduring has to do with the price of shares in closed-end funds. Shares in closed-end funds trade in the market place and share prices can differ from their net asset values in a very strange way. Perplexingly, most closed-end funds sell at a discount to their net asset values, and the discount is sometimes substantial!

For example, suppose a closed-end stock mutual fund owns \$100 million of stock and the fund itself has 10 million shares outstanding. The NAV is \$10. But it is not at all unusual for the share price to trade at \$9; a discount of 10%. What is so puzzling is that you can purchase \$10 worth of stock for only \$9!

Even more puzzling is that the typical discount fluctuates over time. Sometimes the discount is very wide; at other times, it almost disappears. Despite a great deal of research, the closed-end fund discount phenomenon remains completely unexplained.

Because of the discount on closed-end funds, it is often argued that funds with the largest discounts are attractive investments. The problem with this logic is that it assumes that the discount will narrow or disappear. Unfortunately, this may or may not happen; the discount might even grow wider.

Avoid at all costs IPOs of closed-end funds. When a closed-end fund goes public, its shares are offered without a discount. Using the example above, you would have to buy the IPO shares at \$10. You will get hosed in two ways. First, the fund promoter will be paid a hefty chunk, perhaps 7% off of the top from the proceeds, or about \$7 million in this example (this will be disclosed in the prospectus that you can read before buying shares of the fund). The problem is that this fee will come straight out of your money that you put in the fund, leaving a total value of \$93 million and an NAV of 9.30. Second, the shares will then drop in value to reflect the discount relative to the NAV in the market, so you would lose another piece of your investment almost immediately. In short, newly offered closed-end funds are horrible investments that you should avoid.

Exchange Traded Funds

Exchange traded funds (ETF) are a recent financial innovation. They have been around since 1993, but they really began to grow in the late 1990s. As of 2003, there were over 100 traded ETFs. Basically, an ETF is an indexed mutual fund. When you buy an ETF, you are buying the particular basket of stocks of an index. For example, the best known ETF is the **Standard and Poor's Depository Receipt (SPDR)**, pronounced “**spider**”, which simply buys the S&P 500 index.

What makes an ETF different from an index fund is that an ETF actually trades like a closed-end fund. ETFs can be bought and sold during the day and can also be sold short. They generally have very low expenses — lower even than index funds — but you have to pay a commission to buy and sell shares.

The fact that ETFs trade like shares in closed-end funds raises the possibility that they could sell at a discount to the net asset values, but this probably won't happen. The reason is a little complicated. The fund will buy and sell directly like an open-end fund, but there is a minimum purchase size of 50,000 shares. Furthermore, an ETF will redeem shares in-kind, meaning that if you sell a block of 50,000 shares to the fund, you actually receive the underlying stock instead of cash. So, if an ETF were to sell for a discount, big investors would buy up the shares, redeem them in exchange for the stock, and then sell the stock, thereby capturing the discount without taking any risk. This kind of buying and selling that ensures that ETFs will probably never trade at a discount has a special name I mentioned before called arbitrage.

Arbitrage is a risk free activity that involves buying and selling at the same time a security such as a stock, futures contract, option, or ETF to take advantage of a price difference in two markets. In plain language, if a company's stock is selling for \$12 on the NYSE and \$9 on the AMEX, then **arbitrageurs** — people who do arbitrage — will buy the stock on the AMEX and sell the same stock on the NYSE for as much as they can as fast as they can. The increased buying on the AMEX will cause the price to rise on the exchange while the increased selling on the NYSE will cause the price on that exchange to fall until the price is the same on each exchange. In finance, we say that arbitrage keeps prices in line by forcing **price convergence** — a uniform price for the same asset, such as a stock. This is also known as the **law of one price**.

Which is better, an ETF or a traditional index fund? It's hard to say. For an index like the S&P 500, it probably doesn't make much difference. However, one place ETFs seem to have an edge is with some of the more specialized indexes I discussed before. For example, ETFs provide a very cheap way of purchasing non-



HUMOR: Mafia: You have two cows. You give one to the Godfather on the day of his daughter's wedding. In return, he doesn't have your legs broken.

U.S. indexes. Similarly, there are ETFs that track industry indexes for which few ordinary index funds are available.

Like any investment, ETFs aren't appropriate for everyone in every situation. Here is a rundown of the pros.

- You have a lot more flexibility than in a mutual fund because ETFs are listed on an exchange – you can buy and sell them at whatever share price they happen to be trading during the day just like shares of stocks.
- Because they trade like stocks, you can buy ETF shares on margin, with borrowed money in hopes of magnifying your gains.
- You can also use techniques for profiting from market downturns such as selling short — which involves borrowing shares and selling them in the hopes of replacing them with less expensive shares when the market falls.
- Remember, I don't recommend that you short, but it is possible to short ETFs.
- The ETF's biggest positive is low annual operating costs. These expenses are not only well below those of traditional mutual funds, but in many cases even less than the expenses levied by their index fund counterparts.

For example, the iShares S&P 500 ETF charges 0.09 percent of assets per year, or just \$18 a year on a \$20,000 investment, while the Vanguard Total Stock Market VIPER, an ETF that tracks the entire U.S. stock market including stocks large and small, carries annual operating fees of just 0.07% of assets, or just \$14 a year on a \$20,000 investment. When a mutual fund manager sells a stock for a gain, shareholders in the fund are on the hook, regardless of whether they've sold their fund shares — you can *lose* money in a mutual fund *and* still *be taxed!* ETFs trade on an exchange like stocks, which means you're buying shares from or selling them to another ETF investor. So the ETF itself doesn't have to buy or sell securities, meaning there are no taxable gains to be passed on. ETFs may still generate taxable gains, however, if they have to sell shares to reflect a

change in the stocks that make up the index they track. And like any other mutual fund, an ETF must pass along interest and dividend payments it receives. The important thing to remember, though, is that you are dealing with the share price, not the NAV, and you know exactly what your tax consequences are.

Here are the cons to investing in an ETF.

- Probably the biggest disadvantage to ETFs is that you've got to buy them through a broker but the good news is that you don't have to use a full service broker — you can buy them through online discount brokerages like a single stock.
- If you buy through an online discount brokerage, then these commissions are very much minimized — unless you are dollar cost averaging with small amounts of money.
- Even with the low fees available at discount and online brokers these days, brokerage commissions can seriously erode an ETF's low-expense advantage, especially when investing small sums of money. If this is the case, you will have to wait for enough capital to pile up in your investment account to offset the brokerage commission. For example, if you were planning to invest, say, \$100 a month in ETFs, even a cost of just \$10 per trade would mean 10% of your investment is being siphoned off. So your ETF's price would have to rise 10% just to recoup your buying cost — and you'll have to pay a commission when you sell, too.

For this reason alone, ETFs are generally better for investors who are socking away larger amounts of money – such as 401(k) plans that offer ETFs and 401(k) rollovers to self-directed IRA plans like the standard IRA and Roth IRA. If you're more likely to be dollar cost averaging with small sums or you tend to invest sporadically with modest amounts of money, you're probably better off in a regular mutual fund.

Since you can very easily move in and out of ETFs quickly, you could be tempted to try jumping into sectors of the market you

believe are about to explode for gains and then bail out just before the sector tanks. This is called **over-trading** and is a huge problem for single stock investors. This may seem like a great strategy in theory. In reality, it's a difficult feat to pull off. Many investors end up buying into hot sectors late after prices have been bid up and

FACT

FACT: One of the most popular ETFs is the NASDAQ-100 —symbol QQQQ. Many people also trade options on this ETF.

then find themselves selling for a loss after the sector flames out. Even if you manage to time your entry and exit correctly, there's still the matter of transaction costs, which can eat into potential returns. You may be the shining exception, but research by finance professor Terrance Odean shows that the more often individual investors trade, the worse they tend to do.⁹

Hedge Funds

Hedge funds are a special type of Investment Company. They are like mutual funds in that a fund manager invests a pool of money for investors and takes his fee off the top. However, unlike mutual funds, hedge funds are not required to register with the SEC. They are only lightly regulated and are generally free to pursue almost any investment style they wish. In contrast, as you now know, mutual funds are regulated and are relatively limited in their permitted investment strategies. For example, mutual funds are not allowed to do things like sell short or use a large degree of leverage.

Hedge funds are also not required to maintain any degree of diversification or liquidity.¹⁰ They don't have to redeem shares on

9 Odean, T., "Do Investors Trade Too Much?", American Economic Review, 1999, Volume 89, Issue 5, 1279-1298

10 **Diversification** is a portfolio strategy designed to reduce exposure to risk by combining a variety of investments, such as stocks, bonds, and real estate, which are unlikely to all move in the same direction in terms of price. The goal of diversification is to reduce the risk in a portfolio. Volatility is limited by the fact that not all asset classes or industries or individual companies move up and down in value at the same time or at the same rate. Diversification reduces both the upside and downside potential and supposedly allows for more consistent performance over a wide range of economic conditions — Warren Buffet calls diversification, "*an excuse for not thinking!*"

demand, and they have little in the way of disclosure requirements. **Disclosure** is simply the release of relevant information. The reason that hedge funds avoid many of the restrictions placed on mutual funds is that they only accept “financially sophisticated” investors, and they do not offer their securities for sale to the public. A financially sophisticated investor is, as a practical matter, usually either an institution or a high net worth (rich) individual. Some types of hedge funds are limited to no more than 100 investors.

Hedge funds typically have a special fee structure, where, in addition to a general management fee of one to two percent of fund assets, the manager is paid a special performance fee. This special performance fee is often in the range of 20% to 40% of profits realized by the fund’s investment strategy. A modest fee structure might be one that charges an annual management fee of 1% of the fund’s assets plus 20% of any profits realized — even more elaborate fee structures are common. A big investor beware here because hedge funds are notorious for fraudulent Ponzi schemes I describe later in this book. A con artist running a hedge fund can completely wipe you out so be extremely cautious if you are ever considering investing in a hedge fund.

Worldwide, there are thousands of hedge funds, and the number keeps growing. Big hedge funds may require a minimum investment of \$1 million or more. Small hedge funds may only require a minimum investment of \$50,000 or less. Whether large or small, each fund develops its own investment style or niche. For example, a hedge fund may focus on a particular sector, like technology, or a particular global region, like Asia or Eastern Europe. Alternatively, a hedge fund may pursue a particular investment strategy, like the “market neutral strategy” in which the fund maintains a portfolio approximately equally split between long and short positions. By being long in some securities and short in others, the portfolio is hedged against market risk and said to be “market neutral.” Incidentally, this is often thought to be the source of the term “hedge fund,” originally referring

WALLET DOCTOR SURVIVAL RULE #8

If your 401(K) Does Not Match a Percentage of Your Salary When You Contribute, Open a Roth IRA Instead And "Just Say No" To Your Cheapskate Employer. Consider Looking For Another Job as Well!

to funds that were hedged against market risk. Today, however, the term hedge fund refers to any unregistered investment fund pursuing any type of investment style.

Ever dreamed of becoming an investment portfolio manager? You can by starting your own hedge fund. It may be easier than you think. A hedge fund is typically structured as a limited partnership in which the manager is the general partner and the investors are limited partners. Rather than drag you through the legal details, just know you will need the services of a lawyer specialized in investment companies if you decide to create a hedge fund. My point here is that it is not difficult to do. Really, the hardest part about starting your own hedge fund is finding willing investors. Essentially, you need to find well-to-do individuals who have faith in your investment ideas.

Chapter 5

Learn the Language of Stock Options!

Every story in this book is true. I have simply changed the names to protect the individuals' privacy. Each story is upbeat except this one, although there is a message of hope at the end. I have a very good friend I'll call Captain Bob who is a senior pilot for US Airways. I watched inside corporate executives strip his family of everything Americans hold dear and true. Bob was one of the winners in a first-world economy and an example of the American Dream. That is, until inside corporate America stole his income, his defined benefit plan, and ultimately his pension piece by piece. This story will shake you up and make you question many things that you may take for granted. Don't read this to your kids — they are still too young to stop believing that this country is motivated by ideals like the common good as opposed to just a fistful of dollars.

Before I lunge into Captain Bob's personal account, let me give you a brief financial history of fear and loathing at US Airways. First, a brief background in management theory. **Peter Drucker**, who recently died at the age of 95, is often called the father of corporate management. Drucker's most significant contribution is that he recognized the role of the worker in corporate success. He considered the knowledge of a good employee to be the most significant asset of the firm. Most importantly, he preached the importance of managing employees in a corporate community based on trust and respect. I wonder what opinion he would have today about the stewardship of US Airways ex-CEO David Siegel, who made sure his family's medical coverage was guaranteed for life while he stripped 28,000

US Airways employees and 18,800 retirees of their health coverage in his last year at the helm before skipping town in 2004.

In corporate finance, there are also real concerns about an insane upward spiral of CEO paycheck sizes. Even back in 1984, Drucker felt that CEO compensation was out of control. He recommended back then that it be limited to 20 times the salary of the average worker in the company. By 1991, the average large-corporation CEO earned about 140 times the pay of the average worker. And by 2003, the same CEO earned 500 times the rank and file salary.¹ Also, inside corporate executives get huge severance packages called **golden parachutes** when they lose their jobs.

As you read this you should thinking, “How much does this cost me as a shareholder?”

In 1993, the top five executives of U.S. public companies siphoned away 4.8% of company profits. By 2003, they were able to pirate away 10.3% of the earnings of the companies they “managed.” The total in 2003 was roughly \$290 billion — ten times the 2005 discretionary budget for the Department of Homeland Security!²

There is also the problem of **unprofitable mergers**. Did you know that senior inside executives get even more money when they buy a new company or sell their current one as long as they negotiate the whole deal? They make a pile of money when they close the sale or merger of the company they manage and get another pile of money — a golden parachute — for losing their job. Can you see the serious conflict of interest with the shareholders?

Executive Insider	Deal	Booty
James Kilts	2005 Gillette – P&G merger	\$153 million
John Zeglis	2004 AT&T Wireless sale	\$32 million
David Dorman	2004 AT&T Wireless sale	\$10.3 million
Other top AT&T Executives	2004 AT&T Wireless sale	\$31 million
Wallace Barr	2005 Caesar’s Entertainment Sale	\$20 million

1 Bebchuk, Lucian Arye and Fried, Jesse M., “Executive Compensation as an Agency Problem” . Journal of Economic Perspectives, Vol. 17, Summer 2003

2 Lucian Bebchuk and Yaniv Grinstein, “The Growth in Executive Pay” (Discussion Draft, 2005) (“During this period [1993-2003], pay has grown much beyond the increase that could be explained by changes in firm size, performance and industry classification. Had the relationship of compensation to size, performance and industry classification remained the same in 2003 as it was in 1993, mean compensation in 2003 would have been only about half of its actual size.”)

Another real problem is that inside executives get paid even if the company crashes. The year before Refco sold shares to the public — and immediately made the fourth-largest bankruptcy filing in U.S. history — insiders at the firm sucked away more than \$1 billion from the company. The top three executives at Viacom — CEO Summer Redstone and co-presidents Tom Freston and Leslie Moonves — received a total compensation of \$160 million in 2005. Viacom then lost \$17.5 billion as its share price fell 18%. Corporate corruption, however, is not strictly a male trait. Hewlett-Packard paid outgoing CEO Carly Fiorina a severance package of \$21 million — within a month HP paid incoming CEO Mark Hurd a \$20 million “welcoming package.” Former Disney President Michael Ovitz made \$140 million in 1996 after only 14 months on the job. US Airways CEO David Siegel collected \$4.5 million upon leaving after placing the carrier in its second bankruptcy. Procter & Gamble CEO Durk Jager left the company with a package in excess of \$9.5 million after overseeing a 55% drop in share price. Morgan Stanley’s former CEO Phillip Purcell was due to receive \$62 million in retirement, yet was also paid an additional \$44 million plus administrative support and executive medical benefits when he recently left the financial giant under a cloud of problems.³

David Siegel was just one of the recent MBA-holding hit-and-run artists to become a top US Airways executive. He joined US Airways in March of 2002 at a salary of \$750,000. When he filed the company for bankruptcy in August of 2003, he conceded to a 20% pay cut to \$600,000 but had already received a signing bonus equal to one full year of his original \$750,000 pay. When Siegel resigned in April of 2004, employees were informed that he had received \$9 million dollars in salary and stock compensation as severance from the company.

3 See “Insiders Collected More Than \$1 Billion Before Refco Collapse,” New York Times, Oct. 20, 2005; “While Shares Fell, Viacom Paid Three \$160 Million,” New York Times, Apr. 16, 2005; “Our Opinions: CEO Rakes In Money For Nothing,” Atlanta Journal Constitution, Apr. 4, 2005; “Take That Handshake and Shove It!: Carly Fiorina’s Payoff Share Not Fair,” Pittsburgh Post Gazette, Feb. 20, 2005; “Platinum Chutes Gives Fired CEOs a Heavenly Ride,” Chicago Tribune, Sept. 16, 2000; “Nice Work If You Can Lose It” The Economist, July 14, 2005.

This outraged employees, but severance deals for prior US Airways inside executive pillagers were far worse. In February of 2003, employees were told that \$35 million had been paid to three top former executives in 2002 — just months before US Airways’ first bankruptcy filing and after the pilots had been robbed of their wages and pensions. Captain Bob, for instance, had his salary reduced from \$250,000 to \$110,000 per year. Stephen Wolf, former US Airways chairman of the board, received a \$15 million lump payment in March 2002. Rakesh Gangwal got a \$15 million lump sum after he quit as CEO in November 2001. Lawrence Nagin stole away with \$5 million as an already retired executive vice president in March 2002. These payouts were hidden from shareholders and employees. They were deceitfully tucked deep inside a tall stack of US Airways documents filed with the court at the end of 2002, just months after the disbursements. Notice how Gangwal and Wolf were working as a team against US Airways shareholders and unionized employees — Wolf at the top of the board and Gangwal occupying the top two managerial posts.⁴



HUMOR: Totalitarianism: You have two cows. The government takes them both and denies they ever existed and drafts you into the army. Milk is banned.

Inside corporate executives used two bankruptcy proceedings to terminate the pension plan for its unionized pilots. All told, the active and retired pilots of US Airways lost \$1.9 billion in accrued benefits that were not funded by the plan and were not insured by the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a federal agency responsible for insuring certain benefits under private defined benefit pension plans. This loss amounted to just over one-half of the

\$3.7 billion in total benefits that pilots had already earned as of the time the plan terminated. With US Airways’ second bankruptcy, the three pension plans covering the rest of US Airways’ employees were

⁴ See “US Airways gave \$35 million in pension payments to top 3 former executives”, Post-Gazette, Wednesday, February 26, 2003

terminated and taken over by the PBGC. PBGC has estimated that the assets of these three plans cover only 40% of liabilities.

The airline's inside corporate executives contended that unless it could reduce its pension expenses — what it must pay over the next seven years to cover its unfunded pension liabilities — it wouldn't have been able to obtain the federal loan guarantee and equity funding the insiders claimed it needed to survive. The airline's inside executives promised pilots that they would replace the scrapped pension plan with another. They never did; they just left town with bags and bags of US Airway's looted money other employees had worked so hard to earn.

While being cross-examined by the unionized pilots' attorney, US Airways Chief Financial Officer Neil Cohen testified that Wolf, Gangwal and Nagin received their millions in lump-sum retirement payments. The Air Line Pilots Association's spokesman Roy Freundlich said the testimony, which the union immediately posted on its website, confirmed what many pilots suspected — the airline's top executives were protecting their pensions while sacrificing those of other employees. The disclosure of the retirement payouts came at a time when US Airways insiders slashed the airline's ranks by more than 16,000 and wrested more than \$1 billion in annual wage and benefit concessions from its unionized workers.

The pilots as a group agreed to \$565 million in annual concessions without having been informed of the large executive payouts. They contend that if their pension plan is abolished and taken over by the federal Pension Benefit Guaranty Corp., they could lose as much as 65% of their benefits.

This wasn't the first time that Wolf and Gangwal have been criticized for their salary and benefits. In August 2001, when the deal to merge with United Airlines fell through, Wolf, Gangwal and Nagin



HUMOR: Capitalism: You have two cows. You sell one and buy a bull. Your herd multiplies, and the economy grows. You sell them and retire on the income.

agreed to forgo their contractual rights to resign that fall, making them eligible for severance packages totaling a combined \$45 million. The three made the move amid protests from workers. In the next month, Wolf and Gangwal came under fire again from labor unions for retaining their full salaries at a time the airline was slashing its work force and seeking concessions from its employees following the 9/11 attacks. The pair later agreed to give up their salaries and benefits for the last 15 weeks of 2001, moves that cost them nearly \$200,000 apiece — a pittance compared to what they later received.

In 2000, Wolf's compensation from all sources totaled \$11.6 million, including \$7.6 million in reimbursement for taxes paid on restricted stock received over the years. Gangwal earned \$12.1 million in total compensation, including a \$7.2 million reimbursement for tax liabilities. In 1998, Wolf and Gangwal both earned nearly \$35 million in salary, bonuses and stock options.

In 2004 the new CEO of US Airways, Bruce Lakefield, was awarded by the bankruptcy court a compensation package of \$425,000 in annual salary and 760,000 shares of US Airways stock. As of May 24, 2006, US Airways Group Inc. (LCC) is trading at \$43.82 per share of common stock. Lakefield's options are already worth \$33,303,200.00! On top of that, Lakefield will get three years of base salary and bonuses if the company is sold and he loses his job. William Lauer, chairman of Allegheny Capital Management, a former US Airways investor, said, "*These payments are yet another example of outsized compensation to management that borders on looting.*"

As I mentioned before, my friend Bob is a pilot for US Airways. As a Captain, his responsibilities include ensuring the safe transportation of hundreds of thousands of families to their destinations. As a Captain, he viewed his role in the corporation as a production leader, upper manager, and safety expert rather than just labor. During his career, he assumed he was adequately represented by his union, the **Air Line Pilots Association**, Int'l (ALPA). He assumed that the union was looking out for both his career and retirement, as it was supposed to, so that he could spend the majority of his efforts

looking after his passengers, aircraft and crew. He strongly believed that his union was representing him fairly and in his best interest. He also strongly believed in corporate America and in what executive leadership was saying they were trying to accomplish. He saw corporate America as something to be very proud of and he trusted the executives in charge of his company — what a mistake!

Bob started flying as a naval test pilot long before he became a commercial pilot and is known as one of the most safety conscious and competent pilots in US Airways today. The demands of the job of a commercial pilot are rigorous. This is why the job traditionally has been associated with a high salary. Pilots must also spend extensive time away from home. Bob had to make a difficult decision early in his career as an airline pilot — stay in the Navy Reserves and give up his time off each month to qualify for a government retirement or place his trust in US Airways. The carrier offered a pension that guaranteed him 50% of his highest salary over the past ten years upon retirement, which would have been half of \$250,000. Bob decided that the company's pension plan would be enough to retire on comfortably. By giving up the Navy Reserves, he could spend what little time he had left with his family.

US Airways was very profitable in the 1990s and amassed \$2 billion in cash due to a strong economy, low fuel prices, and less restricted travel. Bob recalls:

FACT

FACT: *"In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging."* — Warren Buffett in a letter to Berkshire Hathaway Shareholders

As the climate in the airline industry darkened starting in 2000 when insiders were selling out throughout the stock market, Wolfe and Gangwal needed to prop up the stock price so that their stock options would guarantee

them a vast windfall profit. They used US Airways' \$2 billion in cash with a crude but effective scheme. They used the money to buy the stock back to protect their cost-free-to-them option equity instead of funding the employee pension. They did not even save any of the cash as a safety net as even the most modest of financially literate households do. They were such crappy managers they didn't even hedge the main variable cost of the firm — jet fuel — as all well managed airlines do. Hedging was part of their training in their MBA studies — as pilots we are supposed to know things like how to fly a plane and as haughty-tauty MBAs they are supposed to know things like how to hedge jet fuel! This proved to be a very costly mistake when fuel prices later rose. They probably estimated that they would be retired from the company soon anyway after they sold their options. CEOs can come into a corporation, make changes (whether good or bad) and give themselves in a few years a retirement plan that we all dream of instead of 20 to 30 years of labor like everybody else.

Meanwhile they talked extensively to the press about a negotiated merger with United Airlines — they talked as if the merger was guaranteed. US Airways stock was volatile. Bob was able to swing trade his 401(k) up to \$280,000 and many other pilots were doing the same. Bob explained:

Wolfe and Gangwal didn't like the dampening affect this had on the upward run of the stock price, so they arbitrarily changed the rules of the 401(k) so that when employees traded out of the stock, they could not get back in for at least thirty days. This forced employees to buy and hold for the long term. Remember, Scott, this was a volatile airline stock, not a dividend paying

utility. While we employees were pumping money into the company, inside corporate executives were sucking it out by exercising their inflated employee stock options. In other words, while these US Airways corporate executives were spreading a rosy picture about the stock — and its probability of future price increases — they were selling out. The employees were making a market for the inside corporate executives of US Airways! As insiders told the press, the merger with United was supposed to be a sure thing. Wolfe and Gangwal bragged that sixty dollars a share was going to be the future price for all remaining US Airways shares. If the deal didn't go down, Wolfe would get \$50 million because he had done his part of setting US Airways up for sale.

Bob talked about how disappointed he was when the deal went south with the Justice Department antitrust division. “They stopped the deal! Talk about a precipitous fall in stock price,” Bob lamented. “US Airways stock plummeted. 9/11 just made the slide worse.”

Then came corporate restructurings where Wolfe and Gangwal left filthy rich and brought in a hard-nosed CEO named Siegel who was best known for his ability to play hardball with labor unions. “What a crappy track record he had,” smirked Bob. “In just one year at the helm of Budget Rental Car, he made enough bad business decisions to put it in bankruptcy. The thing that ‘Bugsy’ (as he was known by the pilots) had going for him was that he was friends with Wolfe and had no ethics. He made a statement at a board meeting when he arrived that he was going to make all the corporate executive board members millionaires and he was not going to let the pilot pension plan get in the way.⁵ Unfortunately for him, one of the board members was a pilot who didn't appreciate the statement too much. He did the unthinkable anyway and stripped the pilots of their pensions.

⁵ Benjamin “Bugsy” Segal was a famous mafia criminal who led a giant underground gambling scene during the Great Depression in Las Vegas, Nevada.

“Good ol’ ‘Bugsy’ Siegel left in just a couple of years with millions in his pocket while us pilots who had worked far harder for the firm for most of our adult lives were left behind broke.” Bob is still bitter when he discusses how inside corporate executives stole everything he held dear.

Bob explained to me how he got started investing:

When I got married in 1976, I purchased a house in San Diego — a little townhouse in Chula Vista — for \$36,000. Two years later, I sold it for \$78,000 and made \$42,000. And then I went overseas, but before I did I opened a Merrill Lynch account with Johnny, the stockbroker/vice president of the firm. I made some choices and bought some stock. I bought some Occidental Petroleum that paid a huge dividend — a 14% dividend back then when interest rates were through the roof. I had a couple of investments that were returning high interest rates and I felt that this was the way to go and it turned out that dividends and interest payments actually were the way to go. While I was overseas, my stockbroker called me and said, “Bob, they are about to call (retire) your shares of Occidental Petroleum so you need to buy Buttes Oil and Gas.” I said, “Well, you know more than I do because you are the big stockbroker guy.” So, I sold Occidental Petroleum, and guess what — they never called the stock like my broker said. He bought Buttes Oil and Gas for me at \$15 a share and now if you pull up the 52-week high during that period, you never quite got to \$15 per share. However, he filled me at \$15 per share. I paid \$15 per share because I believe that my stockbroker screwed me on the deal. The stock went down and down while Occidental Petroleum went up and up. Finally, in frustration, I called

my broker and instructed him to sell at \$3.00 per share. I really lost, and today I wonder what special incentive he got for unloading the stock on me.

Bob discussed the dark underbelly of Wall Street — the full-service stock brokerages. “Back in those days,” he said, “and I am sure it still goes on today, these stock brokers have programs incentives to sell certain stocks their big clients own to get them out at a profit by selling the stock to poor suckers — the little guy investors — like me and you who end up holding the bag. That was the first big negative thing that happened to me in the stock market and is when I really lost faith in stock brokers as being the ‘all knowing stock market go-to-guys.’ I also read this book entitled the *Unemotional Investor* that tells you more about how some of these brokerage programs work and why you should learn to hate a full-service stock broker.⁶

“That is when I went to buying and selling directly through a Day Tech account,” Bob continued. “Then they became Ameritrade and more recently merged with TD Waterhouse into TD Ameritrade. This freed me from the web of the full-service broker by working strictly through an online discount trading account. There is never a reason to pay someone \$200 to \$500 for pushing the same button that just says buy a stock at a certain price when you can do the same for under \$10!”

Bob continued with his story:



HUMOR: Enron Venture Capitalism: You have two cows. You sell three of them to your publicly listed company, using letters of credit opened by your brother-in-law at the bank, then execute a debt/equity swap with an associated general offer so that you get all four cows back, with a tax exemption for five cows. The milk rights of the six cows are transferred via an intermediary to a Cayman Island company secretly owned by the majority share-holder who sells the rights to all seven cows back to your listed company. The annual report says the company owns eight cows, with an option on one more.

I came back from the Philippines where I had been stationed as a test pilot to a stateside naval aviation testing center and from there I was hired by US Airways as a commercial pilot. When I got hired by US Airways in that first year, I still had \$30,000 left that I hadn't lost to my Merrill full-service broker. I got the idea that, "Hey, maybe equity options look like an interesting way to go," because I thought I could leverage myself and make all of my losses back — on calls and puts and all that. And I had a little strategy of buying a fractional out-of-the-money option on something that looked like it would move fast and a lot in price. My first trade was in Exxon equity options. I bought forty option contracts at 35¢ apiece and sold them quickly as they increased in value to \$1.25 apiece and made \$4,000 right off the top. That was great! I decided I didn't know what I was doing and needed guidance.

I still had another Merrill Lynch account (because I really still hadn't learned my lesson) and my full-service broker for that account was a guy named Paul. He told me, "You have do this and you have to do that with stock options." I abandoned my plan I had developed through independent thinking (as you teach) because I thought I needed someone "educated" to give me advice as well as to share in all the fun.⁷ Paul talked me into spreads and all kinds of things that just trickled away and added up to a lot — \$20,000 to \$30,000 lost trading options in the end. Of course, I was one of Merrill Lynch's preferred customers because I had turned over 60 trades. I felt kind of proud of that, but I eventually realized it was a marketing ploy — another

7

Most stockbrokers do not have an education in finance — they are trained in sales!

psychological trap the full-service brokerages lay out for unsuspecting investors. This is how I learned that you want to trade less, not more.

