



# Wealth Architecture™ Digest

*Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.*

## Cases in Point

There is a great deal of difference between an excellent company, and an excellent stock investment. There is also a lot to learn about expert opinion and reality. In addition, there is a huge difference between celebrity-endorsed products/investments, and the actual value of those items. This article will, I hope, illustrate these points and explain why I have come to the conclusion that the search for the next Peter Lynch is akin to trying to locate the proverbial Fountain of Youth. Nationally we spend tens of billions of dollars per year trying to look younger, lose weight without effort, etc. We spend (and often lose) even more trying to find the man with the Midas Touch, the person with the Crystal Ball, or the guru with the Secrets of the Ages. I am beginning to think it is simply part of our DNA.

A first case in point is the difference between Cisco the Company, and Cisco the Stock. No one would question the incredible track record of Cisco as one of the greatest technology companies of the past quarter-century. It has been the leader in the networking world since its early days as a company. It has been a great innovator, a super sales organization, and usually a very profitable company. But while the company itself grew rapidly, in the period from 1997-2000, its stock grew exponentially.

Before we consider the potential “whys” of the stock’s