Of course, I wasn't worried through all of this because I reasoned that I was fully participating in the US Airways 401(k). I figured that as long as I was putting the maximum in the 401(k) and being paid good wages as a pilot that everything would be fine. I also knew that I had an additional pilot pension plan that guaranteed me over \$100,000 a year retiring at 60 — you can pretty much make it on \$100,000 if you have your major debt, such as your mortgage, paid off at retirement.

I had a good trading plan. I was very in tune with airline stocks as a pilot and knew the industry like the back of my hand. Airline stocks are volatile so I would trade in and out of the 401(k) on any news of the airline that made prices jump — any time US Airways stock would make a dollar or two movement I would buy it or sell it and reverse the position when it would come back the other way. I would just be in and out in a day and knock off \$2,000 or \$3,000 a trade. Of course, inside corporate executives hate it when anybody else but them makes money, so they changed the rules on the US Airways 401(k). They made it so that if you sold out of the company stock in the 401(k) you had to wait 30 days to buy back in. This made you want to stay in the stock. This is when I really started to just sit in the stock. The new rule forced me to buy and hold and not sell. This really set me up for my biggest loss ever.

The stock was going up in the early and mid-1990s and then in came the big bad wolf and his teeth — Stephen Wolf as chairman and Rakesh Gangwal as CEO. Wolf was known for dressing up airlines and selling them. US Airways was still profitable and we (ALPA) basically came up with about \$2 billion of value that the company had on the balance sheet. Of course, Wolf had options going to bed. It's funny that when you have an employee stock option plan you really have a little savings account. When we pilots are making \$125,000 per year — down from \$250,000 pre 9/11 — or even worse for lower-paid flight attendants, we all get maybe 7 to 10 shares of stock per year. But the executives get 200,000 to 300,000 shares a year.



HUMOR: A stock analyst is an expert who will know tomorrow why the things he predicted yesterday didn't happen today!

What Wolf did is instead of funding our pension plan — like he was supposed to — he was buying company stock back from the market to prop up the stock price. He did this so that he could get out of his options filthy rich — and he was an employee just like us. He took the \$2 billion in cash that we non-executive employees had created by doing a great job that he was supposed to be using for things like funding our retirement plans and used it to buy up the float of the stock instead. This created buying pressure that artificially inflated the stock price while Wolf and other executives sold out their employee stock options for millions before the price came crashing down.

What you see in corporate America today is that the people who do all of the work — the people who are

there the longest and truly make the company valuable by doing a great job day after day — really get nothing in terms of meaningful employee stock options, bonuses or benefits compared to these corporate hit-and-run artists. Executives come in, but because they have the corporate lawyers behind them fighting for their supposed “valued contribution” to the company, they get hundreds of thousands of shares of stock. They also get millions in bonuses and golden parachutes while their corporate lawyers force the company to pay the taxes. This means that they get it all tax-free, and they are only an employee for two to five years until they move on to another company to strip away the employee created wealth again like financial leeches.

Also remember that these executives have control of the accounting — they have different ways to show a profit or a loss when they want. For instance, we just showed a profit in the first quarter of 2006. Yet, after all the prior doom and gloom, nobody is asking why. The reason US Airways showed a profit is that inside executives wanted preferential financing for the purchase of additional aircraft which increases the value of the firm and ultimately the value of their stock options. Inside executives show a profit or a loss when it serves them — who knows what creative accounting goes on behind the closed doors of the inside executive-controlled boardroom.

What happened with our pensions was truly grotesque. They filed bankruptcy and then they said that our pensioned retirements were under-funded. They termi-

nated our pilot pension plans and that got them out of millions of dollars of debt obligations as they turned it all over to the federal pension guarantee board. Then the federal pension guarantee board told the inside corporate executives to turn over their records showing that the US Airways pension fund was under-funded. The inside corporate executives of US Airways replied that they had made an accounting mistake and that it really was not under-funded but it was too late to for us to do anything about it — we got the shaft and they got the gold mine!

This is what all of these large U.S. corporations are doing — they are using bankruptcy to get out of their pension obligations if they can. Corporate governance has increasingly concerned itself in the United States with making a profit with less and less regard to product quality, employee family financial stability or even the good of the community. The inside executives constantly harp that corporations need an increased profit margin to take care of the stockholders. They find ways to pirate off all the profit from behind the scenes while they act like they are protecting the shareholders. The problem is that in the end neither the shareholders nor the employees get anything. The only winners that walk away from the board are the inside corporate executives who went to lying and cheating school.

In fact, what I have heard recently is that top places that produce these arrogantly self interested executives — such as the Wharton School of Business at the University of Pennsylvania — have had such a problem with the bad



HUMOR: If you owe the bank \$100, that's your problem. If you owe the bank \$100 million, that's the bank's problem.

reputation of their MBA graduates they have pumped into the market that they are now emphasizing more ethics than they used to. They are trying to employ damage control because these top schools have put out a whole generation of the most unethical, lying, cheating bastards alive on the planet. These universities also have law schools pumping out Ivy League corporate attorneys who are another big part of the inside den of thieves that know how to get around the system.

It is very frustrating and we can whine about it all we want, but the question is, "What can we do?" The good news is that you answer that question very well in this book. Now we have Doug Barker at US Airways who seems like a good CEO and seems to be doing good things, but the employees have not forgotten how they used bankruptcy to destroy our pensions and union contracts. Mr. Barker's colleagues have taken the career out of being a pilot, which is an unfortunate thing."

I asked Bob what has happened to his 401(k). He replied, "My 401(k) got decimated because I had it all fully invested in US Airways common stock. Wolf said that the buy out was going to be at \$60 per share when there was a lot of talk of a merger pre-9/11. They also expressed great confidence in the merger. When the government shot the merger down the stock dropped so fast that you couldn't get out of the way. My \$280,000 turned into \$14,000."

"Is that stock back up?" I asked Bob. "No," he replied, "The stock dropped to zero and they retired it and issued a new series of common stock. I lost everything." Basically, said Bob, he felt that his 401(k) and

pension plan were both stolen by inside corporate executives.

Executives didn't tell employees to buy stock because of the merger, he said. "But the opportunity was there. They were spreading all of this good news in the media and you could see that US Airways operations were decent."

Bob continued his discussion of the circumstances surrounding the merger and subsequent fall-out:

The merger with United Airways was going to be a great thing. So all of the company employees were talking about it, but the executives did nothing to explain to us the dangers of putting all of our eggs in the same basket. What is worse is when they changed the rules and you could not get back into the stock for 30 days. This made everyone afraid to get out. That tipped the balance for me because I never used to be in US Airways stock for more than a couple of days — I was in and out due to the volatile nature of the stock. But then you fall into the psychological trap of false hope and you think, "What if the stock does go to \$60?" You become afraid of missing an opportunity. Hope and fear is what drives the whole market!

I have learned a lot from all of this and have become a competent stock investor. Things are a lot better because I buy stocks that are undervalued instead of overvalued using the knowledge that you have taught me. I also refinanced all of my debt, which you also talked me into, at low interest rates — you were a very supportive friend in that time of need. The stocks I buy today are of good companies at ridiculously cheap prices, so all I have to do is patiently wait. I am much more relaxed. I have lost my casino mentality when it comes to in-

vesting. People should not act like they are going to a casino. Just as when they walk into a Las Vegas casino thinking that they don't want to lose more than \$300, but they don't set a goal about how much they want to make. Stock investing is not for entertainment, and they need to take their investing very seriously.

The vast majority of stock investors don't even do simple things like setting a profit goal — they don't know when to take a profit. I take profits now. One stock you showed me made a 100% profit and so I sold it. Now I take profits and that is really what the public needs to learn. Then I look for another undervalued stock to buy.

I also invest in ADRs outside the United States because foreign executives can't possibly be as crooked as these bastards here in the United States. Business schools in America are using this major blunder as a lesson in their courses, but we pilots are still the big losers in corporate America just because we do an honest day's work.

Here is the skinny on stock options. Some harebrained economist in the 1970s came up with an idea and published it so that he wouldn't perish as an academic. His idea was that by giving the managers of the firm employee stock options (ESOs), they would think more like shareholders — they would be motivated to maximize corporate performance and thus their own compensation. The problem is that an increase in the stock price of the company is not caused by management's direct actions. Internal factors, such as great employees, or external factors like increased public interest in stock investing, have much more to do with an increase in stock price than anything management does or doesn't do. In the 18-year

bull market that ended in 2000, inside executives who actually reduced the operational results of their firms because of their own bad management were handsomely rewarded just because the stock rose.

Options are securities that make it possible to invest in stocks without actually owning the shares. Warrants are similar but less common. An **option** is a contract that gives one party a temporary right to buy an asset from another investor at a fixed price. Alternatively, an option can also grant the right to sell.

Options in General

Options are used in business all the time. An option to buy real estate will help you understand the way they work and lead us into options on stocks. Suppose a company is interested in building a new factory and has identified a desirable site but will need six months to make a final decision on the project. How can it hold onto the right to buy the land without making a commitment now?



TIP: Stick to an index fund if you are trading in an account where taxes don't matter like a 401(k), or 403(b) — I recommend the Vanguard 500 (VFINX) fund because of its large size. If you are investing through an account where you have to pay taxes then it is imperative that you avoid short-term capital gains taxes — in this case I recommend something like the Schwab 1000 fund.

WALLET DOCTOR SURVIVAL RULE #9

No matter how painful your experiences with Wall Street and the stock market may be, you cannot heal your investment psychology until you erase the fear, guilt and anger from your mind through true forgiveness — without anxiety, the mind is invulnerable to loss!

a limited time. Now consider the following possibility that will help you understand stock options.

Suppose that after six months, the firm decides it's not going to build the factory but notices that the price of real estate has gone up 30%. What should it do? Clearly, it should exercise its option to buy and then sell the land for a profit — all without owning the land while it appreciated. This is possible with any asset on which options are sold. The big advantage of options is that they cost far less than the underlying assets, yet they give you the right to buy or sell at a locked in price. That advantage is what financial options are all about.

Stock Options

Options on stock are conceptually similar to real estate options, but they are not purchased to acquire stock. Rather, they're bought to speculate on or **hedge** against price movements that cause losses.⁸ Stock options are themselves securities and can be traded in financial markets. An option to buy a stock is known as a **call option** or just a call. Options to sell tangible assets like real estate are unusual, but options to sell stock are very common. They're known as a **put option**, or just a put. I will discuss puts and calls separately in the sections that follow.

Options are the most important example of a class of financial assets known as **derivative securities**. A derivative is so named because it "*derives*" its value from



HUMOR: Two women were walking through the forest when they hear a voice from under a log. Investigating, the women discovered the voice was coming from a frog: "Help me, ladies! I am a full service stockbroker who, through an evil witch's curse, has been transformed into a frog. If one of you will kiss me, I'll be returned to my former state!" The first woman took out her purse, grabbed the frog, and stuffed it inside her handbag. The second woman, aghast, screamed, "Didn't you hear him? If you kiss him, he'll turn into a stockbroker?" The second woman replied, "Sure, but these days a talking frog is worth much more than a full service stockbroker!"

⁸ A hedge is an investment made in order to reduce the risk of adverse price movements in a security by taking an offsetting position in a related security, such as an option or a short sale when you own the underlying stock.

the price of another “*underlying*” security, in this case the optioned shares of stock.

Investors are interested in stock options because they provide speculative leverage, a term applied to any technique that amplifies the return on an investment. Option **leverage** comes from the fact that the return on the investment in stock options can be many times larger than the return on the underlying stock just as a lever in a machine increases physical force.

Call Options

Imagine that a stock is selling for \$55 and someone offers you a contract under which he agrees to sell you a share for \$60 anytime during the next three months. This is a basic call option. It grants you the right to buy a share at a fixed price for a specified period, typically three, six, or nine months. At the end of that time, the option expires and can no longer be exercised. **Exercising an option** is when you decide to buy (in the case of a call) or sell (in the case of a put) the underlying shares of stock according to your rights of the option contract.

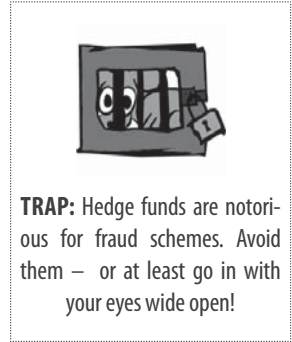
The price the option holder pays for the contract is the **option price**. It’s always a lot less than the underlying stock’s price. An option on a stock worth \$55 giving you the right to buy at \$60 might sell for \$2 or \$3. The stock’s current price is also called the underlying price, but the \$60 guaranteed price you can buy at is known as the option’s **strike price, striking price, or exercise price**.

Ask yourself the following questions: would you pay anything for this option contract? Why? And if you would pay for the deal, what factors would make you pay more or less? Think about these questions before reading on.

My friend Captain Bob might be willing to buy this option, because there’s a chance that the stock’s price will rise above \$60 within the next three months. If that happens, an option owner can buy at \$60 and immediately sell the shares of stock for the higher

market price. For example, suppose Bob pays \$1 in option price for the option. After buying the option, the stock's price goes to \$63. He would exercise at the strike price of \$60 and immediately sell at the underlying price of \$63, making \$3 less the \$1 option premium paid for the option contract — a \$2 total profit.

Notice that the \$2 profit is a 200% return on the \$1 investment in the option. But also notice that if the stock's price doesn't rise above the \$60 strike price in three months, the option expires worthless and the \$1 investment in option premium is lost. That's a 100% loss on the investment that novice option investors often forget about because some investing guru has sold them a course about how non-risky options are!



Two factors make options more (or less) appealing. An option on a volatile stock is worth more than an option on a stock that has less **price volatility** — low volatility means that prices are not bouncing around much. This is because a volatile stock's price is more likely to go above (in the case of a call) or below (in the case of a put) the option's strike price before the option contract expires. **Price volatility** is how much a stock's price moves around. We measure this with something called **standard deviation**.⁹

The Option Writer

There are two parties to a contract — a buyer and a seller. Don't confuse buying and selling the option contract with buying and selling the optioned stock. Until now, I have focused on option buyers who have the right to buy or sell the stock at the strike price, but what about the people who sell options?

Terminology with respect to option sellers can be a little confus-

⁹ Standard deviation is the square root of the average of the squares of deviations about the mean of a set of data. Standard deviation is a statistical measure of spread or variability.

ing until you get the hang of options. Eventually you will come to see that options really are very simple despite all the smoke and mirrors. The first person to sell an option contract is the person who creates it by agreeing to sell the stock at the strike price. He or she is said to **write an option** and is called the **option writer**.

Once the option is written, the option contract becomes a security. The writer sells it to the first option buyer who may sell the contract to someone else later on. No matter how many times the option is sold, the writer remains bound by the contract to sell to (in the case of a call) or buy from (in the case of a put) the current option owner the underlying stock at the strike price if he exercises. A call option writer hopes the underlying stock's price will remain stable. If it does, he or she will get to keep the option premium they received from the buyer when the option contract expires worthless.

Intrinsic Value of an Option

If a stock's current price is below the strike price in the case of a call, or above the strike price in the case of a put, we say that the option is **out**

of the money. This is because the option contract buyer could not make any money exercising the contract. If the stock's price is above the strike price in the case of a call, or below the strike price in the case of a put, we say that the option is **in the money**. This is because the option contract buyer could make money exercising the contract.



HUMOR: What's the difference between buying a lottery ticket and buying a penny stock? In the first case, you help finance your local community swimming pool. In the second case, you help finance the stock promoter's home pool.

When an option is in the money, it has value that doesn't completely depend on the stock's price moving higher in the case of a call or lower in the case of a put. This value is also called the **intrinsic value** of an

option. For example, suppose the stock underlying the option is selling for \$65 in the previous example. Then the option to buy at

\$60 must be worth at least \$5, because an option owner can exercise at \$60 and immediately sell the stock he or she receives at \$65 for a \$5 gain (less the option's price).

The option's intrinsic value is the difference between the underlying stock's price and the option's strike price. In the case of a call, the intrinsic value is the underlying stock price less the strike price. In the case of a put, it's exactly the opposite. The intrinsic value is the strike price minus the underlying stock price.

Investors are willing to pay premiums in excess of the intrinsic value for stock options because of the chance that they will profit if the option goes into the money. **Option premium** is the difference between the intrinsic value of the option and the option's price. The exact amount of a particular option's premium above intrinsic value depends on the stock's volatility (**volatility premium**), the time until expiration (**time premium**), as well as the attitude of the market about the underlying stock — whether investors expect the market price to go up or down. The premium is generally largest when a stock is near but a little below the option's strike price — it diminishes as the stock price rises. This relationship is a result of the way option leverage changes with the price of the underlying stock.

Options and Leverage

Financial leverage is a term used to describe any technique that amplifies **return on investment (ROI)**. For example, suppose a traditional stock investment results in a 10% return. Then a leveraged investment in the same stock might result in a 40% or 50% profit in the same period. Unfortunately, leverage works on losses too, so if the stock's return turned out to be minus 10%, the leveraged investment would have produced a 40% or 50% loss — a lot more of a thrashing than just owning the underlying stock!

Options represent one of a number of leveraging techniques in investing. Imagine that an underlying stock is trading at \$58 and the premium on a call option with a \$60 strike is \$2. The option

price is also \$2 because it is out of the money and its intrinsic value is nothing. Now imagine that the stock price increases to \$65, the option is exercised, and the optioned share is sold.

First let's look at an investment in the stock over the same period. It would have been purchased at \$58 and sold at \$65 for a \$7 profit and an ROI of

$$ROI = \frac{\textit{Profit}}{\textit{Investment}} = \frac{\$7}{\$58} = 12.1\%$$

Now consider investing in the option. The buyer initially paid \$2 for the option. Then he exercised, buying the underlying stock at \$60 and immediately selling it at \$65 for a \$5 gain. But this profit was reduced by the \$2 option price. The option buyer's net profit was \$3, but since he only had the \$2 option price tied up in the transaction, his ROI is

$$ROI = \frac{\textit{Profit}}{\textit{Investment}} = \frac{\$3}{\$2} = 150\%$$

Notice the tremendous power of the option to multiply the investor's return. The option ROI is $150/12.1 = 12$ times that of a straight stock investment! The potential for this kind of return contributes a great deal to the option's value when the stock price is just below the strike price.

The option isn't quite as good a deal when the stock is trading above the strike price. There are two reasons for that. First, the stock price has to rise higher to make a profit; secondly, the buyer has to pay for the intrinsic value and premium for the option. That makes his investment larger, which decreases the leverage effect. These factors make the time premium diminish as the stock's price increases over the strike price.

Suppose the time premium is \$1 when the stock's price is \$65. That means an option buyer pays the intrinsic value of $(\$65 - \$60 =)$ \$5 plus the \$1 time premium, or \$6 for the option. Then suppose that the stock price goes up another \$7 to \$72.

First, consider the return on investment in the stock. It would have been purchased at \$65 and sold at \$72 for a \$7 profit and a return on investment (ROI) of

$$ROI = \frac{\text{Profit}}{\text{Investment}} = \frac{\$7}{\$65} = 10.8\%$$

Now consider the profit on the option. The buyer exercises at \$60 and sells his share at \$72 for a \$12 capital gain. But the option cost \$6, so his profit on the whole transaction is $(\$12 - \$6) = \$6$. His ROI is

$$ROI = \frac{\text{Profit}}{\text{Investment}} = \frac{\$6}{\$6} = 100\%$$

or one-third less than the same price movement from a lower starting point. As a result, the option is less attractive to investors and the time premium is lower.

Options That Expire

It's important to keep in mind that options are exercisable only over a limited period of time at the end of which they expire and become worthless. That makes option investing very risky. For example, if an option is purchased out of the money and the option never goes "into the money," the option expires worthless and the buyer loses the price paid for it. It's important to recognize that this is a 100% total loss — I cannot overemphasize to you that options are very risky!

If an option is purchased at a price in the money — includes a positive intrinsic value and the underlying stock goes down in value — then the option buyer's loss at expiration is the time premium paid plus the decrease in intrinsic value. That will only be a 100% loss if the stock's price declines all the way to the strike price. As its expiration date approach-



TRAP: Options are very risky because of leverage. If you trade options, take them very seriously!

es, any option's time premium shrinks to virtually nothing. Notice that anyone owning an option with a positive intrinsic value just before expiration must act quickly to avoid losing value.

Trading in Options

Up until now, I've treated options as though buyers always hold them until they are either exercised or expire. In fact, that's not the case. An option can be bought and sold between investors at any time during the term of the normal contract. Options on selected stocks are traded on a number of exchanges throughout the country. The largest, oldest, and best known is the **Chicago Board Options Exchange** — abbreviated CBOE.

Price Volatility in the Options Market

Option prices move up and down with the prices of the underlying securities, but the relative movement is much greater for options. For example, an option might sell for \$2 when the underlying stock price is \$58 (with a \$60 strike). Now suppose the stock's price goes up to \$65 while there's still some time until expiration. The option sells for a price with includes its intrinsic value of $(\$65 - \$60) = \$5$ and a smaller time premium. Assume that premium is \$1, so the option's price is \$6 — this is the intrinsic value plus the time premium.

The stock's \$7 price movement from \$58 to \$65 is a 12.1 percent increase, but it has driven the option's price to triple its value from \$2 to \$6 (a 200% increase). As a result, prices in options markets are extremely volatile and fast moving.

Options Are Rarely Exercised Before Expiration

In the situation I just described, suppose the option owner believes that further increases in the underlying stock's price are not likely — the price movement is very tranquil or dropping — and

wants to close out his investment even though there's a good deal of time left until expiration, thus the option has lots of time premium. In that case, virtually all traders would sell the option to another investor rather than exercise it. That's because exercising brings only $(\$65 - \$60) = \$5$, which is less than the \$6 option price. Exercising means throwing away whatever value there is in time premium, in this case \$1. As a result, options are rarely exercised before expiration when the premium value shrinks to nothing.

The Downside and Risk

It's really important to think about the downside when day-dreaming about the upside of option trading. There's a chance of a very high return through leverage, but there is also a good chance of total loss. Another way of saying this is that leverage works both ways, amplifying losses as well as gains. High leverage has a way of sucking people in who want to get rich because they barely have a dime to their name — exactly the person who should not engage in high leverage trading. It's a big mistake to get so caught up in the potential gains that you lose sight of the losses that are also possible. Be very cautious of option courses that promise huge yields without discussing the very real need for damage control — the biggest payoff of all will be to the “guru” who sells you the course!



TIP: Put options can hedge your profits during volatile distribution tops when you own large stock positions in bonanza bottoms in solid companies, thus giving you more staying power to see if there is still more rise left!

Writing Options

Investors can issue or write option contracts which are bought and sold by other investors. People write options for the premium



HUMOR: An architect, a surgeon, and a financial economist were engaged in a discussion. The surgeon said, "Look, we're the most important. God is a surgeon because the very first thing God did was extract Eve from Adam's rib." The architect said, "No, wait a minute, God is an architect. God made the world in seven days out of chaos." The financial economist retorted, "And who made the chaos?"

income they receive when they're bought and sold. But option writers lose whatever their buyers make. Option writers and buyers essentially take opposite sides of bets on which way underlying stock prices will move.

Options are written either covered or naked. With a **covered option**, the writer owns the underlying stock at the time the option is written. If the stock's price goes up and a call option buyer exercises, the writer must sell at the strike price. The option writer isn't out any additional cash, but he missed out on the price appreciation he would have had if he hadn't written the option.

For example, suppose Captain Bob has a share of stock purchased some time ago for \$40 that's currently selling for \$55, and he writes the call option on it at a strike price of \$60. Then suppose the stock goes to \$70 and the buyer exercises. In a sense, Bob has had an "**opportunity loss**" of \$10 by not being able to sell the stock for a profit at \$70. In reality, he realizes a gain of \$20 over his original \$40 cost plus the option price he makes selling the option. If he sold the option for \$2, for instance, his total profit would be \$22.

Someone who writes a **naked option** doesn't actually own the underlying stock at the time he or she writes the option and therefore faces more risk. In the situation above, if the option had been written naked, the writer would have had to buy a share at \$70 and then sell it at \$60 to comply with the option contract, losing \$10 less the option price received before. This is much riskier because instead of simply lost profit, the option writer loses \$8 in cold hard cash straight out of his account. That doesn't sound like much, but what if he sold options for a thousand shares!

Put Options

A **put option** or just a put, is an option to sell at a specified price. Investors buy puts if they think the price of the underlying security is going to drop. For example, suppose a stock is currently selling for \$55 and a put option is available to sell at a strike price of \$50. An option buyer makes money if the stock's price drops to \$45 by buying a share at that price and selling the optioned stock to the option writer for \$50, which the writer is obligated to buy as per the option contract. Put options are in the money when the stock is selling below the strike price of \$50 in this case.

Option Pricing Models

The price modeling problem for option values is more difficult than for stock and bond prices, because it is hard to express an option's value as the present value of a stream of future cash flows. A viable option pricing model was developed in the 1970s by two well-known financial scholars, Fisher Black and Myron Scholes.¹⁰ The **Black-Scholes Option Pricing Model** has achieved widespread use despite the fact that it is extremely complex mathematically. It is popular because calculators and spreadsheets can be programmed to carry out all the complex math from a few simple inputs. As a result, real-world practitioners use this option model frequently.

The Black-Scholes model determines option prices as a function of a few simple variables:

- The underlying stock's current price
- The option's strike price
- The time remaining until the option's expiration
- Volatility of the market price of the underlying stock
- The risk-free interest rate

10 "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy* 81 (May-June 1973): pp.637-654.

At this point in your investment education, I want you to just be aware that the Black-Scholes model exists and that it gives reasonable, but not precisely accurate results.

Warrants

It's important to notice that the options I have been discussing up until now are strictly bought and sold in the secondary market. That is, they're traded between investors, and the companies that issue the underlying stock the option is written on don't get involved and don't get any money when options are written or exercised.

Warrants are similar to call options but are issued by the underlying companies themselves. When a warrant is exercised, the company issues new stock in return for the exercise price. Therefore, warrants are primary market instruments.

FACT

FACT:Traditionally, the public has always preferred bonds to stocks because of the fixed interest payment. Financiers invented dividends to attract the public away from bonds.

Warrants are like call options in that they give their owners the right to buy stock at a designated price over a specified time period. They differ from stock options in that the time period is much longer, typically several years.

Warrants are usually issued with other financing instruments so as to make the primary security more attractive — to sweeten it up. For example, suppose a company wants to borrow but isn't in good financial condition. Lenders (bond buyers) have rejected the corporation's bonds as junk because they have been deadbeats at paying their debts in the past. Assume the company has good long-term prospects, though, and its stock is selling for \$40.

Under these conditions, lenders may be induced to buy the company's bonds if the firm attaches one or more warrants to each bond, giving the bond holder the right to buy a share at \$50 within the next five years. The warrants provide incentives to buy the bonds if people think the

stock is likely to go over \$50 before five years have passed. If bond holders do exercise the warrants, then the company will receive additional cash as they issue new shares that are sold to fulfill the warrants.

Warrants are usually detachable and can be sold independently at a market value of their own. This effectively reduces the price of the bonds and increases their yield to the investor. Alternatively, bondholders can keep the warrants and exercise them for a quick gain if the stock's price rises above \$50. Notice that if the warrants are exercised, the company receives an equity infusion based on a price of \$50 rather than the higher market price. The bonds are unaffected by the exercise of the warrants.



HUMOR: Fundamental Analysis: The less you say, the less you have to retract!

Employee Stock Options (ESOs)

For many years, American companies have given certain employees stock options as part of their compensation. **Employee stock options (ESOs)** are more like warrants than traded options because they don't expire for several years and strike prices are always set well below current prices when the options are awarded. Employees who receive stock options supposedly get less in salary than they otherwise would — at least in theory.

Workers like being paid with options because they don't cost anything when issued. Since employees who receive options supposedly get lower salaries, the practice supposedly improves the company's financial statements by lowering payroll costs. Beyond that, supporters of employee stock options argue that the practice has an important role in keeping the United States a leader in innovation — supporters are corporate attorneys on the payroll of corporate inside executives. They maintain that the chance of getting rich through employee stock options attracts the best and brightest people with innovative ideas to new companies. Without employee stock options, they claim

that struggling companies couldn't afford this kind of new talent and would not prosper. Employee stock options reduce the ownership of each of the paying shareholders in the public, but until recently most investors simply did not understand this. This is called **shareholder equity dilution**. Most still don't understand — but you do!

The Executive Stock Option Problem

Recipients of the biggest employee stock option packages are senior executives. In larger companies, pay packages of top people typically include a salary in the millions of dollars and options that can generate windfall profits in the tens and hundreds of millions of dollars.

In recent years, a great deal of criticism has been directed at option-rich packages for top management. Financial economists have long argued that this kind of pay structure gives executives too much incentive to maximize stock prices. In other words, since the personal wealth of CEOs and CFOs is directly tied to stock prices through options, they may be tempted to drive prices up at the expense of inexperienced investors.

To understand the danger, you have to recognize that financial results can help drive stock prices up and that top executives can manipulate financial results by cooking the accounting books. The situation is a classic conflict of interests in that someone in control of the system that determines his or her own pay has an incentive to manipulate everything to the detriment of the owners, the shareholders. In other words, there are lots of unethical ways to make financial results better — or worse — than they really are. The power to decide to use them rests completely in the hands of the senior inside executives of the corporations that issue the stock you buy.

If these deceptive methods are used, overstated financial results are interpreted favorably by investors who bid stock prices up. Stocks remain overvalued until the investment community discovers what's been going on. Prices crash rapidly, destroying the savings of unsuspecting shareholders who are the real owners. By then, high-flying inside corporate

executives have exercised their options, sold the shares, and pocketed enormous sums of cash. If you want to succeed as a stock investor, you have to get it into your head right now that the **inside senior executives** of corporations thrive by dumping their shares on an unsuspecting public. Becoming an American senior corporate executive is essentially a license to steal. Executive insiders teamed with corporate attorneys get rich on money contributed by investors who were deceived into paying too much for stock — either directly or through 401(k) plans that restrict you to buying mutual funds.

Company-controlled pension funds are an even more startling problem. Company-controlled retirement plans are often heavily invested in the company's own stock, the value of which evaporates when deceptive reporting is uncovered. The result is that top inside senior executives are able to effectively steal their employees retirement savings as well.

For years, the investment community wasn't overly concerned about this deception because everyone assumed auditors would keep financial results reasonably accurate. People knew overstatements existed, but they didn't believe they were so bad. In early 2000, at the top of the biggest bull market of the last century, it became apparent that auditors couldn't always be counted on to police corporate financial reporting — they were caught up in a conflict of interest of their own. Since auditors are paid by the companies they audit, they're likely to bow down to the corrupt accounting demands of the senior inside executives they're supposed to be watching. They do that by interpreting accounting rules liberally and signing off on financial statements that they know are deceptive and likely to mislead investors.

In early 2000, the stock prices of several major corporations collapsed when the investing community learned that their financial statements contained major misrepresentations. The best-known

FACT

FACT:The two essential characteristics of successful stock investors are **patience** and **independent** thinking!

cases were Enron, a leading player in energy, WorldCom, the telecommunications giant that owned MCI, and Tyco, a conglomerate that participates in a wide variety of businesses. In addition, Arthur Anderson, Enron's auditor and one of the world's largest accounting firms, went out of business as a result of its role in the Enron debacle. Enron employees had their retirement plans stolen from them by the inside senior corporate executives that the employees had placed their trust in. The corporate insider thieves that instigated these scandals still live in mansions.¹¹

These collapses led to a loss of confidence in corporate management by the investing public that may depress general stock prices for decades to come — this means that single stock investing is a great opportunity right now because of these low, low stock prices as I show you in my course. Option-based compensation wasn't the only problem uncovered, but many feel the system sets up a climate that encourages management to focus on short-term financial results which inevitably leads to less than honest reporting.

The scandals led to a major review of financial reporting and auditing procedures by the accounting profession as well as congressional legislation aimed at punishing deception by senior inside executives. A major issue within the overhaul continues to be a requirement that companies recognize employee stock options as expenses at the time they are issued. This isn't easy to do because the same corporate senior inside executives have become so rich fleecing the public that they maintain their own special interest group to pay off congress so that such legislation is not passed. Only recently has the SEC been able to force corporations to cost employee stock options gifted to inside executives. But they still cheat by cherry-picking the inputs into the Black-Scholes Option Pricing model that generate a cost that is only a microscopic fraction of the true cost.

Democratic senator Joseph Lieberman is one of the federal stooges for the insiders fighting for executive rights. At present,

11 Watch the movie "Fun with Dick and Jane (2005)" starring Jim Carrey and Téa Leoni and make sure you pay attention to the credits at the end!

WALLET DOCTOR SURVIVAL RULE #10

Maintain healthy suspicion of the executive management of your employment and do not, under any circumstances, buy company stock IN your 401(k). report the company to the SEC if they invest your pension in company stock!

like medieval kings that these abuses will never be controlled. The time certainly has come to do away with employee stock options. Yet the best way for you to succeed as an investor is to learn to buy and sell stocks at the same prices the insiders do — when in Rome, do as the Romans do!

reform is ongoing, but many issues remain unresolved. The bottom line, in my opinion, is that senior corporate executives have so much power over both Washington, D.C. and the companies they rule over

Chapter 6

Fundamental Analysis of the Stock Market

I met Hank in 2002 while I was at the University of South Carolina working on my doctorate in finance. He asked me for advice because he wasn't sure what to do with his IRA from Shell and DuPont. He told me that Merrill Lynch was courting him to manage the account for a 1% management fee. I was puzzled that such a large company would be trying to win Hank's business — they normally go after large corporate clients, and Hank was such a soft-spoken, humble man who did not strike me as rich.

"How much is the IRA worth?" I asked Hank. *"1.4,"* he replied. *"Do you mean \$1.4 million?"* I exclaimed with a startled look on my face. *"Yup,"* he said with a grin.

My jaw literally dropped. Hank explained that since he had retired debt-free, he didn't need the risk of the ups and downs of the stock market and had converted all of the stock into bonds — a form of fixed income investing he was less familiar with.

He told me that he had another \$220,000 in the individual retirement account bringing his total stock market winnings up to \$1.6 million at the age of 78 years young. What is truly remarkable is that he never earned more than \$65,000 dollars a year and raised four sons. When I interviewed Hank for this book, he told me he had established a stretch IRA that would not allow his children to spend the money until they were 59 ½ years old. He also said that his main "problem" was that, although he didn't need money because he was debt-free and had pension and Social Security income coming in each month, the IRS rules required that he make regular withdrawals from the IRA.

He turned down Merrill Lynch's offer to manage the account because their offices were located on the other side of the state. He didn't want to

be too far from the brokerage managing his money. He decided to manage it himself with the help of an investment advisor. Hank's objective today is to extract a 6% return from the bond market using AAA corporate bonds (at the time of our interview Treasury bonds were returning about 4.5%). Hank emphasized that the secret to his success was that he believed he could succeed as a stock investor and never gave up — he stuck to his investing plan!

Here is Hank's fascinating stock market journey. He was stationed in Germany while serving in the United States Army in 1946. This was a fascinating time in history when Germany was being divided into a capitalist west and a Marxist east. The Army was hard at work acquiring as much German high technology as possible from Nazi war machine factories — like V2 rocket parts from the underground plant at Nordhausen that would lay the foundation for the American moon landing two decades later. The U.S. Army had to work fast and hard before the date of the Soviet occupation of East Germany. Hank also witnessed the first baby steps of the rebuilding of Western Europe under the Marshal plan that would transform the area into the economic super power it is today.

Hank served his first tour of duty as a sergeant and was able to save \$800 from his military income. When his tour was over, he returned to his home state of South Carolina and, under the G.I. Bill, enrolled at Clemson University — a school with an outstanding agricultural program. He graduated with a Bachelor of Science degree in agricultural economics in 1949. Shortly after graduation, Hank landed a job with the Farmers Home Administration (FHA) under the direction of the USDA. He used his savings to purchase his first car as part of his responsibilities in his first job. This was a requirement for employment with the USDA-FHA. At the time it was much

WALLET DOCTOR SURVIVAL RULE #11

BUILD YOUR OWN INVESTMENT STRATEGY AROUND WHAT IS UNIQUE ABOUT YOU THROUGH THE DIRECT APPLICATION OF INDEPENDENT THINKING — FOLLOW NO ONE BUT YOURSELF!

more common for people not to own a car, which severely restricted their mobility in the workforce.

In the USDA-FHA, Hank started in a GS-5 position with a starting salary of \$3,100 per year. His supervisor talked him into putting aside \$5 every paycheck to purchase U.S. Savings bonds — the most common form of investment at the time, but ultimately not the best. This humble and meager sounding first investment experience would set Hank on a path to great and enduring wealth as a stock investor — he had the wisdom to just get started investing no matter how small. During the 1950s he also obtained a reserve commission to earn extra money. After 16 months with the USDA-FHA he was called to active duty in the Korean War. He served his 2 year tour as a 1st lieutenant at Ft. Jackson in Columbia, South Carolina.

Hank told me:

My previous experience led me to a sales career with the Shell Agricultural Chemical Division. Shell employees were encouraged to participate in Shell's Provident Fund. Saving and investing was much tougher in those days because salaries at that time started at \$100 per week, and after 6 months advanced to \$150 per week. The Provident Fund required an initial employee savings contribution of 2.5% of pay for 5 years matched by Shell. After 5 years, the contribution bumped up to 5% and then a few years later up again to a whopping 10% of employee salary – all fully matched by Shell. 32 years later my Provident Fund investments turned out to be a nice nest egg consisting of Shell stock and money market funds. Shell USA stock was eventually sold to Royal Dutch Petroleum for \$63 per share. Royal Dutch wanted employees to get \$69 per share, but surprisingly the SEC ruled against it. Royal Dutch made it up to employees later

in the form of a one time bonus — I received \$34,000 because the SEC blocked the sale of my Shell USA stock at \$69. This money received was additional, since they were not allowed to give us 69 dollars for our tendered stock. Can you believe that some employees did not take advantage of the Provident Fund plan?

During employment with Shell, Hank met many colorful and interesting people common to the roughneck petroleum industry. One such character was Bill Tuller, a Shell jobber. A jobber in the petroleum industry is a gasoline and other oil derivative products distributor, in this case a Shell products distributor. Bill told Hank that he was accumulating shares of Shell Transport and Trading because they were transporters of Shell's crude oil to their refineries and even more importantly, the British part of Royal Dutch Group. Shell Transport and Trading income was the major source of finance for other Shell Companies. Hank bought as many share of common stock in Shell Transport and Trading as he could.

Encouraged by his friend Bill to become more active in stock investing, Hank found out about a company called Clinton Oil that was selling around \$10 to \$12 per share of common stock. When the stock hit \$30, Hank sold it for a tidy profit — the first of many such experiences for Hank. Hank's initial success attuned him to opportunities to acquire more stock and some unusual finds popped up. For instance, the North Carolina based utility company that supplied Hank's home in South Carolina with power offered their stock thru a Customer Stock Ownership plan (CSOP) with the common stock trading around \$15 a share. He took advantage of the CSOP and today has over 600 shares trading around \$42-45 paying a dividend of 5.5% annually. Hank was attuned to this opportunity because Shell had a program called the Shell Employees Stock Ownership Program (SESOP) that was then allowing him to acquire more Shell stock even faster. The SESOP was designed to allow employees to pur-

chase additional shares above and beyond the Provident Fund — Hank jumped at the opportunity.

Later, in the mid 1980s, DuPont purchased the agricultural division of Shell. DuPont offered a similar program matching 50 cents, up to 6% of the employee's salary, for every dollar contributed. In a little more than three years he had accumulated over 1,100 shares that today pay a 3.8% dividend. In summary, his participation in all of his company's plans over his working career allowed him to accumulate \$1.4 million in a 33-year period. Hank's highest salary



TIP: Patience, patience, patience! Think for yourself, be patient, and don't be afraid to learn what you have to learn!

over those years was \$65,000. You might be asking what Hank did with the \$34,000 he was paid for his Shell USA stock. He opened an individual account that has grown to just over \$200,000, bringing Hank's total stock portfolio up to a whopping \$1.6 million — an extraordinary feat for a man who earned a relatively meager salary and raised 4 sons with the help of his beloved spouse Cindy, a housewife. Today, without a financial worry

in the world and living in a beautiful home in an upscale golf community in a high-class South Carolina coastal village, Cindy remembers the frustration of not having nicer cars and home furnishings that other Shell employees were buying with their “*not saved nor invested*” extra cash. None of the Shell employees that refused to participate in the company plans retired wealthy.

As I mentioned before, nearly all of the ways the people pick stocks can be grouped onto two categories: fundamental or technical analysis. Most people in the stock market use fundamental analysis to base their buy and sell decisions. Part of this reason is that most stock analysts use fundamental analysis. Most university finance courses teach students entering the industry that fundamental analysis is the only way to decide whether a stock is a good buy or not. The main objective of **fundamental analysis** is to use fundamental factors that describe the corporation's operations and profits (or lack of profits).

These fundamental factors all come from analyzing the firm's accounting statements. The firm's **accounting statements** are the income statement, balance sheet, and cash flow statement. Before I dive in to teaching you this stuff, I want you to clearly understand that there are huge problems in financial accounting reporting today because it is very easy for inside corporate executives to legally produce financial statements that lie to the public. It is for this reason that I personally use technical analysis as my primary method of deciding which stocks I buy and sell. Still, you need to understand fundamental analysis — as misleading as it really is — because so many other investors look at the stock markets this way. At least you will sound smart at cocktail parties if you understand this chapter, and you will definitely understand the financial newspapers better.

The Dividend Discount Model

If the world were perfect and corporations operated like well-oiled efficient machines where executive managers did not lie, cheat and steal, financial journalists didn't pump out wrong information to the public, and financial analysts were actually allowed to do impartial analysis, then the dividend discount model might actually be of some use. Unfortunately, it isn't — but it is our point of departure in understanding “funny-mental” analysis. Basically, a perfect world financial theory says that the economic value of a share of stock is properly measured by the sum of its future cash flows, where the cash flows are adjusted for risk and the time value of money.

A popular model used to value common stock is the dividend discount model. The **dividend discount model (DDM)** values a share of stock as the sum of all expected future dividend payments, where the dividends are adjusted for risk and the time value of money.

Imagine a company that pays a dividend at the end of each year. Let $D(t)$ be a dividend paid t years from now, $V(0)$ represents the present value of the future dividend streams and k is the risk adjusted discount rate. Using the dividend discount model, the present

value of a share of this company's stock is measured as the sum of discounted future dividends:

$$V(0) = \frac{D(1)}{(1+k)} + \frac{D(2)}{(1+k)^2} + \dots + \frac{D(t)}{(1+k)^t}$$

I know that this may look nasty to you, but you don't need to know it to become a great stock investor. If, on the other hand, you do understand these kinds of equations throughout the book, I don't have to just tell you to accept certain things blindly as I teach you to invest. If you understand all these little mechanical details that don't work, you will understand why what actually works when I teach you what makes money in the stock market.

The main point here is that people working in the stock market are taught that whoever buys a stock should value a more profitable company more than a less profitable company. The more profitable company is worth more because it can pay investors dividends, even though they almost never do. This has given rise to the widespread use of ratio analysis in the stock market. I clearly explained to you how Michael Eisner legally stole nearly \$1 billion from Disney shareholders. In other words, just because a company posts profits doesn't mean that inside corporate executives won't find a way to hustle it away from you as the owner-shareholder.

Price Ratio Analysis

Price ratios are used a lot more by financial analysts than the dividend discount model. Don't forget that corporate executives have been caught lying in their financial accounting, so don't place all of your trust in these methods, either. Still, you need to know what it is because you will read or hear about it. Here is a description of the most popular price ratio methods.

The **price-earnings ratio** is the current stock price divided by the annual earnings per share (EPS). This is also called the **P/E ratio**. The **earnings per share** is calculated by taking the profit

during the financial year and dividing it by the average number of shares in float during the year.

The inverse of the P/E ratio is called the **earnings yield**, and is measured as the earnings per share divided by the current stock price. This is also called the **E/P ratio**. Earnings yield and price-earnings ratios are two ways to measure exactly the same thing. You will read and hear about P/E ratios a lot more than E/P ratios.

You can calculate the estimated annual earnings per share roughly by multiplying the most recent earnings per share by four since earnings are reported quarterly — every three months. You get the reported value if you actually sum up the last four quarterly earnings per share values. Most analysts do it the first way, which is sloppier, but some published data sources, including the Wall Street Journal and Investor's Business Daily financial newspapers, will report to you the earnings per share using the sum of the last four quarters' figures. The difference is normally small but can be enough to confuse you.

You will read and hear a lot about growth stocks, but what does this mean? **Growth stocks** have high P/E ratios. This means that the stock has low earnings relative to price. Here is the reasoning: if P/E ratios are measured as the current stock price over the current earnings per share, then think about two companies with the same current earnings per share. One company is a high growth company that has grown a lot in its industry or its industry has grown a lot and the company along with it. The other is a low growth company like an electrical utility company that already has all of its customers in place.

Which company would you expect to have a higher stock price, the high-growth company or the low-growth company? The high growth company, of course, should have a higher price because



TRAP: Both the 401(k) and the standard IRA blast you with huge fees for early withdrawal. For this reason, you should absolutely have a Roth IRA if you can, because you can always withdraw all of your contributions tax-free in an emergency!

people think that the company will probably keep on growing (do you see any problems with that assumption?). In general, companies with higher expected earnings growth (because people think that their sales will keep expanding at the same or better profit margins) will have higher P/E ratios. Does it make any sense to you at all that a company will keep expanding its markets without encountering competitors or that inside corporate executives won't start siphoning profits into their pockets? No, it shouldn't! This is why high P/E ratio stocks are called growth stocks. This kind of nonsensical thinking is exactly what makes inexperienced investors consistently lose.



HUMOR: The CIA had an opening for a new agent. After all of the background checks, interviews, and testing were done there were three finalists — a mathematician, a doctor and a retired inside corporate executive who was bored and looking for action. For the final test, the CIA agents took the mathematician to a large metal door and handed him a gun. “We must know that you will follow your instructions, no matter what the circumstances. Behind this door you will find your wife sitting in a chair. You have to kill her!” The mathematician said, “You can’t be serious. I could never shoot my wife.” The agent replies, “Then you’re not the right man for this job.” The doctor was given the same instructions. >

> He took the gun and went into the room. All was quiet for about five minutes. Then the doctor came out with tears in his eyes. “I tried, but I can’t kill my wife.” The agent replies, “You don’t have what it takes. Take your wife and go home.” Finally, it was the inside executive’s turn. He took the gun and went into the room. Shots were heard, one shot after another. They heard screaming, crashing, and banging on the walls. After a few minutes, all was quiet. The door slowly opened and there stood the insider. He wiped the sweat from his brow and said, “You guys didn’t tell me the gun was loaded with blanks. So I had to beat her to death with the chair!”

Here is an example. Starbucks Corporation is a specialty coffee retailer with a history of aggressive sales growth. Its stock trades on the NASDAQ under the ticker symbol

SBUX. In early 2003, SBUX stock traded at \$21.98 per share with earnings per share of \$0.57 = EPS. This means that it had an P/E ratio of $\$21.98/\$0.57 = 38.6$. This number is much higher than the normal stock in the S&P 500, where the 25 year P/E average is 17.78. At that time, SBUX had never paid dividends and instead had reinvested all of its earnings. In the five years

prior, Starbucks had an average earnings growth of 33% per year.

It is obvious why high P/E stocks are called growth stocks, but value stocks are different. **Value stocks** are low P/E stocks. While this may seem confusing based on what I just taught, what it really means is that the stock has a high price relative to earnings. The reason some people call these stocks “value” is because they consider them “cheap” relative to current earnings. These corporations have low stock prices relative to their earnings. Because of this, inexperienced investors think these stocks represent good investment values, so they call them “value” stocks.

Here is an example of a value stock. Back in early 2003, the big retailer Sears was an S&P stock trading at a price of \$23.24. It had an EPS of \$4.96, so the P/E ratio was $\$23.24/\$4.96 = 4.7$, or about a quarter of the average S&P 500 P/E ratio of 17.78. Because of its low P/E ratio, Sears was considered a value stock at the time. Once again, I warn you that just because a stock has a high or low P/E ratio doesn't mean it won't tank on you. In my extensive experience as an investor and finance professor, I have come to consider fundamental investing to be like driving a car with no windows or map using just the speed and gas gauges!

Price-Cash Flow Ratios

There is an alternative to the price-earnings (P/E) ratio called the price-cash flow ratio. A **price-cash flow (P/CF) ratio** is the current stock price divided by the firm's current annual cash flow per share. Cash flow is reported quarterly and most analysts just multiply the most recent quarter times four when they calculate their ratios as before with current annual earnings. Better data sources will use the actual sum of the four quarters.

There a couple of definitions of **cash flow**, but the most common is to simply add net income and depreciation. The difference between earnings and cash flow is confusing to beginning finance students because of the way the **Financial Accounting Standards Board (FASB)** defines net income. Basically, net income is measured

as revenues minus expenses.¹ This is not logical to a finance person to whom cash is king because not all expenses are actually cash expenses and the most important exception is depreciation.

When a corporation buys or builds an asset they are going to use for a long time, like a new factory, FASB rules do not deduct the cost of the factory all at once — even though factory is paid for in cash all at once. Instead, FASB makes the company accountants deduct the cost over time. The problem is that these deductions look like cash payments, but they aren't because the actual cash payout happened when the factory was purchased. This may seem a little confusing, but bear with me. As a finance professor, I teach university students that cash flow is a lot more important than income. Here's why. Let's go back to our two company example A and B. Imagine that both companies have the same constant revenues and expenses each year for a three-year period. These constant revenues and cash expenses (excluding depreciation) give the same constant cash flows as follows:

	Company A	Company B
Revenues	5,000	5,000
Cash expenses	-3,000	-3,000
Cash flow	\$2,000	\$2,000

You can see that both hypothetical companies have the same \$2,000 cash flow in this example. But suppose both of these companies can depreciate a \$3,000 cost over a three-year period. FASB allows managers to choose different depreciation schedules at different times than when the expense is incurred. Let's say that A uses a straight-line while B uses an accelerated depreciation schedule; the first is spread out evenly and the second is expensed more at the beginning:

	Company A Depreciating	Company B Depreciation
Year 1	\$1,000	\$1,500
Year 2	1,000	1,000
Year 3	1,000	500
Total:	\$3,000	\$3,000

¹ **Revenue** is the amount of money that a company actually receives from its activities, mostly from sales of products and/or services to customers. To investors, revenue is less important than profit, or income, which is the amount of money the business has earned after deducting all the business's expenses.

Looks the same as above. But what does this do to annual cash flows and net income amounts? Remember that, for each year:

$$\text{Cash Flow} = \text{Net Income} + \text{Depreciation}$$

you can rearrange this

$$\text{Net Income} = \text{Cash Flow} - \text{Depreciation}$$

Now look what happens using this formula to calculate net income:

	Company A		Company B	
	Cash Flow	Net Income	Cash Flow	Net Income
Year 1	\$2,000	\$1,000	\$2,000	\$500
Year 2	2,000	1,000	2,000	1,000
Year 3	2,000	1,000	2,000	1,500
Total:	\$6,000	\$3,000	\$6,000	\$3,000

See how much the two different depreciation schedules completely distort the net income values for each company but cash flow does not? If you didn't understand this, you would incorrectly conclude that company B is a growth company. If you did understand this you would quickly see that there is no growth in cash flow to support the growth company conclusion. Either way, this is a simple example among many that complicate fundamental analysis. What if inside executives have found a way to not put an expense on the books — or understate it — that really was incurred, like when they force the board of directors they control to award themselves employee stock options? Again, funny-mental analysis of the stock markets is a great way to lose your money because so much financial reporting today is bogus.

Financial analysts typically use both price-earnings and price-cash flow ratios, because if a company's earnings per share is not much greater than its cash flow per share (CFPS), they consider this a sign of real, or quality, earnings. What they mean by "quality" is that the numbers are more likely to reflect actual cash flow — not just accounting tricks. When net earnings are higher than cash flow, this is a sign that earnings are not real.

Remember the Starbucks example with a CFPS = \$1.28 and EPS

= \$0.57, which means it had a P/CF ratio of $\$21.98/\$1.28 = 17.2$. The ratio does not tell you a lot, but notice that the cash flow per share is more than double the earnings per share. This is a possible sign — at least to people who follow this stuff — that earnings are not an accounting gimmick. Sears, on the other hand, had a cash flow per share (CFPS) of \$2.01 and earnings per share (EPS) of \$4.96. Despite the more promising looking P/CF ratio of $\$23.21/\$2.01 = 11.6$, the fact that earnings per share are more than double cash flow per share ($\$4.96$ to $\$2.01$) is a red flag that accounting gimmicks have been used to puff up profits. There are many other ways corporate executives can fake profits or losses so be very wary of buying and selling stocks based on ratio analysis of any kind.

Price-Sales Ratios

An alternative view of a company's performance is provided by its **price-sales (P/S) ratio**. A price-sales ratio is calculated as the current price of a company's stock divided by its current



TIP: The public pays attention to all of the wrong things at the top and bottom of stock price movements!

annual sales revenue per share. A price-sales ratio supposedly focuses on a company's ability to generate sales growth. Essentially, a high P/S ratio would suggest high future sales growth (and thus high cash flow and high earnings), while a low P/S ratio might indicate sluggish growth. The problem with this is that inside corporate executives have found lots of ways

to fake sales growth legally through creative accounting practices. Remember, they do this because of all of the employee stock options they get for free from the boards they control. If they can puff up the stock price, they can retire rich and early. They can attract more people to the stock by driving the price up — and they do so willingly.

As an example, Starbucks Corporation had sales per share of \$8.73

and P/S ratio = 2.5. Sears had sales per share of \$131.30 and a price-sales ratio of 0.18. There is a huge difference in P/S ratios between these two companies because they follow two very different business models. The point I want to drive home to you is that the price-sales ratio tells you a lot less than ratios based on cash flow or even net earnings — if ratio analysis tells you anything at all these days.

Price-Book Ratios

Price-book (P/B) ratio is sometimes called the market-book ratio and is a very basic ratio. A price-book ratio is measured as the market value of a company's outstanding common stock divided by the book value of its equity.

Book value is all of the assets of the company less everything it owes. This really makes sense to the inexperienced investor who is used to buying consumer goods off the shelf — to whom value in a piece of paper like a share of stock does not make sense. Price-book ratios make a lot of sense to inexperienced investors because it seems like something is really being valued. The stock price is an indicator of current market value of the company in terms of its stock, so a price-book ratio simply measures what the equity is worth today relative to what it cost to create the equity. A ratio bigger than 1.1 supposedly indicates that the firm has been creating value for its stockholders, while a ratio less than 1.1 supposedly means that the company is worth less than it cost.

This way of reading price-book ratios is simple and totally logical but does not take into account the deceptive practices of inside corporate executives trying to increase the value of their employee stock options or dump their employee optioned stock on the public. The truth is that because of the wide latitude executives have — in the varied and changing accounting standards — book values are not only difficult to interpret, but are dangerous to your financial health.



HUMOR: Einstein dies and goes to heaven only to be informed that his room is not yet ready. "I hope you will not mind waiting in a dormitory. We're very sorry, but it's the best we can do and you will have to share the room with others he is told by St. Peter. Einstein replies that it's no problem at all and that there is no need to make such a great fuss. So St. Peter leads him to the dorm. They enter and Albert is introduced to his temporary roommates. "Here is your first roommate. He has an IQ of 180!" "That's wonderful!" says Albert. "We can discuss mathematics!" "And here is your second room mate. His IQ is 150!" "That's wonderful!" says Albert. "We can discuss physics!" "And here is your third room mate. His IQ is 100!" "That's wonderful! We can discuss the latest Broadway plays!" Just then another man moves out to clumsily grab Albert's hand and shakes it. "I'm your last room mate and I'm sorry, but my IQ is only 80." Albert smiles back at him and replies, "So, where do you think the stock market is heading?"

Serious Flaws In The Market Gauges

There are serious problems with three of the most popular ratios that are used as individual stock gauges: dividend-price (dividend yield), price-book, and price-earnings ratios. The problem with the dividend yield ratio is that few corporations pay dividends today. A major exception are the Dow stocks, which is why a "Dogs of the Dow strategy" will still likely give you above average returns over a long time horizon.²

Most investors don't care about dividends because they are taxed more heavily as ordinary income than capital gains on stock price increases. In other words, shareholders would rather buy low and sell high than get a large quarterly dividend.

Bargain hunters in the stock market look for low price-book stocks that show that the company might be selling below book value. Book value is the difference between a company's assets and its liabilities expressed on a per-share basis. The problem with the book-value ratio is that book value has been distorted over the years by stock repurchases due to corporate restructurings designed to benefit inside corporate executives and the adoption of a new accounting rule concerning retiree health benefits. The price-book ratio is no longer of any use to you whatsoever as a stock investor.

2 Read "Beating the Dow" by Michael B. O'Higgins and there is a nifty website that runs the calculations for you every day at www.dogsofthedow.com

Price-earnings ratios have the problem that reported earnings have been depressed by special charges and should (but aren't) adjusted for interest rates and inflation. Also, as I mentioned before, inside corporate executives are adept at posting higher or lower earnings than actual by meddling with the corporation's accounting.

Earnings and Cash Flow Analysis

Cash flow is a corporation's lifeblood. It will literally die without it. It is the primary source of earnings for a healthy company. It's no small wonder why analysts are obsessed with both cash flow and earnings — their goal is to predict future increases or decreases.

Although, this is true, don't forget that famous economists like Bob Shiller at Yale University have pointed out that the relationship between stock price increases and cash flow increases is not very strong. He and I both believe that this is because investors care about stock price increases and NOT how much the company makes. Don't ever forget that a stock increases when it gets bid up by more purchases relative to stock being sold. Whatever makes people buy more without the supply of the stock (float) going up will increase the price.

Most investors have a real hard time reading financial statements. Here is one of the equity industry's dirty little secrets. Not even a finance professor with a Ph.D. in finance or accounting can figure out what today's financial statements really say. This is because accounting rules are so convoluted as well as the fact that inside executives in the corporations — those that are responsible for the preparation of the accounting statements — have their own agendas. For this reason, most investors rely on secondary sources of information that attempt to interpret the, what I consider insider intentional, mass confusion of financial statements. Unfortunately, secondary

WALLET DOCTOR SURVIVAL RULE #12

DON'T TRUST ANY ANALYSIS BASED ON FINANCIAL REPORTING
— THAT INCLUDES FINANCIAL ANALYSTS OR ANYONE ELSE THAT
STARTS TALKING TO YOU ABOUT FINANCIAL RATIOS!

sources also have their agendas as well. So why bother? You need a basic understanding of how to read a financial statement if you are going to read the financial newspapers so that you don't get swayed from what is really important.

Sources of Financial Information

The primary source of financial information about any corporation is the **annual report to stockholders**. I just throw it in the trash along with other junk mail, because I can't tell if the books are "cooked." Most companies spend a ton of money preparing their annual report to the stockholders, and to make these reports available to anyone requesting a copy. A great way to request copies of annual reports from several companies at once is to use *The Wall Street Journal's* **annual reports service**. Look for the shamrock symbol if you read this excellent financial newspaper.

Beyond the direct company reports, the SEC also offers financial information to you. The SEC requires corporations that issue publicly traded securities — stocks or bonds — to prepare and submit financial statements to the commission on a regular basis. These documents are made available through the **Security and Exchange Commission Electronic Data Gathering and Retrieval (EDGAR)** archives. The **EDGAR** archives are accessible free of charge through the internet (www.sec.gov).

The most important EDGAR document is the annual **10K** report, just called the "10K." Corporations have to submit an EDGAR-compatible 10K file to the SEC at the end of each **fiscal year**.³ They are also required to file updates every quarter, called the **quarterly 10Q reports** — 10Qs. The **10Q** is a mini-10K filed each quarter, except when the 10K is filed at the end of the fourth quarter. Every 10K and

³ A fiscal year is a 12-month period over which a company budgets its spending, abbreviated FY. A fiscal year does not always begin in January and end in December; it may run over any period of 12 months. The fiscal year is referred to by the date in which it ends. For example, if a company's fiscal year ends October 31, 2006, then everything between November 1, 2005 and October 31, 2006 would be referred to as FY 2006. Not using the actual calendar year gives many companies an advantage, allowing them to close their books at a time that is most convenient for them.

10Q report contains three important financial statements: a balance sheet, an income statement and a cash flow statement. You need to understand these three financial statements.

The SEC's **Regulation FD (Fair Disclosure) Rule** says that a company has to give any short-term information to the public at the same time it provides any short-term information to analysts and stockholders who could trade in advance of the uninformed public. Most companies comply with regulation FD by distributing announcements through e-mail alerts. To get e-mail alerts automatically for stock you own or are considering buying, you only have to register at the company's website, usually in the investor relations section.

Financial Statements

Financial statements are supposed to give you the hard facts about a corporation's operating and financial performance. This is exactly why the SEC requires that public firms distribute financial statements in a timely fashion. A company's balance sheet, income statement and cash flow statements are supposed to be essential reading for a financial analyst. Each of these statements gives a different perspective.

The **balance sheet** gives you a snapshot view of the company's assets and liabilities on a particular date. The **income statement** measures the operating performance during an accounting period, on a quarterly or annual basis, and summarizes company revenues and expenses. The **cash flow statement** reports how cash was generated and where it was used over the accounting period. Understanding the format and contents of these three financial statements is critical for you to understanding earnings and cash flow analysis.

The Balance Sheet

To teach you how these key financial statements work, I am going to use made up ones for the imaginary company "A." The table below shows you the year end 2004 and 2005 balance sheets for "A" corporation.

“A” Corporation Balance Sheets, 2004 and 2005

	Year 2004	Year 2005
Current assets		
Cash	\$2,000	\$1,356
Accounts receivable	1,200	1,200
Prepaid expenses	500	500
Materials and supplies	300	300
Inventory	6,000	6,000
Total current assets	10,000	9,356
Fixed assets		
Plant facilities	\$35,000	\$35,000
Production equipment	20,000	20,000
Administrative facilities	15,000	15,000
Patents	10,000	10,000
Accumulated depreciation	(20,000)	(17,000)
Total fixed assets	60,000	63,000
Investments		
Company B		
7% Preferred stock	\$10,000	\$10,000
Company C		
Common stock	10,000	
Goodwill	5,000	0
Total investments	\$25,000	\$10,000
Other assets	5,000	5,000
Total assets	\$100,000	\$87,356
Current liabilities		
Short-term debt	\$10,000	\$10,000
Accounts payable	2,000	2,000
Leasing obligations	3,000	3,000
Total current liabilities	15,000	15,000
Long-term debt	30,000	20,000
Other liabilities	5,000	5,000
Total liabilities	\$50,000	\$40,000
Stockholder equity		
Paid-in capital	\$10,000	\$10,000
Retained earnings	40,000	37,356
Total stockholder equity	\$50,000	\$47,356
Total liabilities and equity	\$100,000	\$87,356
Shares outstanding	2000	2000
Year-end stock price	\$40	\$36

Here are a couple of things you need to know in terms of accounting language. If something is negative, like an expense or a loss, we don't use the minus symbol, but rather put it in parenthesis. In the balance sheet above, accumulated depreciation was an expense;

in other words, the company seems to have paid out or lost because of this \$20,000 expense in 2004.⁴ To show that this is a loss, it is put in the balance sheet in parentheses like this: (\$20,000), which is accounting language for a negative cash flow — a loss or a cost.

Another thing to notice is that the balance sheet is broken up into sections where the bottom line of the section is the total for that section. A main component of the balance sheet is shown by a double underline that comes from the **fundamental accounting identity (equation)** that says that assets are equal to liabilities plus equity (stock). This is how everything has to “balance” out on the **balance sheet**: $\text{Assets} = \text{Liabilities} + \text{Equity}$. If things don’t balance out when the balance sheet is prepared, accountants know that there is a mistake somewhere that has to be fixed.

The “A” corporation has four major asset categories: current assets, fixed assets, investments, and other assets. **Current assets** are cash or other things that will be converted to cash and used within a year. For instance, inventory will be sold, accounts receivable will be collected and materials and supplies will be used within a year.⁵ Cash is the ultimate current asset. **Fixed assets** have an expected life of more than a year and are used in normal business operations for things like manufacturing equipment, real estate and furniture. Fixed assets may be tangible or intangible. Property, plant and equipment are the most common **tangible fixed assets** while rights, patents and licenses are common **intangible fixed assets**. Except for land, all tangible fixed assets depreciate in value over time just like your car does.⁶ Investments include various securities held for investment purposes. **Goodwill** measures the premium paid over market value to acquire an asset. For instance, a company may pay \$50 per share

4 I am simplifying to ease the reading a bit. Technically accumulated depreciation is neither an expense of a period nor a loss. It is a contra-asset, an expense of prior periods carried on the books to show that the assets are no longer worth what they were when they were purchased.

5 Accounts receivable is money that is owed to a company by a customer for products and services provided on credit. A specific sale is generally only treated as an account receivable after the customer is sent an invoice.

6 According to FASB Rule 142, intangible fixed assets are no longer depreciated but their values are re-evaluated each time corporate 10Q and 10K statements are prepared.

for a company stock with a market price of \$40 per share when acquiring a very large block of stock. Other assets include miscellaneous items that don't fit into any of the other asset categories. The sum of these four categories of assets is the firm's **total assets**.

The "A" company balance sheet has three major liability categories: current liabilities, long-term debt and other liabilities. **Current liabilities** have to be paid within a year. Examples are **accounts payable** and accrued taxes. **Long-term debt** includes notes, bonds or other loans with a maturity longer than one year. Other liabilities include miscellaneous items not belonging to any other liability category.

Stockholder **equity** is the difference between total assets and total liabilities. This includes **paid-in capital**, which is the amount received by the company from issuing common stock in the case of an initial public or seasoned offering, and retained earnings. Retained earnings are defined as saved up cash not paid out as dividends. It is theoretically used to finance company growth, but in reality is also used to pay for the lifestyle excesses of corporate executive insiders.

Financial analysts like to use a **condensed balance sheet** that reduces the full balance sheet to a summary. This simplifies analysis while revealing the basic structure of the company's reported assets and liabilities. The analyst has to decide how much to simplify. The table below shows a **condensed balance sheet** for the "A" company.

"A" Corporation Condensed 2004 Balance Sheet			
Cash	\$2,000	Current Liabilities	\$15,000
Operating Assets	8,000	Long-term Debt	30,000
Fixed Assets	60,000	Other Liabilities	5,000
Investments	25,000		
Other Assets	5,000	Stockholder Equity	50,000
Total Assets	\$100,000	Total liabilities and Equity	\$100,000

Notice that current asset rows are reduced to two components, cash and operating assets. Cash is separated from operating assets for a good reason — net cash increases from the cash flow statement are used to adjust cash on the balance sheet. This is more clearly shown to you by first separating current assets into cash and operating assets.

The Income Statement

The table below is a **condensed income statement** for the “A” Corporation. I am showing you a condensed statement so that you don’t get confused as we plow through this.

Net sales	\$ 90,000
Cost of goods sold	\$ (70,000)
Gross profit	\$ 20,000
Operating expenses	\$ (13,000)
Operating income	\$ 7,000
Investment income	\$ 700
Interest expense	\$ (2,000)
Pre-tax income	\$ 5,700
Income taxes	\$ (2,056)
Net income	\$ 3,644
<hr/>	
Dividends	\$ (1,000)
Retained earnings	\$ 2,644

This income statement reports revenues and expenses for the corporation over a one-year accounting period. Look at it carefully and make sure you get familiar with its top-down structure to the all important “bottom line”.

The income statement begins with net sales, from which **cost of goods sold (COGS)** is subtracted to yield gross profit. Cost of goods sold is the direct costs of production and sales — costs that vary directly with the level of production and sales. Next, operating expenses are subtracted from gross profit to give **operating income**. Operating expenses are indirect costs of administration and marketing — costs that do not vary directly with production and sales.

In addition to operating income from its own business operations, the “A” company has investment income from preferred stock dividends. Publicly traded corporations buy interests in other companies usually through preferred stock, as opposed

to common stock, due to tax benefits described below. Adding this investment income and then subtracting interest expense on debt yields pre-tax income. Finally, subtracting income taxes from pre-tax income gives net income. You will read and hear about the “**bottom line**” — this is net income, because it is the last line of the income statement. To simplify this example, I have added dividends and retained earnings information that are items that often appear in a separate financial statement. Net income is really the sum of dividends and retained earnings: $\text{Net Income} = \text{Dividends} + \text{Retained Earnings}$.

The Internal Revenue Service (IRS) of the U.S. federal government permits a company to exclude 80% of the dividends received from another company from federal income tax. This means only 20% of the preferred stock dividends that the company received from company “B” (look at the balance sheet) are taxable. For example, “A” corporation receives \$700 in dividends from “B” company, but only has to pay taxes on \$140 (20% of \$700). The normal corporate tax rate is 40%, so in this example the actual tax amount is \$56 (40% of \$140).

The Cash Flow Statement

The **cash flow statement** is specific to finance because it shows where a company generated cash and where cash was used over a specific accounting period — something not particularly interesting to accountants, yet vital to financial managers. The cash flow statement puts all cash flows into one of three categories: operating cash flows, investment cash flows, and financing cash flows.

The next table shows a condensed cash flow statement for the “A” corporation.

“A” Corporation Condensed 2005 Cash Flow Statement	
Net income	\$ 3,644
Depreciation	\$ 3,000
Operating cash flow	\$ 6,644
Investment cash flow ^a	\$ (15,000)
Financing cash flow ^b	\$ 9,000
Net cash increase	\$ 644

a December 2004 purchase of 50% interest in B company for \$15,000 (including \$5,000 goodwill).

b Issue of \$10,000 par value 8% coupon bonds, less a \$1,000 dividend payout.

The cash flow statement begins with net income, which is the main accounting measure of earnings for a corporation. Net income and cash flow, however, are not the same and are often very different in magnitude. The main reason for the difference is because income has **non-cash items**. Depreciation is a non-cash expense that must be added to net income when cash flows are calculated. Adjusting net income for non-cash items gives **operating cash flow**.

Operating cash flow is the first of three cash flow categories in the cash flow statement. The second and third categories are investment cash flow and financing cash flow. **Investment cash flow** (or “investing” cash flow) includes any purchases or sales of fixed assets and investments. For example, “A” corporation’s purchase of “B” company preferred stock reported in footnote ‘a’ is an investment cash flow. **Financing cash flow** includes any funds raised by an issuance of securities or expended by a repurchase of outstanding securities. In my example above, the “A” corporation’s \$10,000 debt issue and \$1,000 preferred dividend payout reported in footnote ‘b’ are examples of financing cash flows.

Standard accounting practice says that dividend payments to stockholders are fi-



HUMOR:

The first Law of Economics:
The only thing more dangerous than an economist is an amateur economist.

The second Law of Economics:
The only thing more dangerous than an amateur economist is a professional economist!

nancing cash flows — interest payments to bondholders are operating cash flows. The main reason for this is that dividend payments are discretionary. The managing directors decide whether or not to pay them, but interest payments are mandatory and have to be paid to bondholders. Also, interest payments are tax-deductible expenses, but dividend payouts are not tax-deductible. In any case, interest payments are cash expenses reported on the income statement. Since they are cash expenses, they do not appear in the cash flow statement to reconcile the difference between income and cash flow.

The sum of operating cash flow, investment cash flow, and financing cash flow yields the net change in the corporation’s cash. This change is the bottom line of the cash flow statement and reveals how much cash flowed into or out of the company’s cash account during an accounting period.

Performance Ratios and Price Ratios

Annual reports to stockholders and SEC 10Ks usually have various items of supplemental information about the company. For example, certain profitability ratios may be reported to help analysts understand the company’s operating efficiency. For the “A” corporation, I calculate some standard profitability ratios for 2005 in the table below.

Ratio	Formula	Calculation
Gross Margin	$\frac{\text{Gross Profit}}{\text{Net Sales}}$	$\left(\frac{\$20,000}{\$90,000} \right) (100) = 22.22\%$
Operating margin	$\frac{\text{Operating Income}}{\text{Net Sales}}$	$\left(\frac{\$7,000}{\$90,000} \right) (100) = 7.78\%$
Return on assets (ROA)	$\frac{\text{Net Income}}{\text{Total Assets}}$	$\left(\frac{\$3,644}{\$100,000} \right) (100) = 3.64\%$
Return on equity (ROE)	$\frac{\text{Net Income}}{\text{Stockholders Equity}}$	$\left(\frac{\$3,644}{\$50,000} \right) (100) = 7.29\%$

Notice that you have to multiply by 100 to express a ratio in percentage terms. This is normally what you will read in analyst reports

and in the financial newspapers. Notice that **return on assets (ROA)** and **return on equity (ROE)** are calculated using current year-end values for total assets and stockholders equity. You could argue that it makes just as much sense to use prior year values for these calculations, but current year-end values are what everyone uses.

Annual stockholder reports and SEC 10Ks may also report per-share calculations of book value, earnings and operating cash flow, respectively. Per-share calculations require the number of common stock shares outstanding. For instance, “A” corporation’s balance sheet reports 2,000 shares of common stock outstanding. I’ve used this to calculate per-share values as follows:

Ratio	Formula	Calculation
Book value per share (BVPS)	$\frac{\text{Stockholder equity}}{\text{Shares outstanding}}$	$\left(\frac{\$50,000}{2,000} \right) = \25
Earnings per share (EPS)	$\frac{\text{Net income}}{\text{Shares outstanding}}$	$\left(\frac{\$3,644}{2,000} \right) = \1.82
Cash flow per share (CFPS)	$\frac{\text{Operating cash flow}}{\text{Shares outstanding}}$	$\left(\frac{\$6,644}{2,000} \right) = \3.32

It is really important for you to notice that I calculate the cash flow per share (CFPS) using operating cash flow, not the bottom line on the cash flow statement! When you hear the words “cash flow” in corporate finance, this is operating cash flow.

Remember the price ratios I taught you earlier? You can use the per-share values above and “A” corporation’s year-end price of \$40 per share to get the following rounded price ratios:

Ratio	Formula	Calculation
Price-book (P/B)	$\frac{\text{Stock price}}{\text{BVPS}}$	$\left(\frac{\$40}{\$25} \right) = 1.6$
Price-earning (P/E)	$\frac{\text{Stock price}}{\text{EPS}}$	$\left(\frac{\$40}{\$1.82} \right) = 22.0$
Price-cash flow (P/CF)	$\frac{\text{Stock price}}{\text{CFPS}}$	$\left(\frac{\$40}{\$3.32} \right) = 12.1$

Pro Forma Financial Statements

Pro forma financial statements show the forecasted (projected) operating results of possible future changes in the income and cash flow statement as well as the balance sheet. You will read or hear about three of these: pro forma income statements, pro forma balance sheets and the pro forma cash flow statement. I am not going to go into much detail about these. As I've said before, the current financial statements can be grossly inaccurate for all sorts of reasons, so just imagine how inaccurate pro forma statements are!

So Is Fundamental Analysis Good For Anything?

Fundamental analysis uses ratios derived from the balance sheet and income statement. It has five categories: liquidity, debt, coverage, profitability, and market value. Every analyst out there has a special way of mixing their own personal “ratio cocktail” that has some special meaning to them. Also, my experience is that most load non-indexed mutual fund companies also use some special “ratio cocktail” that the mutual fund managers hangs his “financial genius cap” on.

The reality is that mutual funds do not predict stock price increase well nor do market analysts. If they did our doctoral empirical studies in finance would show that analyst predictions and mutual fund returns to be superior to the market averages — academic studies show just the opposite. So if ratios by themselves are meaningless and ratio analysis is not very useful (to determine which stocks are going to go up) in price than what are ratios good for?

*AUTHOR'S NOTE: The following discussion is **advanced** and we are at the end of the chapter so if you are starting out as a stock investor please feel free to skip ahead to the next chapter.*

The answer is that a comparison of the same ratios of the same corporation over time uncovers clues in determining trends and changes in the firm's financial condition and profitability. A number of academic studies have tested the predictive power of financial ratios. The best ratios for predictive purposes if you must use them are debt-to-equity, cash-flow-to-debt, net operating profit margin, debt coverage and its stability. It appears that financial ratios can be used successfully to predict bankruptcy. This is important because you may be able to avoid investing in stocks that go bankrupt and force you to lose all your money when the stock is de-listed.

Beaver was the first academic researcher to use statistical techniques to predict corporate failure (bankruptcy).⁷ He found that the financial ratios for defunct corporations deteriorated very fast as bankruptcy approached. New York University finance professor Edward Altman, in a similar kind of study, used a multiple discriminate analysis to predict bankruptcy, using various financial ratios.⁸

Discriminate analysis is similar to regression analysis but assumes that the observations come from two or more universes. In Altman's study those two universes were bankruptcy and solvency. The weights on the discriminate function below are derived by determining the linear boundary line between observations of each independent variable categorized by bankruptcy and solvency — the fit is not perfect and there is overlap.

Altman found that five financial ratios very effectively predicted bankruptcy, beginning up to five years prior to financial collapse. He showed this using a **Z-score model** he created as follows:

$$Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5$$

where X_1 = working capital/total assets,
 X_2 = retained earnings/total assets,
 X_3 = earnings before interest and taxes/total assets,

7 Beaver, W., "Financial Ratios as Predictors of Failure," *Empirical Research in Accounting: Selected Studies*, supplement to *Journal of Accounting Research*, 41, (1966), 71-111.

8 Altman, E., "Financial Ratios, Discriminate Analysis and the Prediction of Corporate Bankruptcy," *Journal of Finance*, 23 (September 1968), 589-609.

X_4 = market value equity/book value of total liabilities,
 X_5 = sales/total assets, and
 Z = overall index.

The **Z ratio** (dependent variable) is the overall index of the multiple discriminate function. Altman found that corporations with Z scores below 1.81 (including negative amounts) always went bankrupt, whereas Z scores above 2.99 represented healthy companies. Firms with Z scores in between were sometimes misclassified, so this is a grey area. On the basis of these cutoffs, Altman recommends that you can predict whether or not a company is likely to go bankrupt in the near future.

The Z-score model was expanded by Altman and others into what is known as the **Zeta model**. This model is more accurate in prediction, but the coefficients are not published. It was developed for private sale by **ZETA Services, Inc.**, (www.ZetaScore.com) and the output consists of Zeta scores for thousands of companies. As a result of this and other work, financial ratio analysis has become more scientific and objective. I want you to be cautious with ratio analysis because even Altman admits, “...*academicians seem to be moving toward the elimination of ratio analysis as an analytical technique in assessing the performance of the business enterprise. Theorists downgrade arbitrary rules of thumb (such as company ratio comparisons) widely used by practitioners.*”

Chapter 7

Technical Analysis of the Stock Market

Captain Bob explained to me why it is so important for him to practice in a simulator before flying a new military or commercial aircraft:

Test pilots often must push an aircraft to the limits of its performance capabilities and have to be at their best when they do it. When training future test pilots, however, it is preferable to go to the edge of the flight envelope in a safer environment — on the ground. Specifically, flight training simulators can help a student understand concepts and improve his or her flight skills before trying them in the air. It also can provide hands-on training at a fraction of the cost of flying. And it introduces the students to what will be one of their best tools when they graduate and put their new skills to good use in testing and evaluating new aircraft, weapons, and tactics.

This is very important because some forms of investing are slow and others are fast paced and highly risky. Either way, you have to practice, and the less your money is exposed while you practice the better. Futures trading is a great example where the leverage is so great that a moderate move in a week's trading can cost an individual his or her "farm" on margin call. Professional futures traders have struggled to find adequate ways to simulate futures trading

before entering a new market. They do this for damage control, just as the Navy doesn't want to put a rookie kid in a multimillion dollar jet without good assurance it won't be destroyed. Brilliant entrepreneur and first-class business manager Lan Turner decided in the early '90s to create a futures trading simulator on the computer that has won accolades worldwide.

His company, Gecko Software (www.GeckoSoftware.com), creates the only charting and stock investing trading simulator in the world — 'Track N' Trade High Finance — that allows futures traders to get years of experience for under \$100 a month. The average futures trader loses thousands of dollars in just the first few months of trading due to inexperience. The futures traders that do survive their own initial ignorance become Gecko Software clients sooner or later — best sooner than later. Lan and I became friends during my Ph.D. studies and his company gifted me part of the data I used for my dissertation. When I finished my Ph.D., he asked me for help in creating the most ambitious and exciting project his company has endeavored to date — the extension of the futures simulation platform into equities. Lan is now widely known for his breakthrough software, but really, he created the simulator out of personal frustration. He recounts:

One of the largest losses I ever had was from a tip I received off the television. These guys had an expert on the TV and he was talking about how great this stock was going to be and how wonderful it was. I believed him — fell into the trap — and threw a chunk of money in there. Three months later, I had half of what I had in there. This was one of the things that opened my eyes to the danger of taking tips off of the TV. Like they say on Wall Street, "If you are hearing it on the news it's already too late, because everybody else in the market that creates the news has already taken advantage of it." If you are hearing it on the news, then it is too late

for you. That is why I ignore the news and turned to technical analysis to guide my investing.

I also started to wonder if there was a way to practice in the markets without risking. I thought of the flight simulator, which is really just a piece of software, and decided that there must be a way to create simulation software for investors. Then I became a futures trader and really became motivated to find a way to practice risk-free. If I had our simulator back then, I would never have made some of my worst errors as an investor.

When I started investing, I knew absolutely nothing! One of my biggest mistakes when I first started trading was that I didn't even know how much I had invested or even how much I was risking. I didn't know where the decimal point went. I had the decimal point in the wrong spot. I thought I was investing \$100 and I was really investing \$1,000 because I had the decimal point in the wrong spot. Questions like, "Hey, where does the decimal point go?" sounded to me like too dumb of a question to ask. So I made the mistake. It is like Dr. Brown says all the time, because he started from scratch, too: "There are no dumb questions!" You can't ask a dumb question in this industry, because if it is a question that you might have and not having the answer is risking your money. When your money is on the line – well then, man, you have to ask that question and someone has to answer it for you — hopefully the right someone. You have to be able to find that answer. We can't be untouchable and people have to be comfortable asking these questions. The great thing

about both our organizations — Gecko Software and the Wallet Doctor — is that if you are reading this, you have the ability to call and ask us in a “There Are No Dumb Questions” community of successful investors that started right where you are today.

We have been working very closely with Dr. Brown to bring out the new version of our simulator. We have for the last eight years been working very diligently over in the futures industry, which is the background that I come from. Because of the success of our simulator over there, we have received a number of awards in the industry and our clients have asked us to bring the simulator into stocks. And we have done that. This is very important, because now you can practice what Scott teaches and get years of experience with no risk! Also, once you become an independent and unique thinker, as Scott wants you to be, you will probably come up with investing ideas of your own. This is also very important, because now you can trade those ideas in the stock market without risking any of your money and decide for yourself if they are worth pursuing. The comment we hear the most from our clients is that our investing simulator radically reduces their anxiety about investing in the markets because they can “fly the jet before they are on the hot stick” for less than \$100 a month.

We have my entire staff working over the last year and working together with Scott to get it all done right. The great thing about the simulator is that it has the ability to go back in time and simulate stock investing. You can practice everything the Wallet Doctor teaches

you. You can get his course, read through it, and go back and practice in Track n Trade High Finance stock charting software, because it is an investing simulation program. You can go back and simulate investing forward from any point in time and actually test your skills to see if what you think is going to happen will happen in the market. It also has the ability to track intra-day data because it is state of the art. Our simulator is also the best way to gain experience as a technical investor, but also helps fundamental investors. You have already had a little taste of our simulator, because all of the chart examples in this survival guide were generated by it.

I just taught you that fundamental analysis focuses on company specific financial and accounting information. There is a completely different approach to fundamental stock market analysis that was created in response to the problems of inaccuracy and corporate corruption that leads to informational asymmetries — a fancy way of saying they know more than you about where the stock price is going to go — and outright lying by insiders to the public. In plain language, fundamental analysis just doesn't work. Still, I had to drag you through all of the dysfunctional fundamental underpinnings of the stock market so that you can appreciate an approach that does work. This approach is called **technical analysis**, and it focuses on three types of information exclusively: (1) historical price movements, (2) trading volume, and (3) investor psychology. Technical analysis techniques are centuries old, dating back at least to samurai-dominated imperial Japan, where merchants traded rice using these techniques. The “lower”-class merchants so arrogantly downtrodden by the

WALLET DOCTOR SURVIVAL RULE #13

Don't start green like Lan and I had to — practice at least 15 minutes, five days a week (or more) USING everything you learn about investing in the TNT High Finance investing simulator for a minimum of six months and attend all the training workshops you can! Practice, practice, practice makes perfect.



TIP: The trend is your friend!

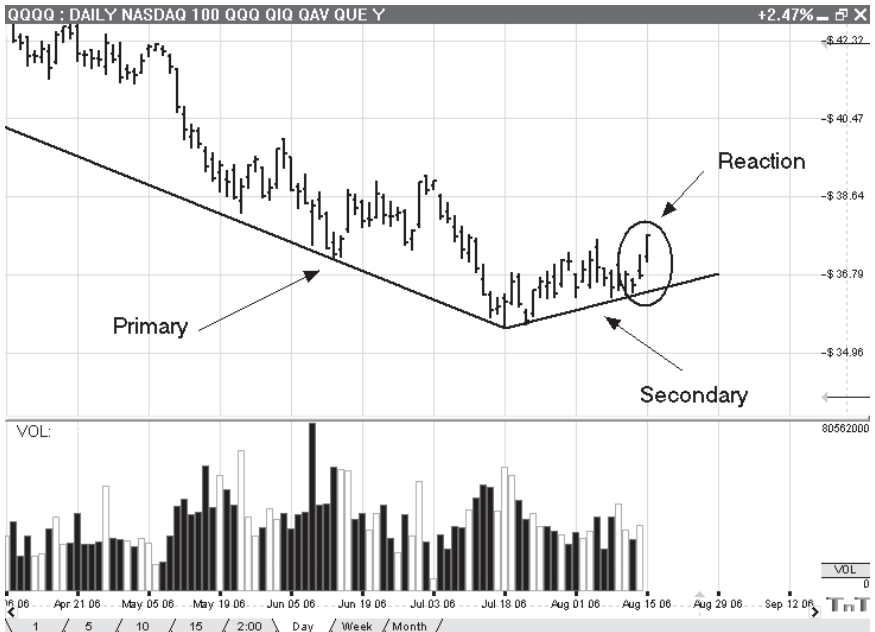
samurai caste eventually drove their oppressor into financial ruin, collapsing the Japanese samurai system.

Investors with a positive outlook on the market are called “bulls.” A rising market is called a **bull market**. On the other side, pessimistic investors are called “bears” and a falling market is called a **bear market**.

Technical analysts hunt for bullish or bearish technical signals about the direction of the general market and specific stocks.

Dow Theory

Dow Theory was invented in the late 1800s and is considered the birth of technical analysis. It is named for **Charles Dow**, co-founder of the **Dow Jones Company** and an editor of Dow-Jones owned newspaper *The Wall Street Journal*. The main point of Dow Theory



is that there are three forces continually at work in the stock market: (1) a **primary market trend**,¹ (2) a **secondary reaction** or **secondary market trend**, and (3) **daily fluctuations**. The primary market trend is either bullish (up) or bearish (down), and it reflects the long-run direction of the market.

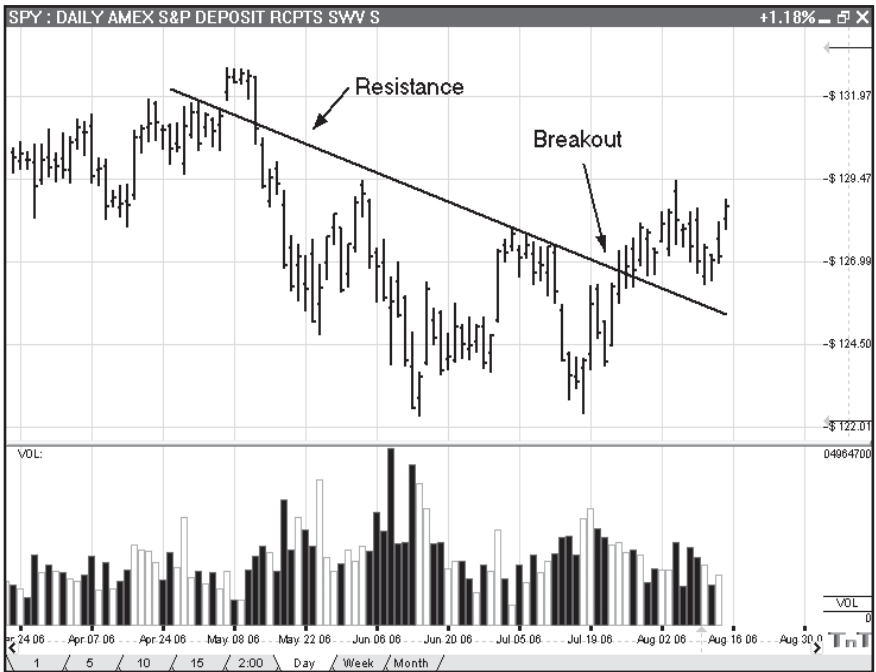
For limited periods of time, the market can depart from its primary direction. These departures are called secondary reactions, or secondary market trends, and may last for weeks — up to six months. A general market trend is eliminated by a market correction, which is a reversal back to the primary market direction. Daily fluctuations are essentially noise and are of no real importance. The basic purpose of the Dow Theory is to signal changes in the direction of the primary trend. This is monitored by two stock market indexes I taught you about before, the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA). If one of these indexes breaks the primary trend but the other does not, then this is viewed as a secondary market trend. If both break the primary trend, then this is called a **confirmation** that the market has shifted from a bull to a bear market or vice-versa.

Support and Resistance Levels

A key concept in technical analysis is support and resistance levels. A **support level** is a price or level below which a stock or the market as a whole is unlikely to fall. Even more important in the stock market, where there is much less short selling than in the futures market, is resistance. A **resistance level** is a price or level above which a stock or the market as a whole acts like it just can't break up above.

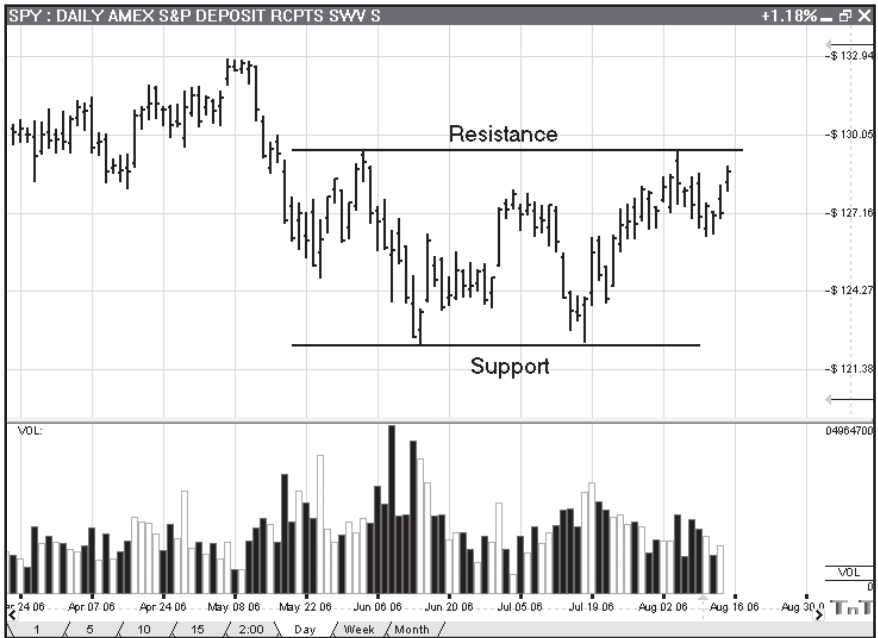
Here is the basic concept behind these price levels. As a stock's price (or the market as a whole) falls, it reaches a point where people stop selling (as compared to people buying) and it bottoms out as bargain hunters start buying again. The new buying activity supports the stock price above a level visible on a price chart. A resistance level

1 A market trend is the upward or downward movement of a market for six months or more.



occurs for exactly the opposite reasons. The price rises and more people buy the stock (as compared to people selling) and it goes up in price. As the price goes higher, more people who have bought it at lower prices start selling to take a short-term profit and the stock reaches a point where it “tops out” and falls back a little.

Technical analysts view resistance and support levels as psychological barriers because stocks seem to take a while to hit a level and then move up (or down) fast once they break through. For instance, as the DJIA approaches levels with three zeros — like 10,000 — you will read and hear of “psychologically important” barriers in the financial press. A **breakout** occurs when a stock or a market index passes through a support or resistance level. A breakout usually continues up or down for a while after it occurs. Not only is technical analysis a more profitable way to analyze the stock market, but it is also a lot of fun and has lots of colorful language and colorful people.



Technical Indicators

Technical analysis is used to forecast the direction of the market in not only stocks but also futures and Forex. I will discuss technical indicators specifically used for the stock market first, then give you a sense of other indicators that you can use.

Market Breadth

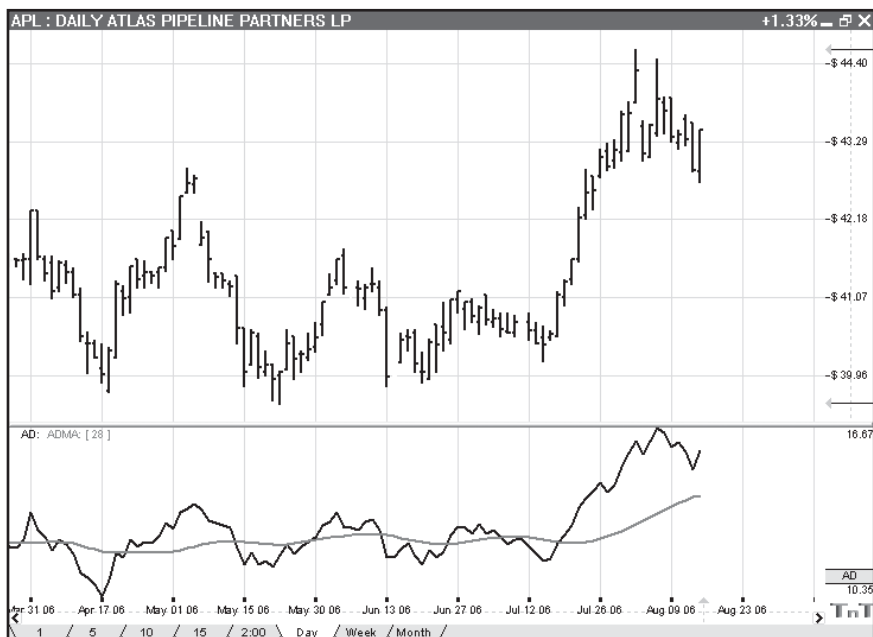
The idea behind market breadth is to attempt to measure the overall health of the stock market, working down through sectors to individual stocks. Your objective is to pick stocks in the best groups in market conditions when the stock market is healthy in terms of technical indicators. You will measure market breadth using advancing versus declining issues, new highs versus lows, and up volume versus down volume.

The Advance-Decline Line

This is the most commonly used measure of market breadth and is really simple. Every day on any stock exchange there are stocks that advance (increase in share price), decline (decrease in share price), or do not change in price at all. The way the **advance-decline (AD)** line is calculated is by simply subtracting the number of declining issues from the number of advancing issues.

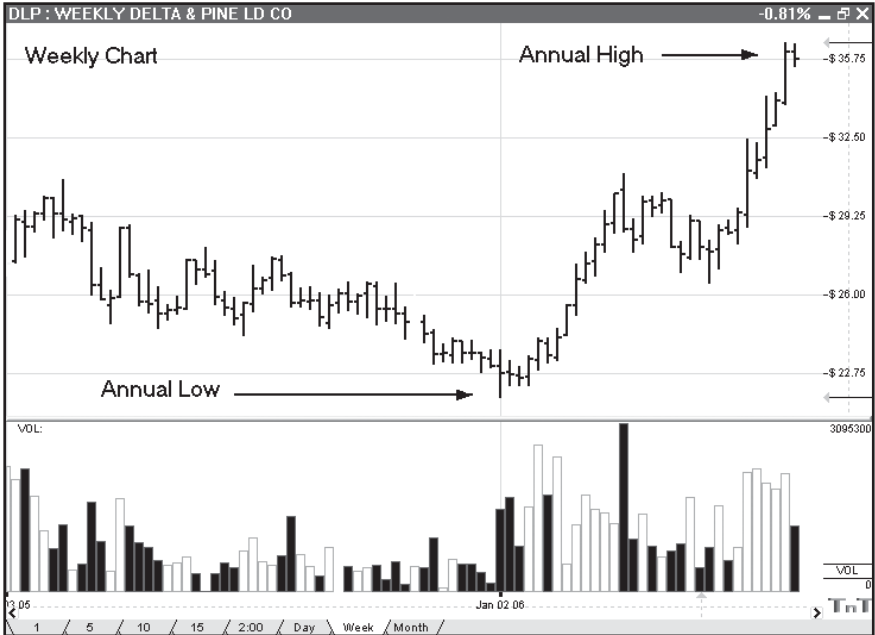
If there are more advances than declines, the number is positive. If there are more declines than advances, the number is negative. The day's number is added to the cumulative AD line to display the trend. The basic idea is to make sure that the AD line and the market averages are trending in the same direction (don't diverge).

The McClellan Oscillator is constructed by taking the difference between two exponential moving averages of the daily NYSE advance-decline values. Specifically, the **McClellan Oscillator** is the difference between the 19-day (10%) trend and the 39-day (5%) trend.



New Highs Versus New Lows

To measure market breadth you also need to know the number of stocks hitting new 52-week (yearly) highs or new 52-week lows in a chart of **new highs versus new lows**. Since the daily values make pretty erratic squiggly lines, these technical charts are often smoothed with a ten day moving average.



TRAP: Fundamental analysis is faulty because of accounting inconsistencies, but a lot of the "technical analysis" systems out there are nothing more than

gobbetygook that is no more useful than psychic tea leaf reading. Use technical indicators the way I show you, and you are far less likely to get into trouble.

Upside Versus Downside Volume

This is the third and final piece of data you need to measure the breadth of the market. **Upside volume** is the trading volume of advancing shares, **while downside volume** is the trading volume of declining shares.

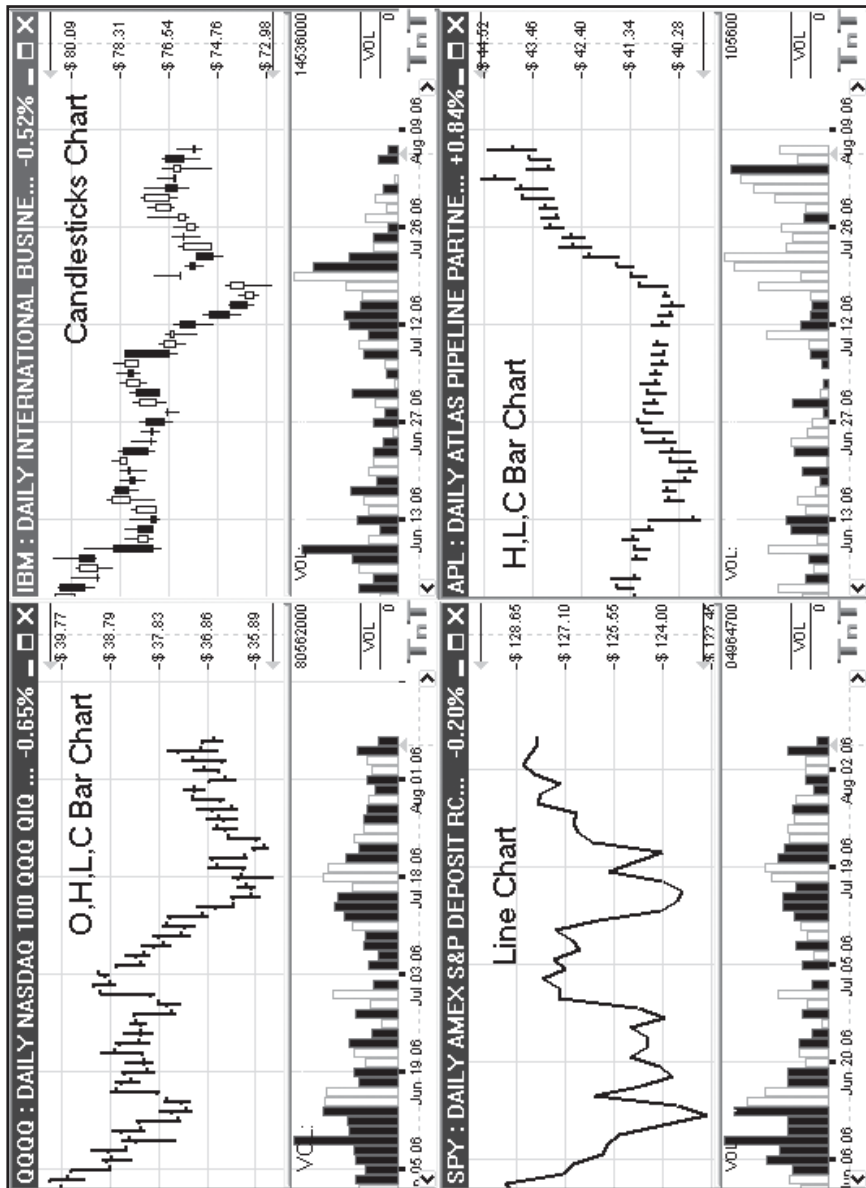
The Arms Index

The **Arms Index**, named for its creator Richard Arms, is a ratio of a ratio. A ratio is just a fraction. The numerator — the top part of the fraction — in this case is the ratio of the number of advancing issues (stocks) divided by the number of declining issues. The denominator is the advancing volume divided by declining volume. The purpose of the Arms Index is to gauge whether there is more volume in rising or falling stocks. A reading below 1.0 tells you that there is more volume in rising stocks (you would think it would be the other way around) and a reading above 1.0 tells that there is more volume in falling stocks. On an intraday basis for day traders, a very high Arms Index reading is bullish, and a very low reading is bearish. The Arms Index is a contrarian indicator that trends in the opposite direction of the market that can be used for intraday trading by tracking its direction and for spotting signs of short-term market extremes.

$$\text{Arms Index} = \frac{\left(\frac{\# \text{ of advancing issues}}{\# \text{ of declining issues}} \right)}{\left(\frac{\text{advancing volume}}{\text{declining volume}} \right)}$$

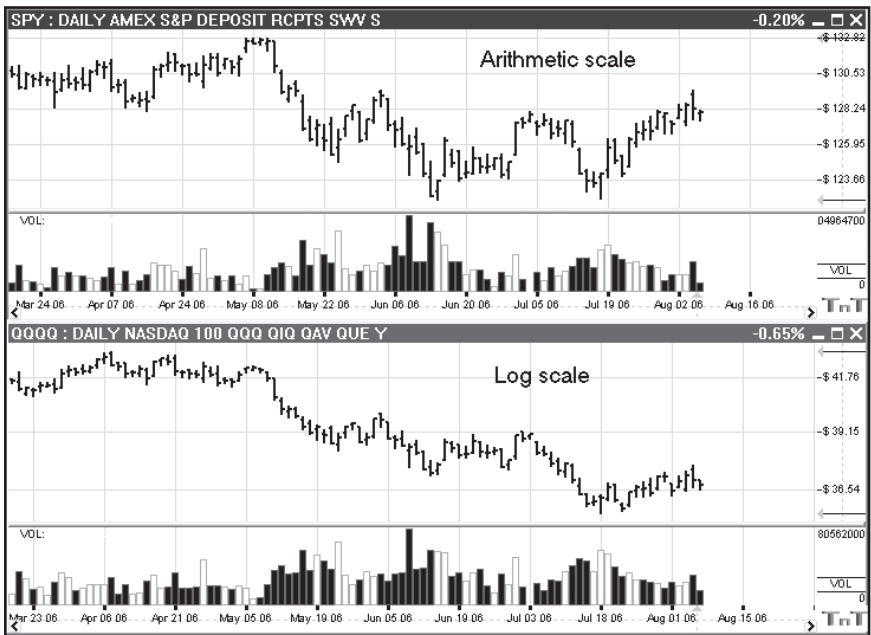
Chart Construction

The daily bar chart is the most commonly used chart in technical analysis, but there are also line charts, and candlestick charts.



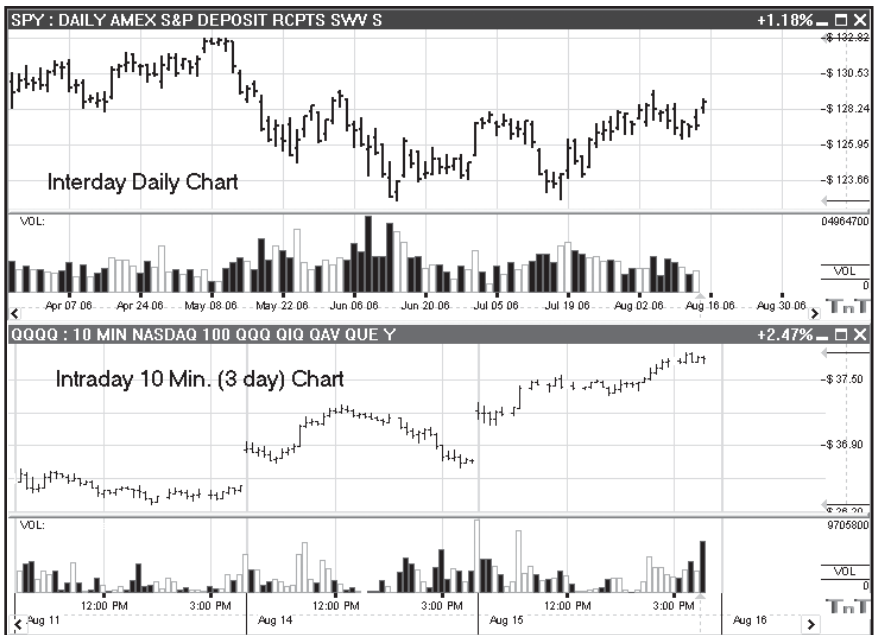
Arithmetic versus Logarithmic Scale

On the **arithmetic scale**, the vertical price scale shows an equal distance for each price unit of change. On the **log scale**, the percentage increases get smaller as the price scale increases.



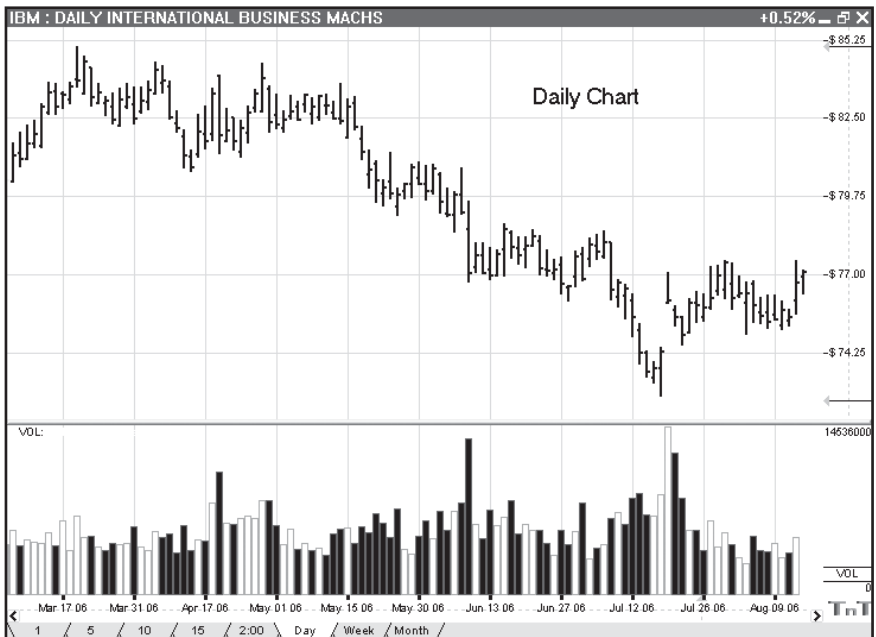
Intraday Charts

The **intraday chart** shows you one day's session of price activity, where each blip is a transaction. These charts give you a sense of the size and movement of the bid-ask spread during the day. They are very useful when you are trading in an illiquid stock. *Intra* is a Latin word that means inside. Since this chart is intended to show activity within one day it is called an "intra" day chart. *Inter* means "between" in Latin, so the daily, weekly, and monthly charts I explain next are called **interday charts**.



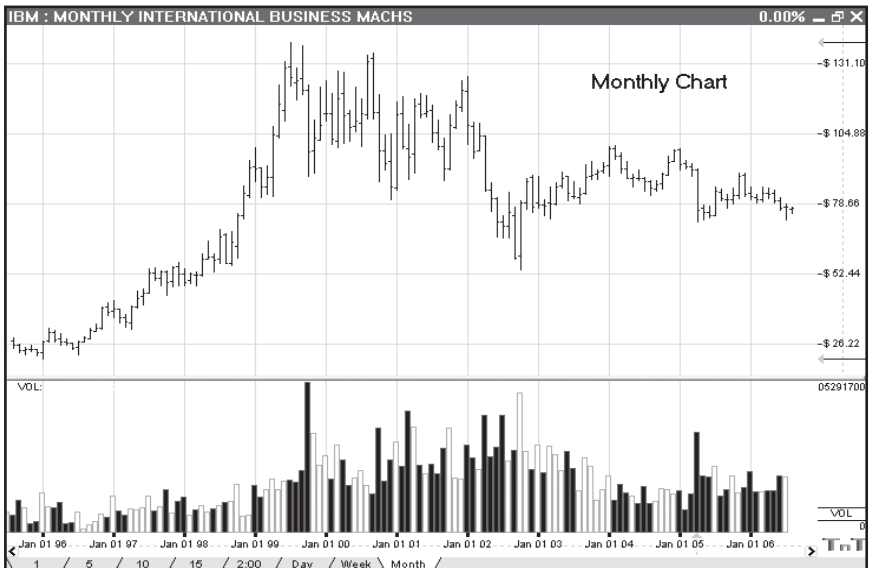
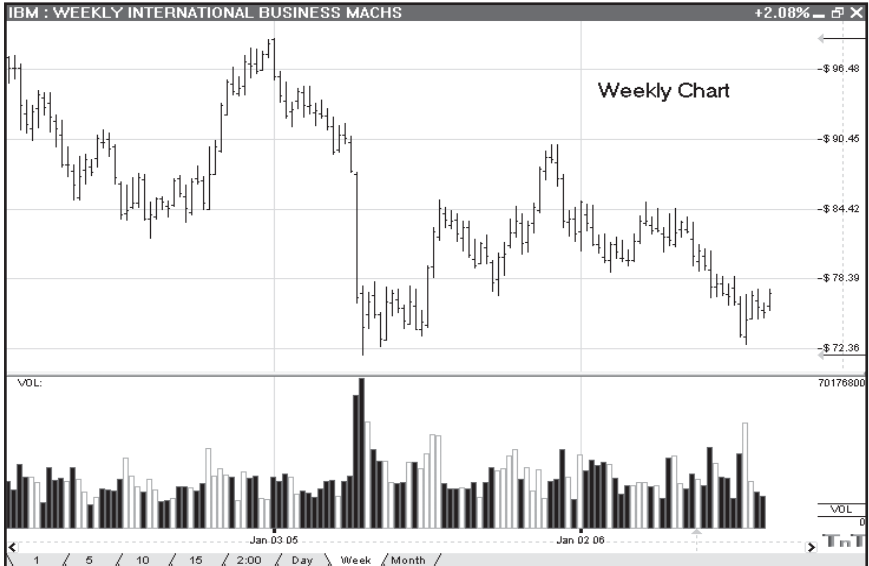
Daily Charts

The **daily chart** condenses an entire day's price activity into one bar that shows the open, high, low and close prices during the day. Normally, daily charts will show a year of trading.



Weekly and Monthly Bar Charts

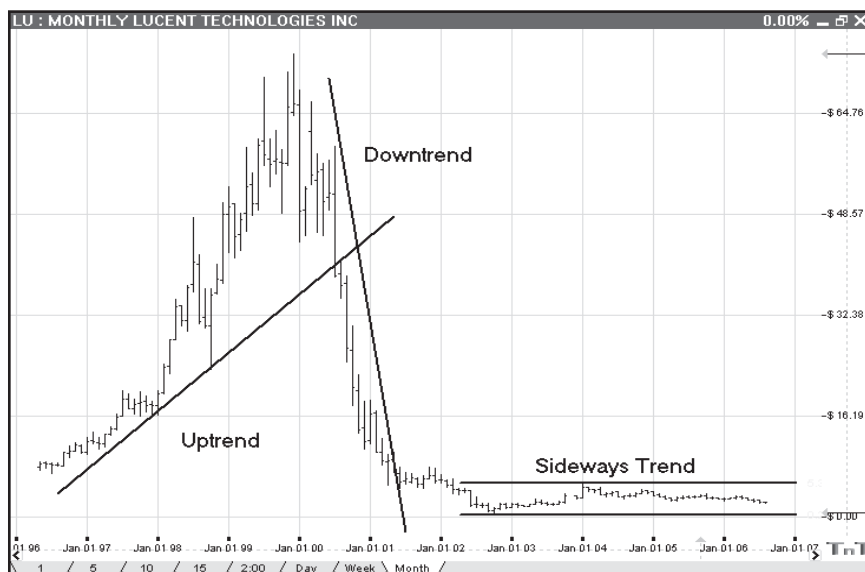
The **weekly chart** shows you an entire week of price activity in each bar. The **monthly chart** shows you an entire month's price activity.



Trend

The **trend** is simply the recent direction of the market. An **uptrend** is a series of successively higher price peaks. A **downtrend** is just the opposite — a series of declining peaks and troughs. Horizontal peaks and troughs, on the other hand, are a **sideways trend** also known as a **price channel** or a **trading range**.

The trend has three classifications — **major trend**, **intermediate trend** and **near-term trends**. There is not a lot of consensus as to exactly how long each is, but here is a rule of thumb. Dow Theory says that a major trend has to be in effect at least a year to be confirmed. The intermediate trend is three weeks to less than a year. The near-term trend is price movement in the same direction for two to three weeks.

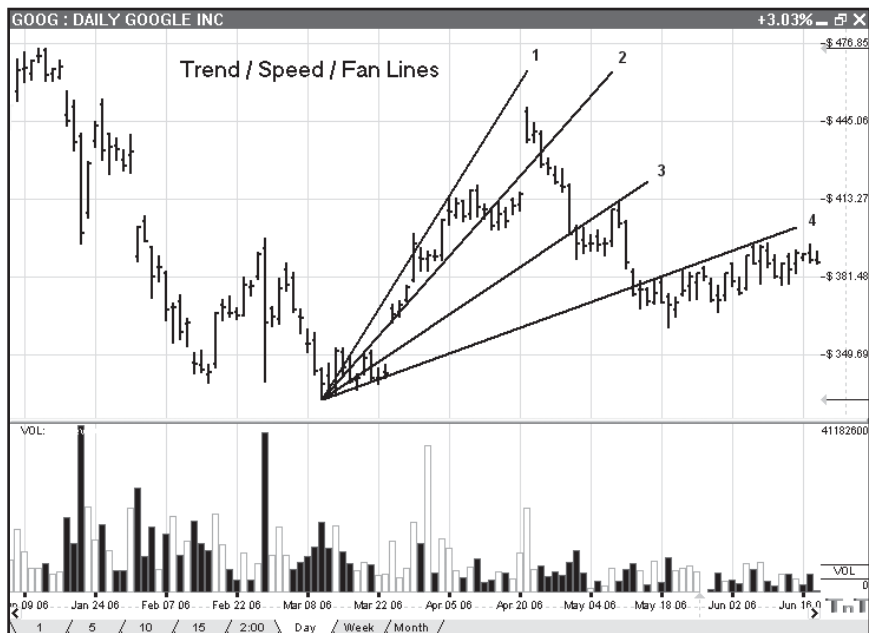


After the violation of a new up trend line, the stock price will decline a bit sometimes before rallying back to the bottom of the old uptrend line (now a resistance line). **Fan lines** can be drawn along

successive peaks to help you deal with minor trend line breaks, where you can buy more or place a **stop-loss order**. A **stop-loss order** is an order to sell (buy) when the price of a stock falls (rises) to a designated level called the stop price — where you want to cut your losses and get out.

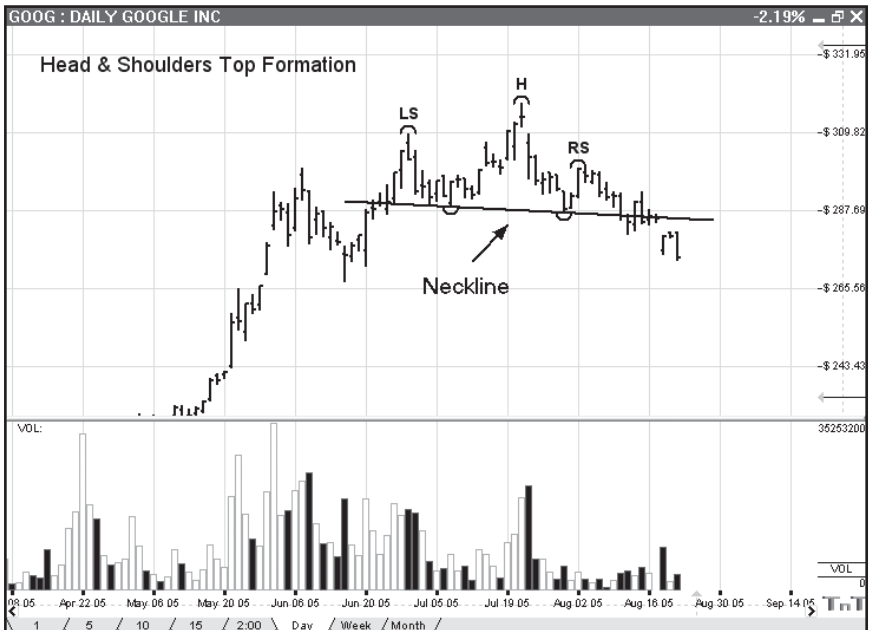
Reversal Patterns

There are two major categories of price patterns — reversal and continuation. **Reversal patterns** imply that an important reversal in trend may be taking place. The **continuation pattern**, on the other hand, tells you that the market is only pausing for a while, possibly to correct for a near-term **overbought** or **oversold** market condition, after which the existing trend should resume. It is very important for you to learn to recognize between these two types of patterns as early as possible during the formation of a reversal pattern so that you can take appropriate action.



The Head and Shoulders Reversal Pattern

In the case of the **head and shoulders reversal top pattern**, there is a major uptrend in which a series of rising peaks and troughs gradually begin to lose momentum. This is bullish. With this pattern you want to watch the **neckline** for a break. The neckline is projected across the top of the shoulders of a bullish head and shoulders pattern or the bottom of the shoulders of a bearish head and shoulders pattern. The **head and shoulders reversal bottom pattern** is just the opposite and is a bearish pattern.



Saucer Bottom Reversal Pattern

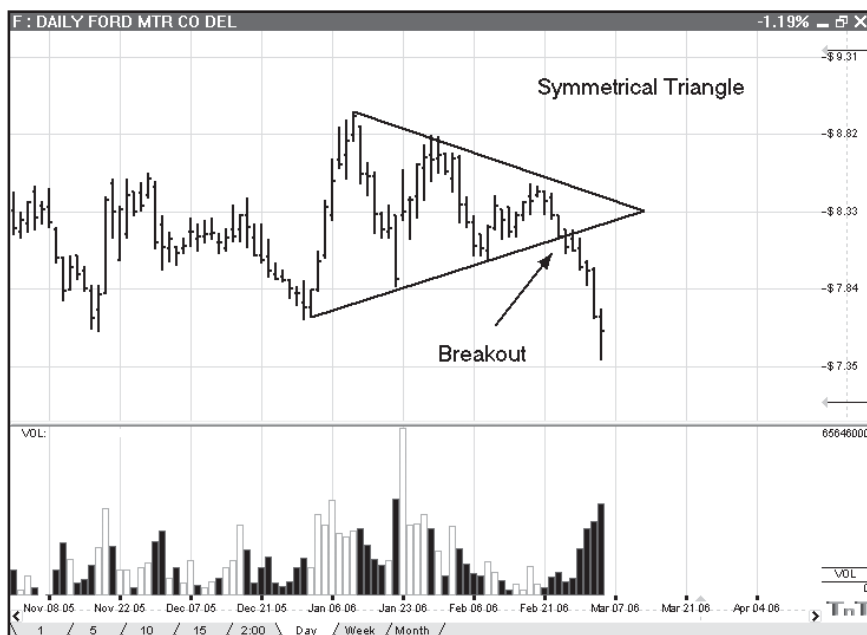
Saucer bottoms are usually spotted on weekly or monthly charts that span several years. The longer the saucer bottom lasts, the larger the rise. My core expertise is investing in these types of bottoms. Buying these stock price bottoms is a great way to get rich in the stock market.

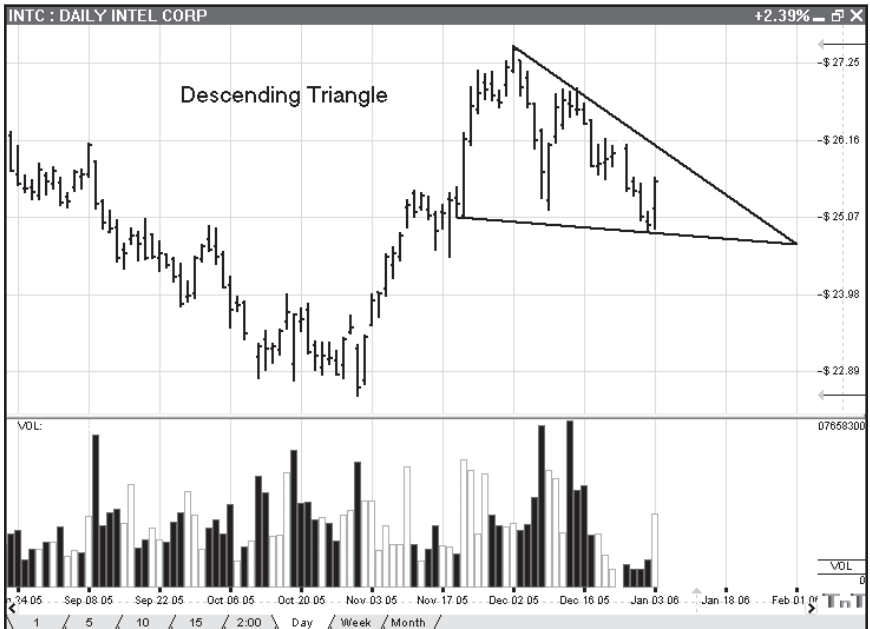
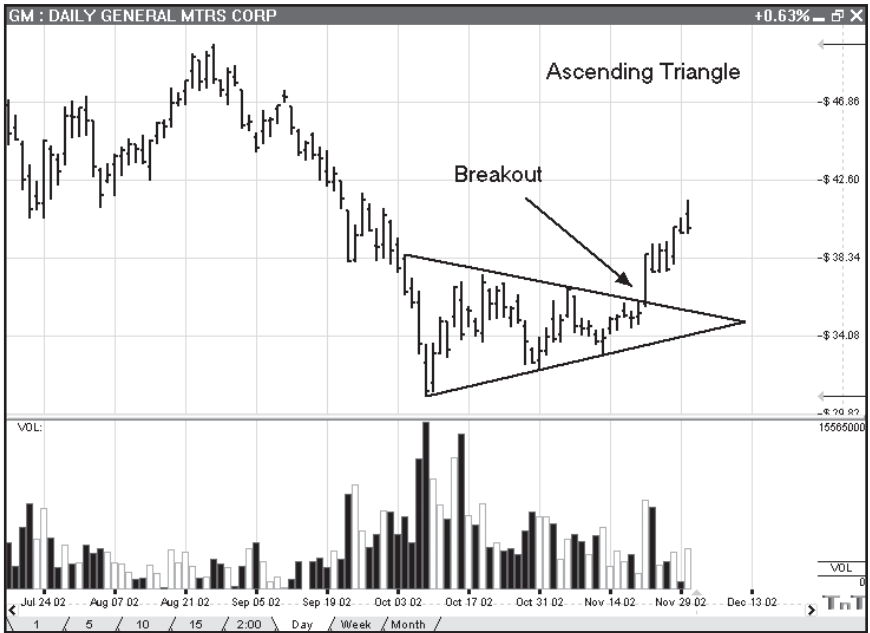


Continuation Patterns

Triangles

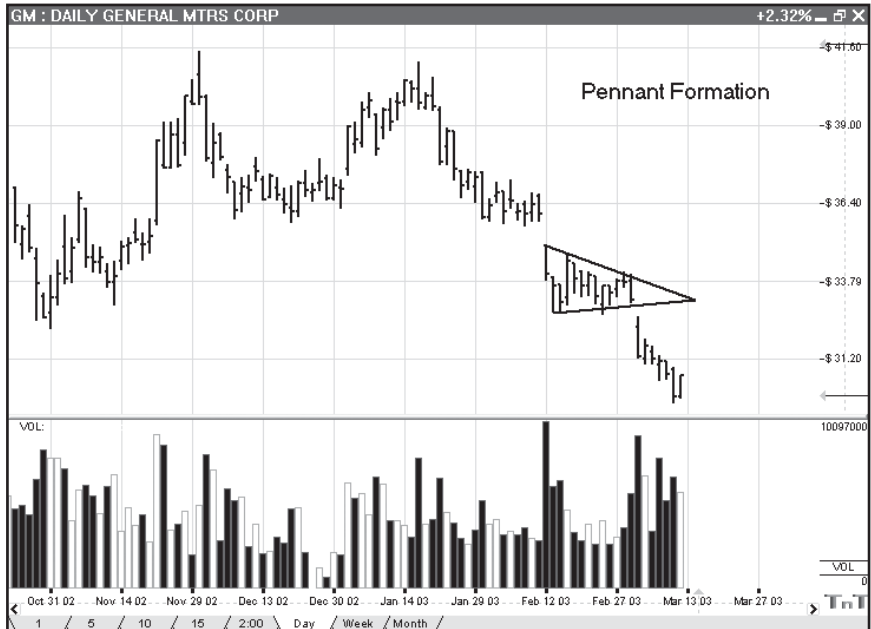
There are three types of triangles. The **symmetrical triangle** shows up as converging trend lines like a sideways letter “v”. This is also called a **coil** — because the stock price is “coiling up” for a break out — and breakouts from these patterns are spectacular. The **ascending triangle** has a rising lower line with a flat or horizontal upper line. The **descending triangle** is just the opposite of the ascending triangle. These are also called **wedges**.





Flags and Pennants

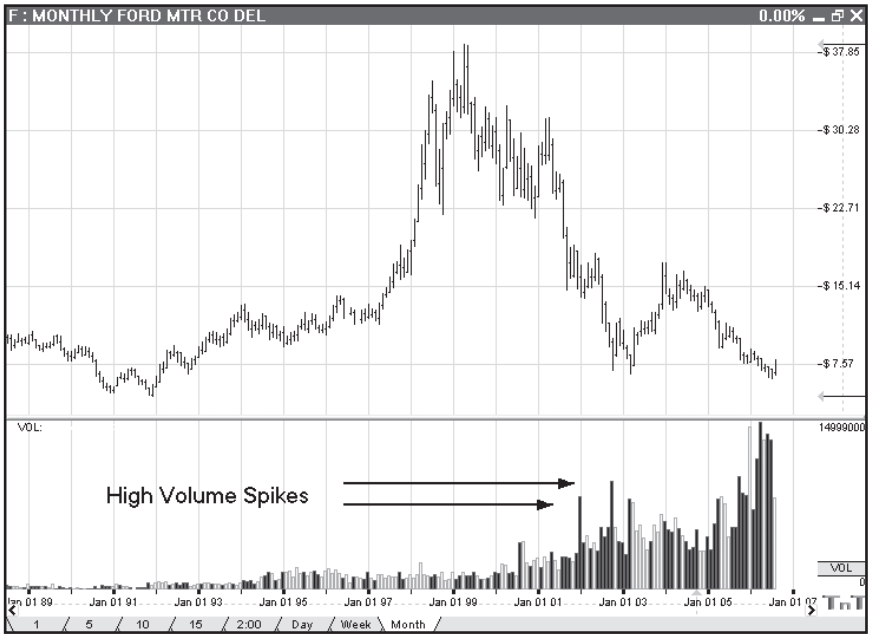
The **flag** and **pennant** are brief pauses in upward or downward market moves and rarely produce trend reversals. Most technical analysts consider these to be the most reliable of all short-term patterns.



Volume

Volume is the total amount of trading activity on an exchange or in a single stock for that day. Volume is plotted on daily, weekly and monthly charts. In general, investors place way too much faith in volume and, in fact, I emphasize that volume is actually used by insiders to sucker the public into buying or avoiding a stock when it serves manipulators best. The one specific time where volume is really useful is during **blow-off tops** when insiders are selling out of a stock. You will learn specifically how to watch the trading volume

in stocks that have been rising in price for extended periods to great heights in my course “*Bulletproof Stock Investing... What the Insiders Don't Want You to Know.*”



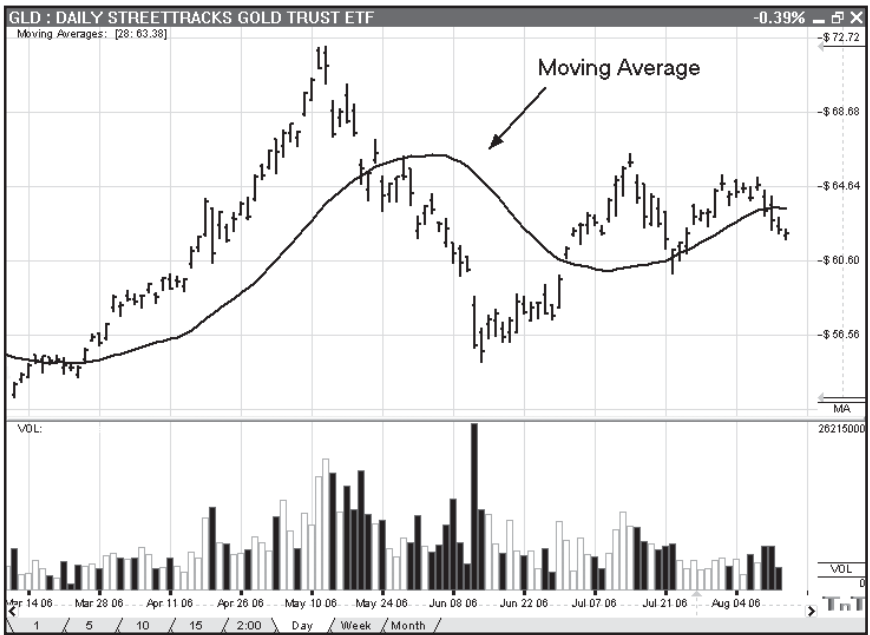
LONG-RANGE CHARTS

Long-range charts of five years or more provide a perspective on the market trend that is impossible to see with daily charts alone. One of the greatest advantages of technical analysis is its application over virtually any time dimension easily and efficiently. Contrary to popular opinion, longer-range forecasting is best done with technical analysis, not fundamental analysis. Trend analysis, support and resistance levels, trend lines, percentage retracements, and price patterns all lend themselves very well to the analysis of long-range

price movements. If you don't consult long-range price charts, you will miss an enormous amount of valuable price information absent from financial reports.

Moving Averages

The moving average is one of the most versatile and widely used of all technical indicators. The **moving average** is a trend following device to identify or signal that a new trend has begun or that an old trend has ended or reversed by averaging the price data.



Oscillators

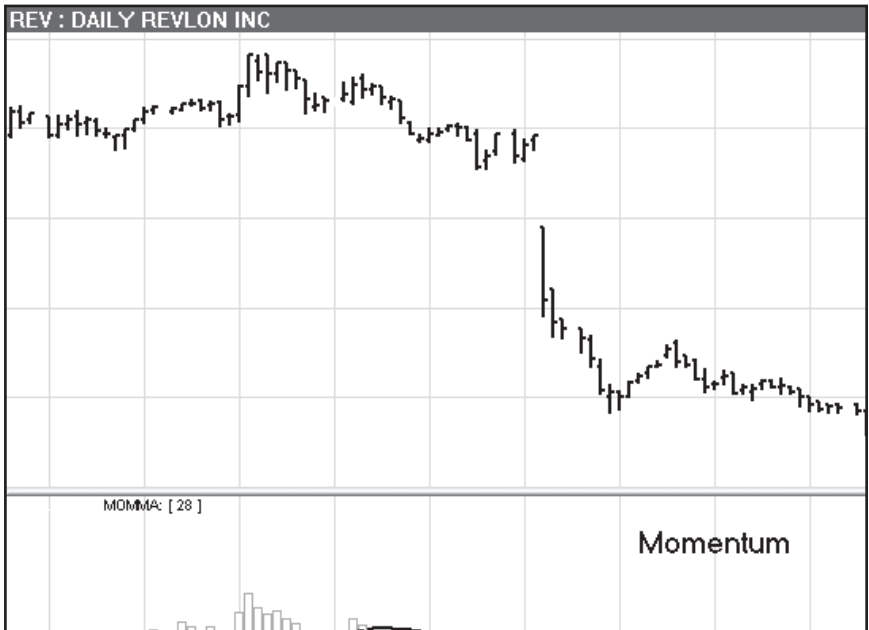
The **oscillator** is extremely useful in non-trending markets where prices fluctuate in a trading range horizontally — it is very useful in

flat-trending markets. Short-term stock traders, called **swing traders** or **market timers**, use oscillators to try to profit from flat, trendless sideways markets. The oscillator identifies overbought or oversold conditions in the price channel. The idea is that if the market is overbought — at the top of the channel — that it will soon begin to fall back to the bottom of the channel from selling pressure. At the bottom of the channel, the oscillator tells you if the market is likely oversold, and may soon rise to the top of the channel from buying pressure.

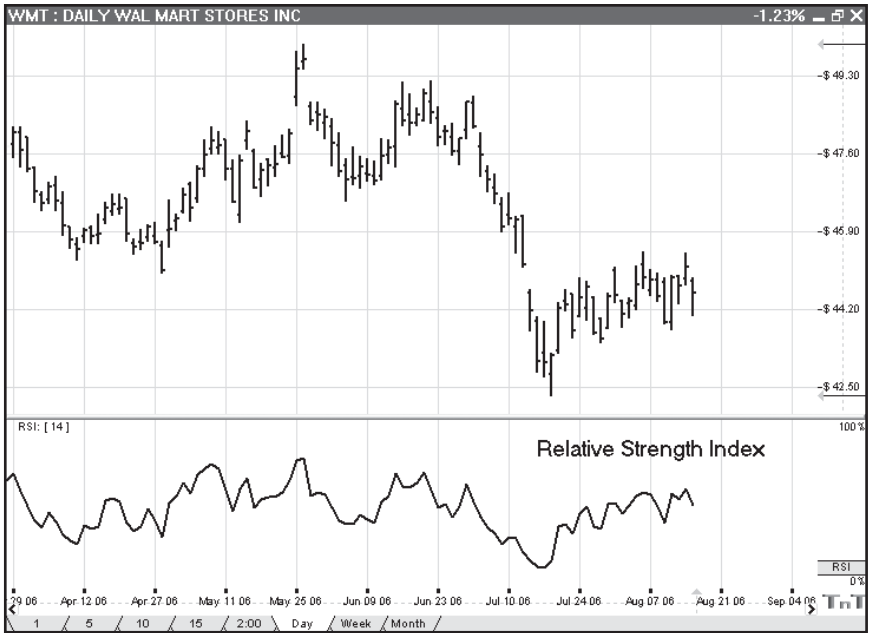
Momentum is the most basic of all oscillators and is positive or negative around a zero line. The formula for momentum is:

$M = P_0 - P_i$ where P_0 is the latest closing price and P_i is the closing price i days ago. 10 days ago is the most common lag time.

A **relative strength index** is calculated as follows:



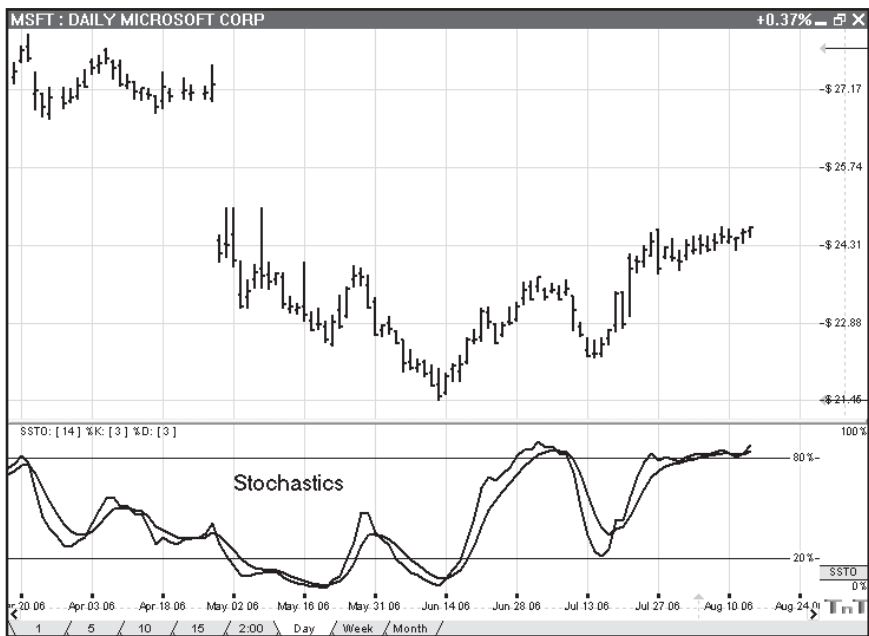
$$RSI = 100 - \frac{100}{1+R} \text{ where } RS = \frac{\text{Ave. of } x \text{ days' up closes}}{\text{Ave. of } x \text{ days' down closes}}$$

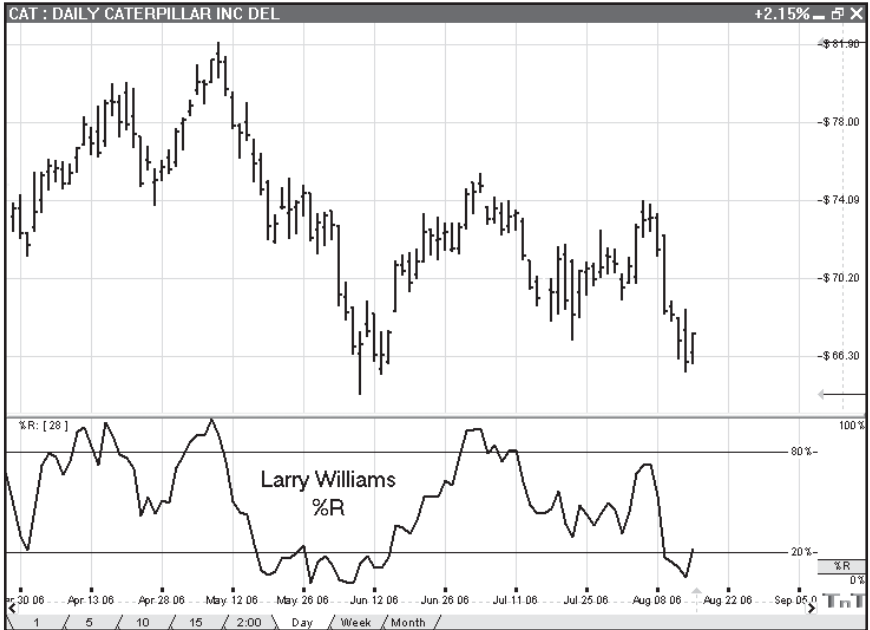


The **stochastic (K%D) oscillator** is based on the occasional tendency for up-trending prices to have daily closing prices that tend to be closer to the upper end of the intraday price range. Conversely, in downtrends, the closing prices are near the lower end of the intraday range. The idea is to figure out where the most recent closing prices are in relation to each intraday price range over a desired time period. The K line is:

$$K = 100 \left[\frac{(C - L14)}{(H14 - L14)} \right]$$

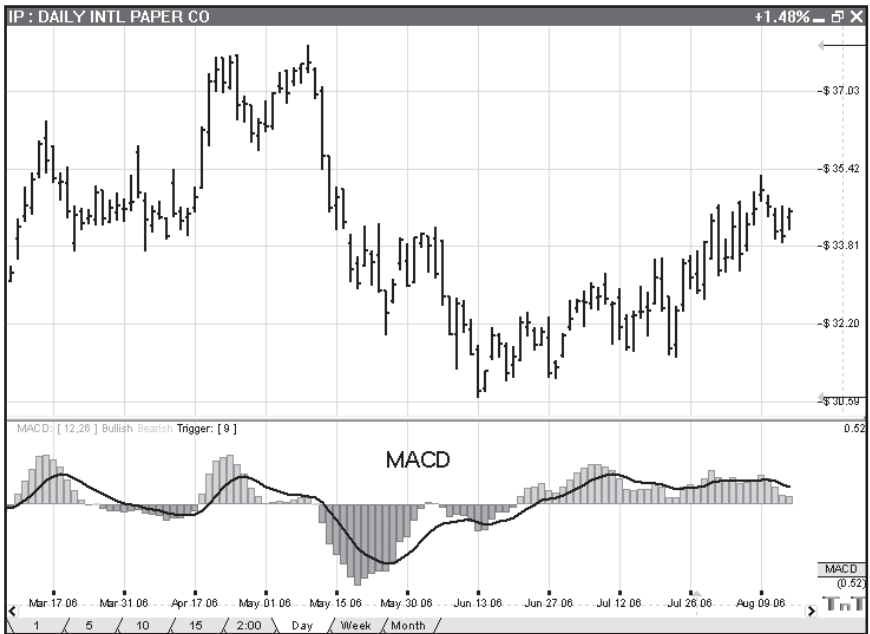
where C is the latest close, L14 is the lowest low for the last 14 periods, and H14 is the highest high for the same 14 periods (a period can be a day, a week, or a month). The %D line is just a 3 period moving average of the K line.





Larry William’s %R is based on a similar concept of measuring the latest close in relation to its price over a given number of days. Today’s close is subtracted from the price high of the range for a given number of days and that difference is divided by the total range for the same period.

Moving Average Convergence/ Divergence (MACD) is the difference between two exponentially smoothed moving averages of closing prices (usually the last 12 and 26 days or weeks). The slower line (called the signal line) is usually a 9 period exponentially smoothed average of the MACD line. The actual buy and sell signals are given when the two lines cross.



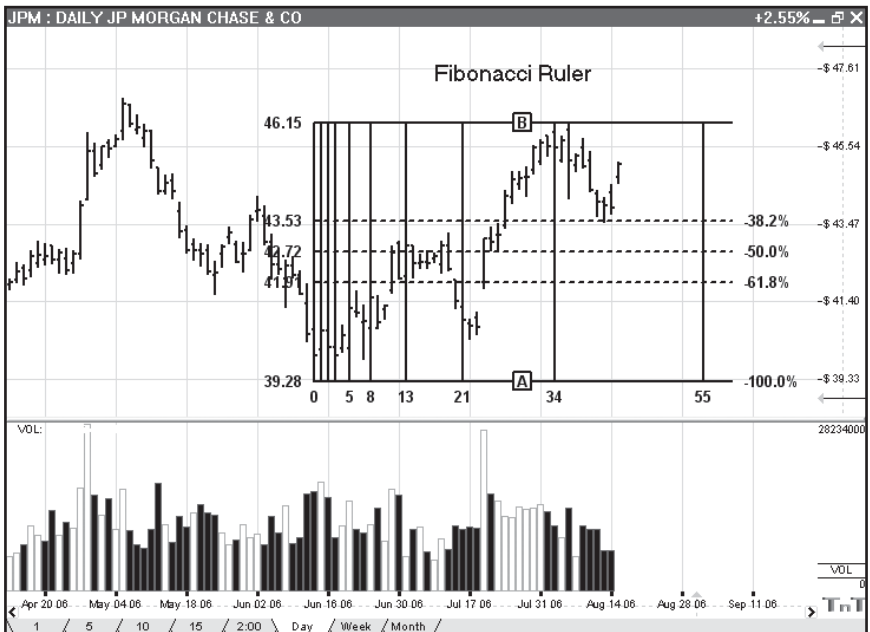
Japanese Candlesticks

Charting market data in **Japanese candlesticks** uses the same data available for standard bar charts. This charting method uses open, high, low and close prices, but in a much more visually appealing form. Different body and shadow combinations have different meanings. Days in which the difference is great between the open and close prices are called long days. Days in which the difference between the open and close price is small are called short days. These charts can also be shown in daily, weekly or monthly form.



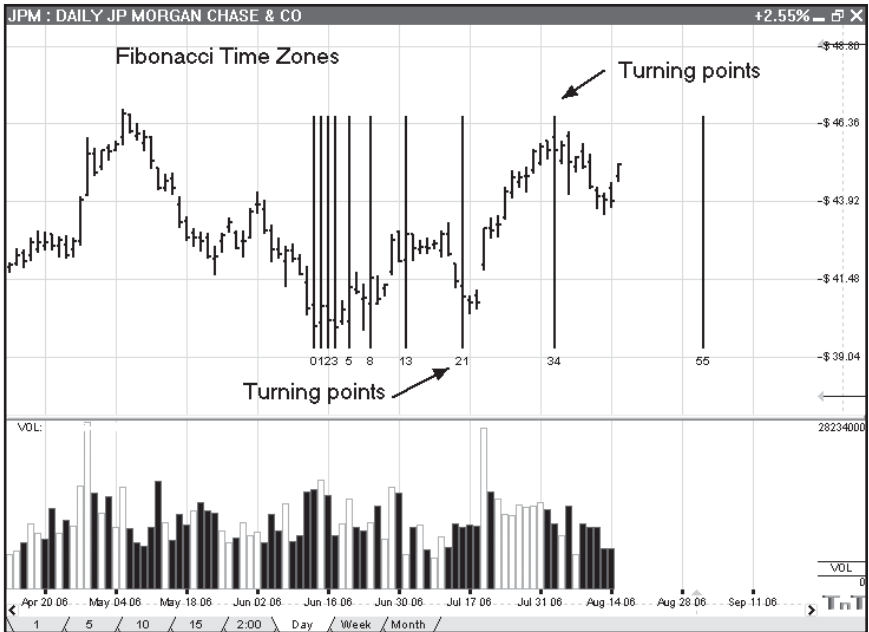
Elliot Wave Theory

Elliot Wave Theory compliments Dow Theory. There are three important aspects of wave theory: pattern, ratio and time. The **Fibonacci number sequence** forms the mathematical basis for the Elliot Wave Theory. Part of the Fibonacci number sequence is as follows: 1,2,3,5,8,13,21,34,55,89,144, etc. One of the most important Fibonacci rules is that a correction can never take place in five waves.



Time Cycles

People have noticed – what at least appear to be – **time cycles** in the natural world. Atlantic salmon peak in abundance every 9.6 years, 22.20 years pass between international battles, sunspot activity increases every 11.11 years, the real estate market goes boom to bust every 18.33 years, and 9.2 years pass between bull market tops in the stock market. Cyclic analysts measure cycle lengths from high to low. The three qualities of cycle are amplitude, period and phase.



Chapter 8

The Strong Forces and Players That Are Really Behind the Market!

Fred left a job with John Deere in the agricultural industry to become a university business professor. The three cash flow centers of a university are the medical school, law school and MBA programs. For this reason, those of us accredited Ph.D.-holding business professors are very highly paid. Fred did a number of smart things when he became a business professor. The first was to take full advantage of the university 403(b) plan. The second was to use his good credit and high income to purchase a home in the most desirable part of town. As a friend, he approached me seeking advice because he wanted to get his savings earning more than just bank interest.

He had purchased a large piece of land for \$75,000 in his home state and wanted to build and retire to a dream home. Throughout his working life, Fred had methodically saved and bought his way into a lot of net worth. He had \$200,000 in home equity, \$200,000 in his 403(b) and \$50,000 in savings. He would also have \$2,300 per month coming in from Social Security and a \$400 pension from his employer prior to obtaining a Ph.D. and becoming a professor. His wife would also have Social Security coming in.

I told Fred to work the numbers backwards to figure out how much he should invest in the stock market. My first big concern was that, upon retirement, Fred would lose his health insurance plan from the university. Fred told me that he wasn't worried, because both he and his wife had "good genes." I explained that 87% of all bankruptcy cases are from only three reasons: job loss, divorce and illness. After

listening to me, he realized that he could use the small pension to pay for a good health plan, and I congratulated him wholeheartedly on the decision.

The next step Fred had to take was to work out the budget for building his dream retirement house in his home state. I told him to ask the realtor who had helped him purchase the land to give him the range of costs per square foot for new home construction. I explained how important it was to take the high estimate and then add an additional 30% for unexpected costs and furnishings. When I explained how important it was for Fred to be completely debt free at the end of the process, he laughed and said, “*It’s great to finally hear someone who speaks my language!*” I told him to be most concerned about working out a building budget that would make sure he would be debt free after selling his current residence and moving to his dream home. He could then invest a fraction of what he had left over, putting the bulk into treasury bills for emergency savings.

The point of this story is that Fred thought that he didn’t know what he was doing with his finances yet when I gathered the facts

I decided that both he and his wife were very adept at managing their personal finances. All he really needed was a solid strategy for investing in the stock market to get a little extra push from a small part of his

WALLET DOCTOR SURVIVAL RULE #14

Focus on retiring debt free — you don’t want to be risking your assets in retirement in the markets except with money that, if you lose it, will not affect your lifestyle.

net worth. These last two chapters are devoted to explaining just such a strategy based on everything I have been teaching you.

Bulletproof Stock Investing is my stock investing method I developed around the tendency of stock shares to migrate from weak investors to strong investors — from stock investors who are not sure about what they are doing in the market to those that are. My trading system is also based on evidence of insiders dumping stock at historic high prices on **inexperienced public investors** who are attracted into the market hoping for a quick profit by hype at the top of a bull

market. In 1999 and 2000, the majority of insiders were dumping their stock holdings on the public. And the public was buying it up as fast as they could dump it. It's vital to your financial health that you understand exactly what the forces and players are that drive the stock market's prices up and down that can make you rich!

Once the market crashes, as it did from 2000 to 2003, inexperienced investors become discouraged and begin selling out at historic low prices. Investors buying stock at historic prices are of two classes. The first group of bottom buyers is composed of highly **experienced investors** who are astute as to the cyclic rise and fall of the general stock market and individual stocks. The second group consists of insiders who must report all of their stock purchases and sales to the SEC. If an individual owns 5% or more of the float of the stock or is a manager or director, then they are in this reporting class I call the **visible insiders**. Pay attention to the gifting and selling off of ESOs by the top inside executives — the CEO, CFO, COO, chairman of the board and president. There are also **invisible insiders** who are actively trying to buy up the float of stock from the discouraged public over a long period of time so that they can ride the backs of the visible insiders who use the media to pump up the price of a stock they hold employee stock options in. Anecdotal evidence from history and recent SEC prosecutions of smaller boiler room “pump and dump” schemes tells us that hidden insiders still manipulate penny stocks — watch the movie *Boiler Room* with Ben Affleck. There is no reason not to suppose that this same type of activity is occurring in companies with larger market capitalizations — I just can't prove it, because if they are doing it they have to hide their tracks.

I use long-term price charts to identify low price trading ranges where the public is not interested in a specific stock. These are times

FACT

FACT: Wall Street works hard to make stock investing seem harder than it really is. The last thing the equities industry wants is public investors that think on their own, as I teach you to do!

when the public may be influenced into not buying by astute stock investors who are hidden from public view and yet inside a group attempting to buy up enough of stock to exert control over the price. If you know when to buy, you simply sit and wait for the price to rise.

By combining long-term technical charts and looking for good companies, I have developed what I call **long-term technical value investing**. Long-term technical value (because you buy the stock cheap) investing involves studying long-term weekly and monthly price charts to look for price patterns that would discourage the inexperienced public into selling their shares of stock to experienced investors that buy and hold as a group for years. I call this group **hidden insiders** because they buy as teams so that they can avoid reporting their positions to the SEC. They are hidden because you can't see their holdings at places like Yahoo Finance (<http://finance.yahoo.com>), like you can inside corporate executives. In addition, these special long-term price patterns create an environment where inside corporate directors are in a much stronger position to badger shareholders into large gifts of free **employee stock options** at obscenely low prices. Visible insiders put additional upward pressure on the company stock price any way they can, as managers and in collusion with other visible insiders behind the locked doors of the board rooms they control.

Inexperienced Public Investors

The worst thing you can do for your financial health is invest or work in an area that you know absolutely nothing about. Success in our modern economy relies on specialization of all of us as we work in our chosen craft. What happens when large groups of individuals in the public who know absolutely nothing about the stock market come and go en masse? The answer is a public dog pile into and out of the market creating massive bull and bear markets. This has been happening since the dawn of time in one way or another. Here is an excellent example of a documented **Dutch tulip bulb**

craze centuries ago where the public dog piled into – and later, out of – a hobby flower market.

The Dutch Tulip Mania

In Holland a “**tulip mania**” occurred that has been extensively studied by psychologists, economists and stock market observers. This is a truly unbelievable story that actually happened many centuries ago — and still happens every day in our stock markets in one or another equity issue or part of the globe. Just like tulip bulbs centuries ago, single stocks routinely go from record low to record high prices in the stock markets on all of our stock exchanges around the world.

In 1559 **Conrad Guestner** brought the first tulip bulbs from Constantinople to Holland and Germany where almost everyone fell in love with them. Tulip bulbs soon became a status symbol for the wealthy because they were beautiful and, more importantly, hard to get.

Early bulb buyers were people who truly prized the lovely flowers, but after prices took off, people began to speculate on the possibility of further price increases. These were the same type of people who knew nothing about flowers, just like the people who were attracted to the massive 1920s bull market who knew nothing about stocks except that they thought they were going to make some very quick money.

The inexperienced tulip bulb “investors” created a high volume of buying and selling activity, and eventually, tulip bulbs were placed onto the local stock market exchanges. By 1634, the rage over owning tulip bulbs had spread to the middle classes of Dutch society and even merchant shopkeepers began to compete with one another for single tulip bulbs.

How crazy did it get? At the height of tulip mania in 1635, a single tulip bulb sold for a basket of all the following vital consumer goods worth nearly \$35,000 today: 4 tons of wheat, 8 tons of rye, 1 bed, 4 oxen, 8 pigs, 12 sheep, 1 suit of clothes, 2 casks of wine, 4 tons of beer, 2 tons of butter, 1,000 pounds of cheese, and 1 silver drinking cup.



TRAP: Con artists target people in cities and small communities with Ponzi scheme high-yield investment programs. Once they take your money, they leave your legal jurisdiction and there is not a thing you can do about it. If it sounds too good to be true or if you really don't understand some supposedly high-yield investment program, then just say, "NO!"

Can you imagine spending \$35,000 for a single tulip bulb? I sure can't. But I couldn't imagine spending the kind of money people were on start up internet stocks at the end of the 1990's, either! This was happening routinely in Holland in the mid-17th century! It got so out of hand that people were selling everything they owned — their homes, their livestock, everything — for the privilege of owning tulips, on the expectation that the bulbs they bought today would be worth a lot more tomorrow. As a result, tulip prices (in today's dollars) ranged from \$17,000 all the way up to \$76,000 per bulb.

By 1636, tulip bulbs were traded on the Amsterdam stock exchange (along with shares of stock in the Dutch East Indies

Company) as well as other stock exchanges in Holland and Europe. Popular interest in tulip bulbs had shifted from hobbyists and collectors to inexperienced public investors and gamblers. People from all walks of life liquidated their homes and real estate at low prices in order to speculate in tulip trading — just as people jumped into the end of the equity bull market at the end of the 1990's.

Tulip notaries and clerks were appointed to record transactions, and public laws and regulations were developed to control the tulip craze. In 1636, inexperienced public investors began to liquidate their tulip holdings. Tulip prices began to weaken, slowly at first, and then rapidly. Public confidence was soon destroyed, and panic seized the market. Within six weeks, tulip prices crashed by 90% — the market bubble burst. Defaults on contracts and liens on tulip bulb speculators were widespread. The market crashed soon after, leaving many families bankrupt — the heavy yet consistent price of financial inexperience throughout time.¹

1 Mackay, C., "Extraordinary Popular Delusions and the Madness of the Crowds," Richard Bentley Publisher in Ordinary to her Majesty, 1841, pp. 89-97.

The Ponzi Scheme

Economist **Bob Shiller** of Yale University explains the bizarre behavior of inexperienced public investors using the Ponzi scheme as illustration. The Ponzi scheme was a con job perpetrated on the public in 1920 that created the exact same kind of public dog pile behavior in rising bull markets and the desperate rush to sell we see in crashing bear markets.

Carlo “Charles” Ponzi was born in Parma, Italy, in 1882. He immigrated to the United States in November of 1903. Over the next 14 years, Ponzi wandered from city to city and from job to job. He worked as a dishwasher, waiter, store clerk and even worked as an Italian interpreter. In 1917, he settled in Boston, where he took a job typing and answering foreign mail. He also had a dark past he was hiding, and it was in Boston on the fateful day of August of 1919 that Ponzi invented a mechanism to make himself vastly wealthy at the expense of his investors. At the same time, he made his name synonymous with the **high-yield investment program** con job.

At the time, Ponzi was considering publishing an export magazine. He had written a letter about the proposed publication to a gentleman in Spain. When Ponzi received the reply, the man had included an **international postal reply coupon**. The idea behind this enclosure was very simple. All Ponzi had



HUMOR: An investor calls his stockbroker in a bear market anxious and out of breath. He screams, “Sell it all, and sell everything fast, right away.” The stockbroker tries to explain that the market is cyclical in nature and that the long term outlook for stocks is still promising. The man says, “Let me tell you a secret. You know I’ve been married for 6 years now and I’ve been your client for 5 years.” “Yes, go on,” the stockbroker says. “Well. My wife has this thing about the market. Her grandparents lost it all in the great crash and ever since her family considers investing in the stock market an original sin. When we got married I promised her that I would follow in her parent’s footsteps and never venture into the stock market — that I would always leave our savings under the mattress.” The stockbroker replied, “Wow, I didn’t know that. I guess you want the money because the market is going down, in case she asks for it.” To which the investor exclaimed, “No, I want the money because she just ordered a new mattress!”

to do was take the coupon to his local post office and exchange it for American postage stamps. He could then use the American stamps to send the magazine to Spain.

Ponzi noticed that the postal coupon had been purchased in Spain for about one cent in American funds. Yet, when he cashed it in, he was able to get six American one-cent stamps. Thoughts of riches whirled about his mind. He could buy \$100 worth of stamps in Spain and then cash them in for \$600 worth of stamps in the United States. He also knew that he could not get this kind of interest return at a bank.

Ponzi's mind quickly went into overdrive as he devised a clever scheme to capitalize on his idea. He was determined to be a rich man. His first step was to convert his American money into Italian money (or any other currency where the exchange rate was profitable). Charles Ponzi then claimed that he had found foreign agents who were using the money to purchase international postal coupons in countries with weak currencies. The stamp coupons were supposedly exchanged back into a strong foreign currency and finally back into American funds. He claimed that his net profit on all these transactions was in excess of 400%. It sounded reasonable enough, but nobody knew it was a scam from the start.

He really couldn't do what he was claiming. The red tape of dealing with a bunch of different country postal organizations and the long delays in transferring currency would have destroyed all of Ponzi's promised profits. Yet Mr. Ponzi knew exactly what he was doing and began bragging to everyone he knew about his high-yield investment program. Friends and family members easily understood what he was saying and they wanted in. They understood exactly the same way investors in London understood and bought stock in the company that claimed to be able to turn chickens into sheep I described to you at the beginning of this book.

On December 26, 1919, Ponzi filed an application with the Boston city clerk establishing his new business as **The Security Exchange Company** — remember that this was before the SEC existed.

He promised a 50% interest payment in 90 days, and the world wanted in on it. Word spread very quickly about Ponzi's great idea and, within a few short months, the lines outside the door of his office began to grow. Thousands of people purchased Ponzi's promissory notes, paying \$10 to \$50,000. The average investment people made with Ponzi was \$300 (which is over \$3,000 today).

Why would so many people pay into a scheme that didn't really work? The reason was that the early investors did get great returns on their money. Ponzi used the money from later investors to pay off his earlier obligations. It was a new twist on the age-old pyramid scheme.

With an estimated income of \$1,000,000 per week — \$10 million a week in today's money — at the height of his scheme, his newly-hired staff couldn't take the money in fast enough. They were literally filling all of the desk drawers, wastepaper baskets and closets in the office with investors' cash. He opened branch offices. Copycat schemes popped up quickly across New England as other fraudsters caught wind of Ponzi's success.

By the summer of 1920, Ponzi had taken in millions and began to live the life of a very rich man. Ponzi dressed in the finest of suits, had dozens of gold-handled canes, showered his wife in fine jewels and purchased a 20-room mansion.

From the start, regulators were suspicious; federal, state, and local authorities investigated him. Yet no one could pin Ponzi with a single charge of wrongdoing. Ponzi had managed to pay off all of his notes in the 45 days he had promised. Since everyone was happy to get their profits, not a single complaint had ever been filed.

On July 26, 1920, Ponzi's house of cards began to collapse. The *Boston Post* headlined a story on the front page questioning the legitimacy of Ponzi's scheme. Later that day, the District Justice was



TIP: If you buy stock in good companies really low in share price when the public is afraid of the market, then when the public does jump on board, you can just sit back and relax as the price rises and your profits increase!

mysteriously convinced to suspend him from taking in new investments until an auditor had examined his books.

Within hours, crowds of people lined up outside Ponzi's door demanding that they get their investment back. Ponzi obliged, assuring the public that his organization was financially stable and that he could meet all obligations. He returned the money to those that requested it. By the end of the first day, he had settled nearly 1,000 claims with the panicked crowd.

By continuing to meet all of his obligations, the angry masses began to dwindle and public support swelled. Crowds followed Ponzi's every move. He was urged by many to enter politics and was hailed as a hero. Loud cheers and applause assured him of public confidence and people were eager to just touch his hand.

Ponzi continued to dream and scheme. He had planned to establish a new type of bank where the profits would be split equally between the shareholders and the depositors. He also planned to reopen his company under a new name, the **Charles Ponzi Company**, whose main purpose was to invest in major industries around the world. Ponzi wasn't as bright as inside corporate executives are today who know that the key to any successful swindle is to take the money and run.

The public continued to support him until August 10, 1920. On that day, the auditors, banks, and newspapers declared that Ponzi was definitely bankrupt. Two days later, Ponzi confessed that he had a criminal record, which only worsened his situation. In 1908, he had served 20 months in a Canadian prison on forgery charges related to a similar high-yield investment scheme he was part of. This was followed in 1910 by an additional two-year sentence in Atlanta for smuggling five Italians over the Canadian border into the United States.

On August 13, Ponzi was finally arrested by federal authorities and released on \$25,000 bond. Just moments later, he was re-arrested by Massachusetts authorities and re-released on an additional \$25,000 bond.

The whole thing turned into a gigantic mess for the public. There were federal legal suits, state civil suits, criminal trials, bankruptcy hearings, individual law suits against Ponzi and countersuits filed back by Ponzi. Five different banks collapsed in the aftermath! At least 40,000 people had paid \$15 million (about \$151 million in inflation-adjusted U.S. money today) into Ponzi's scheme. A final audit of his books concluded that he had taken in enough money to buy approximately 180 million postal coupons, but auditors could only confirm the purchase of two.

Ponzi's only legitimate source of income over the period of the scam was \$45 that he received as a dividend of five shares of telephone stock. His total assets came to \$1,593,834.12, which didn't come close to paying off the outstanding debt. It took about eight years, but inexperienced public investors who were note holders were able to recover a meager 37% of their investment in installments over time. They got their money back just in time to lose it again in the 1929 stock market crash!

Irrational Exuberance

Dr. Shiller explains in his book *Irrational Exuberance* that it is completely rational for inexperienced public investors to behave in the stock market like tulip bulb or postal reply coupon investors. He explains that such people are attracted into a rising stock market or single stock if they have heard of windfall profits of inexperienced family, friends, acquaintances or even media accounts of the sort. The inexperienced public investor rationalizes that if another inexperienced public investor has made money in a specific stock, if they buy the stock at today's prices, it will probably be worth more tomorrow.



TIP: One of the great advantages of Exchange Traded Funds (ETFs) is that you can buy ETF put stock options to hedge against any unexpected general breaks in the stock market that might cause a loss in your stock portfolio.

Shiller explains that this is very rational in the middle of an extended bull move in a single stock, but is very dangerous at the top when insiders have sold out and no smart money is left to support the market. When the bull market collapses like a house of cards, the public sells in panic and dramatic stock price crashes occur — the 1929 to 1933 and 2000 to 2003 crashes are two examples.

The Wall Street hype machine works hard to pull inexperienced investors out of the public into the market as the stock market comes to a boil and insiders bail out, leaving the public holding the bag. **Maggie Mahar**, a Yale English professor and first-rate financial journalist, describes what happens to the trustingly unwary at the top of a bull market in her book *Bull!*:

While [corporate executive] insiders bailed out, most small investors did not sell. They did what they were told [by Wall Street], “buy and hold,” doubling their bets all the way up. The higher the most aggressive growth [mutual] funds rose, the greater their allure. In 1999 [inexperienced] investors wagered twice as much on these funds as they had in 1996 and 1997 put together. Even after the NASDAQ began its long slide, investors continued to chase the last best thing — at the end of 2000 [inexperienced] individuals were investing in aggressive growth funds at more than twice the rate as they had in 1999.

As always, when a bull market ends, those who could afford it least lost the most. In Massachusetts, Sharon Cassidy, a divorced college professor who had single-handedly put her four children through college, began to step up saving for her own retirement in 1990. By then she was 52, and earning roughly \$42,000 a year. Listening to the financial advisors who visited her

college, she stashed most of her money in broad-based equity funds, and, by the end of 1998, she had managed to accumulate over \$350,000. At that point, she felt she was in sight of her goal: retirement in four years, at age 62, with \$500,000.

When the market skidded, she held on. “I felt I had no other choice,” said Cassidy. Then the bear showed his claws. By the end of 2001, at age 63, she was forced to rethink her life plan. “If I work until I’m 70, I can retire with \$400,000” she said. I’m lucky – I like my work, and \$400,000 is a lot more than most people have. But I’m angry, angry at myself and angry at the people who advised me.”

My advice to you is not to let yourself be misled by Wall Street. Learn to buy when inexperienced public investors like professor Cassidy are discouraged, and you won’t have to suffer through what she has. Learn to sell when people like professor Cassidy are counting their eggs before they hatch!

Experienced Investors

Experienced investors are a different breed altogether from the inexperienced. An individual who has ridden through an extended bull market and perhaps lost — or at least witnessed the financial carnage wreaked upon the inexperienced public investor by inside corporate executives at the top — has an altogether different perspective on the market. Individuals that at least recognize that they could have bought at extremely low prices in the ‘80s and early ‘90s are currently buying stocks in good companies at drastically reduced prices to hold long-term and sell out years from now.

These are the big winners in the public, those wise enough from

experience to buy stocks low and hold on to them for long multi-year periods of time and then sell when the signs are obvious that there is too much inexperienced public interest in a stock and the insiders are selling out with windfall profits.

Here is a description of the appropriate attitude of the experienced investor at the top of an extended bull market from *Bull!*:

*As the market heated up, experienced investors knew, with a sinking certainty, that the big caps were rising too high, too fast. In the three years ending in December 1998, Dell alone shot up 3,197%. With the benefit of hindsight, market watchers would point out that the broad market peaked in 1998 and that the first phase of the bear market began in August or September of 1999. By the fall of 1999, [corporate executive] insiders were bailing out en masse. Once again, **Richard Russell**, editor of **Richard Russell's Dow Theory Letter**, sounded a warning. "Holding for the long-term works beautifully in a bull market. In a major bear market, it is absolutely disastrous policy," Russell told his subscribers in October of 1999.*

As I write this book in 2006, many good stocks are severely depressed in price due to the recent market crash. These same experienced investors and insiders are now loading up again on as much stock in good companies as they can to prepare for the next inevitable stock market Bull Run in stock prices.

Corporate Executive Insiders

The insider that you will hear about in the popular financial press is the corporate executive insider. This first class of **insider** successfully conspires to gain control of the **board of directors** of a publicly traded corporation. They do this to obtain large gifts of

employee stock options for free when share prices are low and shareholders are desperate.

The corporate executive insider does everything possible to get the price of the stock to go up over the next few years as their options vest. They use news leaked to the media and also use legally (or illegally) **misleading financial statements** to draw in **inexperienced public investors**.

For example, **America Online (AOL)** corporate executive insider Bob Pittman used both Wall Street and the general media effectively to promote AOL as the bull market heated up in 1996: *“During Pittman’s first full year as president...AOL held twice as many analyst conference calls and received 10 to 20 times the coverage in media and entertainment publications as any other company in its then-peer set, which included Yahoo! And Lycos.”*²

What inexperienced investors fail to realize is that all U.S. media sources are now fully owned by large publicly traded corporations that are controlled by inside corporate executives. This was not so before World War II, but it is today. Is it any wonder that insiders use the media to promote their stock to get the public to bid it up to astronomical prices? Is it any wonder that inside corporate executives bail out at the top and leave the public holding the bag?

In addition, the inside corporate executives at AOL were “cooking the accounting books” to intentionally mislead inexperienced public investors into believing that the company was profitable. This was done to seduce inexperienced investors into buying more stock to pump up the share price so that the inside corporate executives could dump their holdings of stock on the inexperienced public. These same inside corporate executives had acquired their stock at low, low



TIP: Buy low when nobody you know is looking at the stock market. Sell high when everybody you know wants into the stock market!

2 Amy P. Hutton, “Four Rules for Taking Your Message to Wall Street,” Harvard Business Review, May 2001, 125.

prices with their free employee stock options they had received from a corporate board of directors they controlled.

Lisa Buyer, a fund manager at T. Rowe Prices Associates, said about AOL in the fall of '95: "*What the shorts [short sellers] can't understand is that Wall Street, witnessing such growth, is willing to overlook the company's losses and well-known aggressive accounting methods.*"³ The "growth", however, that she was talking about was a growth in the number of subscribers, not a growth in earnings. The cost of acquiring those customers was so high that AOL had not, in fact, yet earned a profit — though, thanks to its creative accounting, it was reporting profits. Nobody in the public knew that AOL insiders were also hiring themselves out to teach other different company insiders how to cook their accounting books — they were proud of their accounting skill at deceiving the public!

Inside corporate executives' employee stock options also create misleading financial statements. Remember that the employee stock option was intended to retain highly skilled employees critical to the key engineering and production processes of the firm. The reality is that the idea was poorly thought out and implemented, because options flow straight to the top of the corporate pyramid far from production. Today, employee stock options are the biggest corporate governance problem in the field of finance. In 2000, the Bureau of Labor looked at who actually received options in 1999 and found that, nationwide, only 1.7% of non-executive private sector employees received any stock options and only 4.6% of executives received them — 93.7% went up to the CEO and his or her cronies!

In 1999 — a banner year for employee stock options exercised — 98% of all U.S. workers of publicly traded corporations did not receive a single stock option as part of their pay. At the end of '99, the CEOs running the 800 largest companies in the United States were sitting on "fully vested" options worth \$18 billion. They could cash them in at any time when they knew they had driven the market up as

3 Linda Sandler and Jared Sandberg, "Heard on the Street: America Online Lures Investors, Dismays Shorts," *The Asian Wall Street Journal*, 13 November 1995, 15.

high as they could — and this is exactly what they did. Not one inside executive was prosecuted or even subpoenaed by the SEC for inside trading which nearly all of them had done in masse. Perhaps, now you understand why Martha Stewart was so flippant with the judge when she was subpoenaed and prosecuted as a scapegoat for alleged inside trading that amounted to a few hundred thousand dollars!

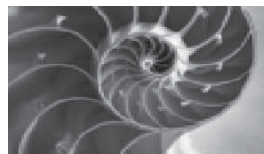
Even more sinister, a 1999 study by the Federal Reserve of 138 firms estimated that, by legally not accounting for the value of corporate executive employee stock options, the companies had falsely boosted their profits by 10.5% — the managers walked away with a big cut of the owner's profits. Do you trust P/E ratios now? I hope not. This has occurred because inside corporate executives have been successful in garnering the support of Washington, through executive special interest groups, to stop the SEC's attempt to force corporations to show inside employee options as a cost to the company.

Hidden Insiders

These people as a group buy stock low and then manipulate the stock price up to dump it on an eager, overly-optimistic, inexperienced public. I first learned of these investors when I began studying the history of the stock market. These individuals still to this day operate in teams to buy up (corner) the supply (float) of a company's stock. They created investment pools and became notorious as part of the corruption on Wall Street. These investment pools were renamed mutual funds after the depression to get people to forget their very murky past.

FACT

FACT:The Fibonacci numbers exactly measure the nautilus shell's dimensions.



Market Corners

Market corners are defined as “*a market condition brought about intentionally — though sometimes accidentally — when virtually all of the purchasable, or floating, supply of a company’s stock is held by an individual or group who are thus able to dictate the price when settlement is called.*”⁴ A market corner is an extreme form of **short squeeze**, where the buy side of the market has almost complete control of all floating (purchasable) shares. A 2006 academic finance article finds strong evidence that large investors and corporate insiders possess enough market power to manipulate stock prices through a market corner.⁵ They make it clear in their article that “*one of the main hurdles in studying market manipulation is that the data are hard to obtain since the activity is often illegal and thus participants do their best to hide it.*” The article further notes that “*although stock markets are far better regulated today than in the 19th century, market manipulations by large investors and insiders still occur around the world.*”

A Brief History of the Market Corner

You need to understand how the robber barons of the past manipulated the market to understand how the stock market has evolved into what it is today — especially how it is manipulated today. The favorite tool of the super-rich stock market manipulator, the robber baron, was the **bear corner**.

These financially powerful men were in a special position to hoodwink unwary investors because they were generally inside corporate officers as well as large stockholders. These manipulators often controlled a huge amount of the common shares of stock — often more than the whole float at the time they forced settlement — putting them in a position to dictate the share price the

4 Wyckoff, P., 1972, *Wall Street and the Stock Market: A Chronology (1644-1971)*, Philadelphia: Chilton Book Company.

5 “F. Allen, L. Litov and J. Mei, “Large Investors, Price Manipulation, and Limits to Arbitrage: An Anatomy of Market Corners”, Working Paper 06-02, Wharton Financial Institutions Center, University of Pennsylvania.

short sellers had to pay. Stock prices generally gapped a lot when the stock was cornered causing huge increases with no intermediate price points around the corner date. The amount of wealth controlled by the manipulators was also large compared to the market capitalization of the stock.⁶

I have to admit that it was probably easier for these men to corner the market back then. It was also a lot easier to take a short position. According to John Gordon, *“Most short sellers were not affected by borrowing the stock as is done today but by using seller’s options. Stock was often sold for future delivery within a specified time, usually 10, 20, or 30 days, with the precise time of delivery up to either the buyer — in which case it was called a buyer’s option — or the seller...These “options” differed from modern options — puts and calls — in that the puts and calls convey only a right, not an obligation to complete the contract.”*

Since many short sellers often sold large quantities of naked options, the manipulator, having acquired the float, could force a corner by exercising his buyer’s option for immediate delivery and then wait for the delivery due date to bear squeeze other investors who had sold the seller’s option. Insider Cornelius Vanderbilt purchased all floating shares as well as all sellers’ options during the Hudson River Corner which I will explain shortly.⁷

Margin requirements were also less restrictive. You learned earlier in this book that the most Wall Street will lend investors today is 50% margin. Prior to 1934 when Roosevelt enacted the Securities Act, margin was negotiated between brokers and their clients. It could be as low as 10%, which allowed the manipulator to acquire large

6 Cornelius Vanderbilt, for instance, put together a stock pool of \$5 million in cash for the second Harlem corner. At the time, he already owned a large block of Harlem stocks from the first Harlem corner. On March 29, 1864, Harlem had a market capitalization of \$11.9 million with 110,000 shares outstanding. By the end of April, Vanderbilt and his allies in the pool owned 137,000 shares, with the difference sold to them by short sellers. At the time of his death, Vanderbilt left an estate to his heirs worth \$90 million. See Gordon, J. 1999, *The Great Game: The Emergence of Wall Street as a World Power: 1653-2000*, New York: Touchstone.

7 In the second Harlem corner, Vanderbilt was so furious at the short sellers, led by Daniel Drew, that he was planning to drive the stock price up to \$1,000 per share. He dropped the plan after he found out that this would bankrupt almost all brokerage firms on Wall Street. See Clews, H. 1888, *Twenty Years in Wall Street*, New York: Irving Publishing Co.

blocks of stocks with relatively little capital. Corporations also had no financial reporting requirements to stockholders whatsoever, so the general public had very little knowledge about the float of a particular stock — or even who the major stockholders were — let alone how much stock they owned.

Because of this, short sellers had a false sense of security when they shorted a stock, not realizing that the float was often far smaller than they had thought — meaning the stock price would shoot up, not down. There were other reasons for the restricted float. Poor transportation made it difficult for out of town and overseas investors to bring their shares to market — effectively taking their stock out of the float. In 1869, for instance, foreigners owned \$243 million in railroad stock shares, but were not a concern to manipulators during this period when many railroad stocks were cornered.⁸

The legal system was much more corrupt than it is today and judges could be bribed by manipulators to issue injunctions to restrict the issue of new shares. By controlling the supply of new shares, it made it a lot easier for the manipulator to achieve a corner. In addition, there was an even more blatant disregard for director conflicts of interests and minority shareholder rights. Directors often took advantage of their position to manipulate the stock price because they were able to restrict the supply of shares. All of these reasons made corners easier in the 19th century. People still get caught doing them today, so pay close attention.

Hudson River Corner (1851)

The **Hudson River Railroad** was built despite strong opposition from both the Harlem Railroad and the Vanderbilt steamboat interests. It was constructed on the east bank of the Hudson River and reached to east Albany by 1851. The main passenger depot was located at Tenth Avenue and 30th Street on the West Side of Manhattan.

By the summer of 1863, Cornelius Vanderbilt owned a substantial block of stock in the Hudson but was still primarily interested in the Harlem. This changed when a group of traders began selling the Hudson short. Vanderbilt then participated in a scheme (which he suggested) to convince the “shorts” that the supporters of the Hudson were lacking in cash. “Supporters” sold large blocks of stock to the “shorts” for cash with an option to buy back the stock within 30 days at a slightly higher price. Instead of holding the stock, the “shorts” immediately sold it.

The “supporters” then quietly bought the stock the “shorts” sold along with all other shares in the market. By July 1863, the stock of the Hudson was cornered and the shorts took a bath. Vanderbilt and his allies took control of the board of directors of the Hudson in 1864 and Vanderbilt became president of the railroad in 1865. The important lesson I want you to take from this is that very rich and powerful men in the stock market work behind the scenes to get everything they want at the harsh expense of those inexperienced in stock investing.

*The First Harlem Corner (1863)*⁹

At the beginning of 1863, **Cornelius Vanderbilt** purchased enough stock in the **Harlem City Railway** — from \$8 to \$9 per share — to have a controlling interest. Cornelius was well known as an iron-fisted but outstanding business manager in both the ocean and rail transportation industries — if you were a stock investor in railways, you would have been very happy to have him managing the firm. He began actively



HUMOR: Remember the First Law of Economics: For every economist, there is an equal and opposite economist — so for every bullish economist, there is a bearish one. The Second Law of Economics: They are both likely to be wrong!

9 Allen, F., and D. Gale, 1992, “Stock Price Manipulation,” Review of Financial Studies, Vol. 5:503-529.

managing the company, and its stock rose to \$50 per share. In April 1863, the New York City Council passed an ordinance allowing the Harlem City Railway to build a streetcar system along the length of Broadway. Investors reasoned that the large increase of paying passengers would boost the company's profits. The stock price soon soared to \$75 per share.

Daniel Drew was a major stock manipulator at the time who preferred to attempt to force stock prices down — bull corners — by short-selling a stock. In this case he was trying to short the stock at \$75 per share. Drew was a member of the highly corrupt New York City Council for this very reason. He and all of the other council members sold the stock short and then, as council members, they all voted to repeal the Broadway ordinance to force the stock price down.

Vanderbilt got wind of the manipulation scheme and used secret agents to quietly buy up almost all of the remaining floating stock. Since Vanderbilt now owned all of the stock, its price shot up again. When the members of the New York City Council tried to cover their short positions by buying it back, they found out that there was none available for sale because Vanderbilt owned it all. Cornelius forced them to settle for \$179 per share, a loss of \$104 per share for the short sellers. Daniel Drew himself lost over a half a million dollars in Vanderbilt's bear squeeze revenge. The important lesson I want you to take from this is that smart stock investors like Cornelius Vanderbilt know when a stock's price is in the basement, and they buy as much as they can. Notice that, even without dealing with short sellers like Daniel Drew, Cornelius had already set himself up for a profit of \$66 per share, or 733%. His profit was actually much higher after he won out control of the corporation!

The Second Harlem Corner (1864)¹⁰

By 1864, the Harlem City Railway stock price had settled down to about \$150 per share because the Broadway extension still had not

been approved. Vanderbilt was furious with the corruption of the **New York City Council**. He decided to go directly to the New York State Legislature in Albany to get the extension down Broadway approved for the Harlem City Railway in the form of a state bill. Daniel Drew was mad, too, and wanted revenge against Cornelius.

Drew talked state legislators into doing a bull squeeze with him by spreading rumors the bill was going to pass. The good news drove up the Harlem City Railway stock, and Daniel Drew began selling it short. He had also talked the state legislators into secretly planning to defeat the bill even though they were spreading lies that they were going to pass it. The defeat of the bill forced the stock price down from \$150 to \$100 in two days.

Vanderbilt was furious (he was also known for his bad temper and mean nature) and bought more shares of the Harlem City Railway than were really in existence. This forcefully restricted the supply of the stock and, as per the law of supply and demand, the share price skyrocketed. He forced the short sellers to settle at \$285, and Daniel Drew lost over a half million dollars again.

WALLET DOCTOR SURVIVAL RULE #15

History proves that a few people get so rich from stock scams — as corporate insiders do today with ESOs — that they can buy off politicians and even control the government — insiders still do this today with inside corporate executive special interest groups on capital hill!

***The Prairie de Chien Corner (1965)*¹¹**

At the same time that Daniel Drew — the bear — and Cornelius Vanderbilt — the bull — were fighting it out in New York, the beginning stages of the mutual fund had come in the form of the investment pool. An enterprising bullish investment pool operator, **William Marston**, was becoming very wealthy organizing stock market corners with a small group of investors. By November 6, 1886, he had gained control of the entire 29,880 share-outstanding float of **Prairie du Chien Railroad Company** and just as much short interest.

11

See New York Times, 11/07/1865, Financial Affairs section.

Mr. Marston, as leader of the bull pool, called for settlement that very morning and drove the stock straight up in price. *The New York Times* reported this to be “one of the sharpest, and beyond all precedent, the most sudden corners known to the 40-year history of the New York Stock Exchange.” Investment pools were major market manipulators, and this gave them a very bad reputation.

WALLET DOCTOR SURVIVAL RULE #16

If you have to invest in mutual funds as you do in a 401(k), only invest in no-load index funds.

For this very reason the same band of thieves behind the investment pool renamed it to the “mutual fund”!

*The Michigan Southern Corner (1866)*¹²

Daniel Drew was caught in another bear squeeze when the **Michigan Southern Railroad** was cornered by inside executive directors of the railroad. According to *The New York Times* of April 6, 1866, “the Street was enlivened today (referring to April 5) by one of those extraordinary special movements in the railway market which will periodically occur on the bull side of the speculation, as it more frequently occurs on the bear side of the speculation...the cash stock was at no time made scarce for delivery up to yesterday afternoon (April 4). The case appeared to be different this morning, judging from the eagerness and excitement at the early Board.” This source also points out that one of the manipulators has reportedly been a director of Michigan Southern Railroad: “two of the three prominent managers (in the cornering clique) are said to have been notorious bankrupts (short sellers), whose paper is in every man’s pocketbook, and the third a prominent official of the road, whose speculations have been so flagrant that a bill has been introduced into the legislature to check them.”

Apparently the cornering pool was well organized, because Daniel Drew filed with the Supreme Court seeking an injunction against the firm of Scott, Capron, & Co. (lenders of the Michigan

12 Chancellor, E., 2000, *Devil Take the Hindmost: A History of Financial Speculation*, New York: Plume Books., Chapter 6.

Southern stock to Daniel Drew). *The New York Times* noted that “*the plaintiff (Drew) is informed and believes that the defendants (Scott, Capron & Co.) are a party to the said fraud and conspiracy, and desire and intend thereby to defraud and injure the plaintiff.*”

I teach my students of Bulletproof Stock Investing how to track insider holdings in the company they manage as well as other companies. My university finance students are always amazed at how an inside corporate executive of a company owns interests in so many other companies — this is because inside corporate executives work as a team in driving up stock prices for monster paydays on their employee stock options.

WALLET DOCTOR SURVIVAL RULE #17

Inside manipulators are frequently involved in multiple stocks at the same time

The Failed Erie Corner (March 1868)¹³

Erie Railroad was under the control of Daniel Drew and Jay Gould. Cornelius Vanderbilt decided that he wanted it. Cornelius was very confident he could acquire control because he had beaten the tar out of Drew and Gould in the Harlem City Railroad stock market battles. He now had allies in a group of Boston capitalists who owned a large block of Erie Railroad shares of stock. Vanderbilt poured millions into the purchase of the stock and thought that he had completely cornered the equity issue, because he had bought more shares than were in existence.

Daniel Drew was ready this time after dealing with Cornelius Vanderbilt in the Harlem City Railroad corner. As a director of the board of the company, he surprised Vanderbilt by converting a large issue of convertible bonds into common stocks and flooded the market with these new shares. Vanderbilt’s corner was broken by the sudden increase in float that dropped the price. He lost \$7 million. Cornelius Vanderbilt was infuriated with Daniel Drew, and was already schem-

13 Chancellor, E., 2000, *Devil Take the Hindmost: A History of Financial Speculation*, New York: Plume Books., Chapter 6.

WALLET DOCTOR SURVIVAL RULE #18

learn how to tell when a manipulation fails, or it will be you left holding the bag!

ing to get even. The lesson here is that sometimes manipulators are not successful at driving up the stock price.

*The Erie Corner (November 1868)*¹⁴

Daniel Drew and Jay Gould teamed up and worked out a scheme to short the Erie Railroad and other stocks. They started shorting heavily in a **bear raid**, another term for a bull squeeze. They then tried to force the interest rates up and caused a general stock market decline by withdrawing lots of money from New York banks. Jay was a lot more aggressive and ruthless than Daniel, who was skeptical that they could really have a significant impact on interest rates and, even so, if that

would affect the stock market significantly in the short term.

Daniel Drew began to waver in withdrawing money from the banks. Jay Gould grew angry at Daniel Drew for going soft and switched his strategy from a bear raid to a bull run; he simply switched from short selling to buying up stock. Drew had no idea that he had been betrayed and kept on selling short the Erie Railroad stock, completely unaware that it was actually his “trusted partner” who was buying it all up.

The share price for Erie Railroad stock dropped from \$50 to \$40 in October and went down further to \$35 on November 13, but by then Gould had secretly bought up the entire float of stock. On November 16, the price suddenly jumped to \$55 and caught Drew short 70,000 shares. The lesson behind this corner is that some-



TRAP: Shakeouts are forceful breaks in an uptrend. They are gut wrenching and take knowledge and experience to spot. If you don't learn stock investing well you will buy and sell stock at the wrong prices!

WALLET DOCTOR SURVIVAL RULE #19

Learn how to identify and patiently sit through shakeouts!

times a manipulation will tank in price — this is known as a **shake-out** — before running up dramatically in price.

The Failed Gold Corner (1869)

This corner is very different from what I have taught you so far, because it deals with a major commodity — **gold**. To understand this corner, here is the relationship of gold to money in a nutshell. Money used to be financially guaranteed by gold through the gold standard. The advantages of the gold standard were that it imposed a common standard of value for all currencies and imposed economic discipline on countries. This meant that countries would hoard gold and only a limited amount was allowed to float for industrial purposes, like jewelry. But the gold standard caused as many problems as it solved. Nations could not protect their industries from foreign competition through import or export restrictions, the growth of a nation's money supply was restricted by its gold stock, and governments were limited in their ability to respond to economic crisis such as rapid unemployment.

Remember that this was the time that the problem of trading goods and services with other companies issuing different currencies was solved by using gold as an international standard of value. During the 17th and 18th centuries, major trading nations in Western Europe made their currencies freely convertible into gold. Gold bullion could be exported and imported from one country to another without significant restriction, and each unit of currency was defined in terms of grains of fine gold. Nations adopting the **gold standard** agreed to exchange paper money or coins for gold bullion in unlimited amounts at predetermined prices. Gold was too heavy to transport, so this system had its own problems.

The **gold exchange standard** adopted in the 1800's allowed a country's currency to be directly converted into foreign currencies. The economic chaos of the worldwide Great Depression in the 1930's caused the gold exchange standard to collapse and the **modi-**

fied exchange standard known as the **Bretton Woods System** was developed under the control of an international lender of last resort called the **International Monetary Fund (IMF)** that linked all world currencies to gold and the U.S. Dollar. Foreign governments and investors began to lose confidence in the ability of U.S. policymakers to control the U.S. economy and inflation in the 1960's, and this resulted in the collapse of the Bretton Woods System.

In 1971, President Richard Nixon finally dismantled the failing Bretton Woods System and the world adopted the **managed floating currency standard**. Today, all world monies are **fiat currencies**, which means a country's coins and paper are not backed by a commodity like gold. When you stop and think about the fact that all money is a universal mechanism of exchange of goods and services, it never really made any sense at all to back a currency with a commodity like gold or silver.

In 1868, the federal government held around \$75 million in gold reserves and the whole floating gold supply was about \$20 million. Jay Gould knew that if he could buy up the float, the gold price would soar to where he could sell it at a high price. Gould conspired with **Abel Corbin**, the brother-in-law of **President Grant**, to influence the government's policy on gold. Abel continually lobbied Grant to influence government policy on gold — a sensitive subject, because gold also anchored the U.S. dollar's value at the time. The flaw of the gold standard and Bretton Woods System was that politicians failed to recognize that money is nothing more than a common medium of exchange of goods and services and, as such, does not and should not have any inherent value in itself.

For a while, it looked like Grant was going to go for it and Gould bought \$50 million in gold, driving the price up from \$130 to \$137 per ounce. Gould then set out on an aggressive lobbying campaign of government officials, but they began to suspect he was trying to corner the market. Gould got a bad feeling that the federal government was on to him and might try to break his corner.

What Gould did next is typical behavior for him and the

reason his family was never invited to high society parties despite his great wealth — I know Gould seems like a monster and in the financial markets, he was — but at the same time he was a very loving husband and father. Cornelius Vanderbilt was loved by society but was an oppressive father. He was a monster of a family man and when he tired of his wife he put her in a lunatic asylum! Members of Vanderbilt's own family charged that he did it to make way for some other woman.¹⁵

Gould secretly began selling gold while he convinced his friends to buy at any price. On October 4, 1869, the feverish purchases of Gould's friends had pushed the gold price from \$140 to \$160 per ounce. This was recorded as a **Black Friday**, because hundreds of firms on Wall Street were driven into bankruptcy by the huge price swing. The price quickly subsided as short interest poured into the market. The flood of sell orders drove the price of gold back down.

The important lesson here is that a commodity is widely consumed by the public and monitored heavily by governments. This makes the manipulation of a commodity market much harder to pull off. For instance, there are less than 50 major futures commodity markets, but there are more than 16,000 stocks trading in North America. It is a lot easier for manipulators to pump up the price of a stock and dump it on the public, because there are fewer people paying attention to a specific stock because there are just so many of them around.

The Failed Erie Corner (1872)

In the summer of 1872, Jay Gould invited Daniel Drew and Henry Smith to join him for a bear raid on Erie Railroad stocks. They schemed to push down the stock price by suddenly withdrawing large sums of money from New York banks, which created a liquidity crisis restricting margin that made it hard for speculators to buy stock. This reduced the number of buy orders entering the

market and reduced upward pressure on prices. This was possible due to the lack of lenders of last resort at the time (now we have the Federal Reserve System).

Drew turned bullish after the team's initial success to extract revenge on Gould for having done the same before in the first Erie Corner I described to you. Daniel built a large long position without notifying Gould or Smith. On September 17, he cornered the market by calling for a settlement of all short interests, but Gould was able to deliver the shares of stocks he had borrowed to sell short. The corner had a large impact on the prices of all stock prices, which caused a general decline. Gould was mad and came away intent on teaching Daniel Drew a final lesson which I will explain shortly.

When inside corporate executives decided they had driven stock prices up as much as they could and then sold as a unified team at the same time in 1999 and 2000, this strengthened the 2000 through 2003 crash. The really great news is that the big market players, like Jay Gould and Daniel Drew of the world today, have to report all of their holdings if they are a director or own more than 5% of a company. This is important, because if you know when and where to look, you can actually see visible insiders selling at the top of a bull market!

WALLET DOCTOR SURVIVAL RULE #20

The big players behind the scenes have a huge impact on the market.

***The Northwestern Corner (1972)*¹⁶**

Jay Gould tricked Daniel Drew and Henry Smith into joining him for another bear raid by selling Northwestern stock short. They didn't suspect that Gould was going to try to trick them and kept selling the Northwestern Railway stock short while Gould built up a big long position buying as much as he could. As prices rose instead of dropped, Smith got suspicious and acquired a warrant from a judge for Gould's arrest on charges of looting the Erie Railroad treasury that Gould controlled.

16

See New York Times, November 26th, 1872 and also Chancellor (2000), page 171.

Gould wriggled out of the charges and decided to ruin Drew and Smith by cornering the market for Northwestern even more. The price soared from \$80 to \$230 in a few days, then Gould forced them to settle their short positions at that price. The corner had a serious impact on all stocks, as people sold their holdings to buy into the rapid price increases of the Northwestern Railway stock. What I want you to notice here is that the people in the public who noticed that this was a good stock and bought it cheap ended up walking away with a huge profit — the manipulation only increased the smiles of experienced public investors who had bought low and thus could sell high.

WALLET DOCTOR SURVIVAL RULE #21

Buy good stocks when nobody else wants to.

*The Northern Pacific Corner (1901)*¹⁷

In the spring of 1901, J.P. Morgan fought with a group of investors led by **Edward Harriman** for the control of the **Northern Pacific Railroad** — which would lead to the control of all railroad freight receipts and fares to the Pacific coast. Harriman started by acquiring \$40 million in common stock, running just short of 40,000 shares of gaining control. J.P. Morgan got wind of the scheme and, in a panic, rushed out to acquire the remaining float of stock. Morgan's large purchases sent prices soaring from \$114 to \$147 per share in five days.

A group of short sellers noticed the unusual increase in prices and built a large short interest in the stock. On May 9, short sellers realized that they were caught in a bear squeeze from both Harriman's corner and Morgan's response and the price went from \$170 to a record level of \$1,000 during the day. The market for other stocks plummeted, since short sellers were hard pressed to cover their positions by selling their other stocks.¹⁸ The trading volume was 3,336,000 shares for the day, a record not broken until 1925. Morgan and Har-

17 Thomas, D., 1989, *The Plungers and the Peacocks: an Update of the Classic History of the Stock Market*, New York: William Morrow and Company, Inc.

18 Kyle, A., and W. Xiong, 2001, "Contagion as a Wealth Effect," *Journal of Finance*, Vol. 56: 1401-1440 develop a model that captures this contagion effect.

riman agreed to settle with the short sellers at \$150 the next day. The lesson here is that it was very dangerous to short sell, even back when it was easier to do it. Today it is harder, and I don't ever want you to think about short selling. You can accomplish the same goal as short selling with far less risk using stock options — just buy puts.

WALLET DOCTOR SURVIVAL RULE #22

Never sell short in the stock market — buy puts if you must go short!

***The Stutz Motor Company of America, Inc. Corner (1920)*¹⁹**

A well-known short squeeze market manipulator in the early 20th century was Allan Ryan. He bought a controlling interest in the Stutz Motor Company and acquired a position on the board of directors. Mr. Stutz, the founder, hated Ryan for his dishonest business practices and sold out of the company — a bitter departure for an automobile legend whose his cars are still prized by collectors today. Ryan began marketing Stutz cars with overly-optimistic promises beyond what the company could actually deliver.

FACT

FACT: It costs on average \$200,000 to raise a child from birth to 18 years age —that's without college... ouch!

Ryan continued to buy the float, and the company's stock price rose from \$100 to \$134 per share. Ryan was informed that short sellers, who included some prominent members of the New York Stock Exchange, had taken action because the price had risen too high. To counter the bears, Ryan borrowed a substantial amount of money to buy additional shares of the company stock. At first, despite Ryan's large purchase, the stock price went down — since the short-selling pressure was high — but the price finally responded upward in March, reaching \$391.

19 Brooks, J., 1969, *Once in a Golconda: A True Drama of Wall Street 1920-1938*, New York: Harper and Row.

Toward the end of March, short sellers were selling stock that had to be borrowed from Ryan because he had accumulated nearly all of the floating shares. On March 31, the Governing committee of the NYSE announced it had decided to suspend all dealings in Stutz Motor stock for an indefinite period due to irregular price movements.

On April 20, the Protective Committee of the NYSE announced that it was ready to accept impartial mediation on a negotiated-settlement price that led to a settlement for the short sellers at the price of \$550. Shortly after this fiasco, the NYSE quietly amended its constitution by allowing the governing committee to postpone the time for deliveries on short contracts with the purpose of preventing corners.

Ryan's bad management eventually ran Stutz Motor Company into bankruptcy. What I want you to take from this is that you should never buy a stock just because you like the product. Stutz automobiles were incredibly well built and are prized by collectors today. If you buy a stock just because you like the product, you will then hesitate too long to sell when you should or worse buy when the common stock price is too high.

WALLET DOCTOR SURVIVAL RULE #23

Never buy a stock just because you like the product!

The Piggly-Wiggly Corner (1932)

Piggly-Wiggly is a supermarket chain founded in the Midwest by a grocery clerk who noticed that it would be far more efficient for shoppers to shop in aisles and pay in checkouts instead of dealing with a clerk at a grocery counter. Clarence Saunders was fired for repeatedly suggesting the idea to his boss, but eventually founded the first supermarket chain. In 1923, he wanted to make a seasoned equity offering, but also wanted to bring in as much cash as he could for it — he got greedy.

He hired Jesse Livermore, a well-known stock manipulator I mentioned at the beginning of this book, to push up the share price

in the secondary market before issuing the new stock. Mr. Livermore was very successful in driving up the price, but the trading volume and the fast rise attracted in substantial short interest, which eventually led to a bear squeeze in mid-March. Given his large position, **Clarence Saunders** thought that he could make even more money by canceling his previous plan to issue more stocks and thus make the bears pay even more.

In early 1932, Merrill Lynch and other bear interests on Wall Street tried to hammer down the price of Piggly-Wiggly stock. Saunders took a train to New York City with \$2 million in cash in a small bag and fought back, buying Piggly-Wiggly stock until he had orders for 196,000 of the 200,000 outstanding shares. Pressured by the bulls, the stock price soared 50 points on March 23. The next day, the New York Stock Exchange declared a ‘corner’ existed and de-listed the stock, and gave the ‘bears’ five days rather than the normal 24 hours to deliver the stock Saunders had bought — Merrill Lynch was a prominent and influential member of the NYSE.

Saunders’ bank and his friends were put under pressure to sell under any terms and the price was driven back down. Clarence Saunders was driven into bankruptcy from being forced to sell all his stock in the company he had founded at a loss. On October 15, 1953, Clarence Saunders died. Having built and lost two fortunes, he is the man who brought the retail store into the 20th century. He was a well-known corporate inside executive at the time and was well liked by the public. The lesson here is that you have to assume all inside corporate executives are potentially corrupt because you simply can’t tell them apart. This is important because the better you know their name from the popular press, the less I want you to trust them with the savings you pump into the companies they control — examples are Eisner, Iacocca, Jobs and Welch.

WALLET DOCTOR SURVIVAL RULE #24

Assume all corporate executive insiders are dishonest — you can never tell an honest insider from a dishonest insider until long after they have left the company.

The Radio Corporation of America Corner (1928)

William C. Durant was a millionaire in the horse-drawn carriage business before taking over the Buick Motor Company. He then created General Motors and Chevrolet. In 1927, William Durant decided to manipulate the share price of RCA, Radio Corporation of America. He noticed that the bulk of shares RCA had issued were held by RCA itself, General Electric, Westinghouse and several other big corporations. More importantly, these shares were not traded — they were not in float. In addition, there was a lot of hype in the market for RCA since its radio transmission equipment was considered a revolution in communications technology at the time.

Durant started a pool to accumulate the RCA stock. As a result of the feverish purchases of the Durant manipulation group, they soon bought all floating shares and all shares sold short. Their trading generated a daily turnover of more than 500,000 shares, while officially there were only 400,000 shares actually available for purchase in float. In other words the public was buying more shares than were actually available and the market skyrocketed. This was because of the enormous order imbalance resulting from high demand and restricted supply of shares. The pool forced the market into a technical corner in March 1928. The corner was unintentional, because the Durant group was simply trying to manipulate the price of the stock upwards to make a lot of cash — they weren't trying to gain control of the firm. They never controlled a large part of the shares and could never call the shorts to settle. The short sellers suffered, though; from March 12, the bears started struggling to settle their accounts and the price skyrocketed more than \$61 in just four days. The enormous profit Durant extracted from this corner helped him form General Motors.

The lesson here is that there is so much potential profit in stock manipulation — enough in this case to fund the start of a major motor company like General Motors — that it is hard to imagine a stock market free of manipulation. I don't care how much the government at least *acts* like it attempts to regulate the stock market,

WALLET DOCTOR SURVIVAL RULE #25

Learn to spot long-term stock price patterns that seem intended to discourage the public when prices are low and encourage the public to dive in when high.

it is simply out-gunned by the vast wealth of inside corporate executives and hidden insiders behind the scenes. Democratic and Republican campaigns

alike are largely financed by inside corporate executives. Elected federal officials know better than to bite the hand that feeds them — individual shareholders unwillingly put up the money but it is the insider that writes the check when re-election rolls around. Learn to spot long-term stock price patterns that seem intended to discourage the public when prices are low and encourage the public to dive in on the rise.

Anti-Corner Regulations

Several legal and regulatory developments have made corners more difficult. For instance, the **NYSE and Open Board Rule** of November 30, 1868 required corporations to register all securities sold at the exchange and provide 30-day notice on any new issues. This made the float of the company much more open public knowledge. This came about because the Legislative committee of the NYSE launched an investigation of corners, from an increased concern of members of the “Big Board” on the negative impact of corners on market transactions.

The 1934 Securities Act imposed a mandatory margin requirement between 50% and 75% under the control of the Federal Reserve Board, which increased the capital needed to control large blocks of stock. Then, in 1968, the **Williams Act** required the filing with the SEC of any one person or group of persons who have acquired a beneficial ownership of more than 5% of a stock issue within 10 days of share acquisition. This made large shareholders that own more than 5% of the company stock visible insiders, because their holdings are tracked by the SEC — up to this time insiders were invisible to the public. If you know what you are doing today, you can monitor large shareholders with relative ease.

The **Governing Committee of the New York Stock Exchange** de-listed Stutz Motors after its corner in 1920, setting a stern precedence that effectively voided the contract between short seller and manipulator. Delisting prevents manipulators who are caught from distributing their position at the stock exchange to short-sellers after the corner. Manipulators can still profit from high prices short-sellers have to pay for the borrowed shares but, with this rule, they lost the liquidity to sell their vast holdings they had enjoyed before 1920. As a result, this Stutz Motor corner was the last publicly detected intentional corner on the New York Stock Exchange — the RCA corner was unintentional.

Contemporary Corners

Stock markets are better regulated today than in the 19th century, but market manipulations by large investors — insiders who are hidden because they have to keep their presence a secret — still occur in all stock exchanges around the world. Only the blatant cases make it into press. For instance, in August 2004, Citigroup sold more than 200 different Euro-zone bond series in the space of 2 minutes.²⁰ After the price fell, they bought it all back again at a lower price and netted around 15 million Euros in profit. This came to press because they were heavily scrutinized by market authorities — their rapid short selling substantially restricted market liquidity, causing major problems for other investors.

In May 1991, a bond trader at Salomon Brothers was discovered attempting to corner the market in two-year U.S. Treasury notes. During the 1990's bull market, numerous price manipulation schemes for penny stocks — stocks trading under \$5 per share — were discovered by the SEC.

In 2002, China's worst stock-market crime was a scheme to manipulate the share price of a firm called China Venture Capital. Seven

²⁰ Eurobonds are issued in the geographic area comprising the European Union countries using the euro as a monetary unit

WALLET DOCTOR SURVIVAL RULE #26

Stocks become targets for cornering when there is bad news about a good company and prices stay low — when nobody you know is paying attention.

people, including two of the firm's former executives, were accused of using \$700 million and 1,500 brokerage accounts nationwide to manipulate the company share price upward. The copper futures market was manipulated upward by a supposedly rogue trader at the Japanese trading firm Sumitomo — at least the official position of the company is that the trader was acting on his own as a rogue.

These are just the cases that have hit the press. Manipulators do everything possible to stay hidden from the public. If they restrict their buying and selling to the long-term, they are really hard to detect because nothing the public pays attention to stands out as unusual. Because of this, the empirical literature in finance regarding this subject is very limited. The widespread manipulation through stock pools, the forerunners of today's mutual funds, before the crash of 1929 is vividly documented by Harvard economist **John Kenneth Galbraith**.²¹ **Pump-and-dump schemes** — slang for stock price cornering manipulations — usually in nano-cap stocks today — have also been detected in small markets like Pakistan.²²

21 Galbraith, A. J., 1972, *The Great Crash, 1929*, Boston: Houghton Mifflin Company.

22 Khwaja, A., and A. Mian, 2004, "Unchecked Intermediaries: Price Manipulation in an Emerging Stock Market," *Journal of Financial Economics*, forthcoming.

Chapter 9

Putting It All Together

The Worry Free Wealth Way!

You've learned a lot in this book. In fact, I can easily say that you now know more than the vast majority of the people in America today about the stock market. But let's cut to the chase...

You have to be thinking by now, "how can I do what Hank did? How can I become a stock market millionaire even on a modest living?"

The answer is in *how you manage your money relative to your net income and net worth*. There is a very simple approach to your money that allows you to know instantly if you're on track.

The Worry Free Wealth Ratios

The worry free wealth ratio is a simple way to manage your money by keeping your needs expenses below 50% of your total net income. Don't forget that needs includes all the insurance you need for health, life, disability, and property. Then you keep your wants expenses below 30% of your total net income. What this does is force you to save 20% of your total after tax income — that's \$20K for a family that makes \$100K combined.

It really is that simple!

Once you have 20% saved I want you to set aside $\frac{1}{4}$ to pay off your house as fast as possible. That way you won't lose it to foreclosure.

But if you have any consumer debt I want you to pay that off first with all of the 20% savings. You simply can't get ahead with stuff like credit card debt hanging over your head. Once you've got those steps under your belt you can really begin to get rich.

First open a Roth IRA at an online discount brokerage. If you make too much to open a Roth then open a standard IRA. You can check to see if you earning too much to have a Roth at IRS.gov.

Its really important to tax shelter as much of your stock investing as possible!

In fact if you have a profitable business you can tax shelter up to \$30K for yourself or \$60K for you and your wife in a business IRA. But you'll have to set this up with your accountant. If you want to carefully work through this process — which in-

cludes asset protection, estate planning, and adequate insurance go to...

www.WorryFreeWealth.com.

I have a 6 month curriculum that teaches you everything about managing your money.

Now the big question is what to do with the money you stuff into your retirement account. Does it go into stocks? Into Bonds? What?

The Behavioral Beta Portfolio Concept

Is there a way to consistently trounce the S&P 500? As an MBA program finance professor at a major state university I am here to give you an unequivocal...

Yes!

It's called the Investment U Behavioral Beta Portfolio. This is cutting edge finance that's vital for you to understand so let me carefully explain.

Mean-variance efficiency, as developed by Nobel Laureate Harry Markowitz is the practical application of his portfolio theory. Efficiency in this framework prescribes reducing portfolio risk by moving out of stocks & bonds and into cash.

However, the relative proportions of stocks and bonds that remain are left intact.

Top-drawer finance Professor Hirsh Shefrin points out in his

book, *“Beyond Fear and Greed,”* that *“mean-variance efficiency — and thus mean-variance portfolio theory — is ill equipped to deal with investor goals and the psychological factors of attaining those goals.”* Shefrin’s also talks about an exciting new way of looking at the markets I teach in my advanced stock course, *“Investment U’s How To Create Your \$1,000,000 Portfolio From Scratch!”*

Is Traditional Beta Dead?

There’s this wacky idea that markets somehow know what to do through the “magic” of efficiency. The idea is that everybody “magically” knows what’s going on.

The worst efficiency theory that’s caused more financial grief is the Capital Asset Pricing Model and its **beta**.

The **Capital Asset Pricing Model** (CAPM) won Stanford economist Bill Sharpe a Nobel prize. This is the culmination of modern portfolio theory that began with the Marcowicz’s mean-variance portfolio. CAPM says that investors should only be concerned with matching the return of a proxy for the market portfolio.

Mean variance theory says you can set up a diversified portfolio and get rid of a lot of risk — this make some sense but...

CAPM is wacky because it’s based on the idea that everybody knows exactly what’s going on and that simply is not true.

The S&P 500 is the benchmark for CAPM but critics have suggested that all tradable assets should be included. There’s a way you can do this through something called the Gone Fishin Portfolio — I’ll explain below — that is an improvement over market portfolio proxies based on a single large stock index.

The Three Factor Model

But there are still problems.

Efficient market theorists were hindered by two high returning “anomalies.”

The first is firm size where companies with smaller capitalizations have been shown to consistently outperform large companies. The second major market efficiency anomaly is that companies with high book-to-market values also consistently outperform the market.

The battle raged as efficiency academics struggled to disprove these high yield anomalies. They fought to prove these efficiency bashing results wrong until finally...

They Gave Up

When they realized they couldn't just explain them away they developed a new theory — to account for the anomalies of the “*small firm effect*” and “*value*” investing. That theory is the three-factor model.

This new model cued in on (1) **value**, (2) **size**, and (3) a proxy for the return of the market.

In this framework, the average small stock is seen as riskier than the average large stock.

Accordingly, investors demand compensation for higher risk. Because of this, small stocks — where new products and innovators incubate — tend to earn a higher return than large stocks.

It explains why small caps do well in almost every market environment, and why Lou Basanese's White Cap Index posts such high returns.

But in that same small cap universe there are numerous small companies that are little because they are soon to fail. In this view large capitalization companies are seen as established in their industry and less likely to go bankrupt than their smaller counterparts.

The three-factor model says that a portion of the higher return reflects the premium for risk that investors demand over less risky large stocks.

Unfortunately, the rub here is that investors consistently expect large-value stocks to outperform small-growth stocks — statistically it's not going to happen.

Then a flood of academic papers rolled in documenting many more high returning anomalies ranging from newly issued stocks to international equities with inexplicably high returns from an efficiency perspective. Cutting edge finance researchers realized that a whole new market paradigm was needed where beta is not fully linked to the market proxy but to individual investor behavior.

Human behavior is not mathematically precise since it's often based on fuzzy thinking and psychological quirks.

We can do even better...

Investment U's Behavioral Beta Portfolio — A Better Model For Investors

In order for a behavioral beta portfolio to work it has to be tilted away from overpriced securities in order to consistently beat the markets. It also must take into account the differences in returns of high versus low book-to-market stocks — ditto for small versus large capitalization stocks.

This is exactly why our new Investment U behavioral portfolio recommends an allocation of 70% of your investment savings in a diversified market proxy — like the Gone Fishin' Portfolio.

And we recommend the remaining 30% in under-priced market “anomalies,” or undervalued situations. Some of the most profitable anomalies we've discovered to date include deep-value, momentum trading, hot IPOs, insider stocks, takeover candidates, small caps, and foreign investments.

In short, the fundamental make-up of the Oxford Club's premium services.

Our Investment U Behavioral Beta Portfolio makes it easy for you to consistently beat the markets. You'll have the best market proxy portfolio working for you in the form of the Gone Fishin' Portfolio and the best special situation investment ideas from the Oxford Club.

I teach you all of the fundamental aspects of how to profit from these special situations in my course “Investment U's How To Create Your \$1,000,000 Portfolio From Scratch!” Go here for more information:

www.WorryFreeWealth.com.

It all starts with education,

- Doc Brown

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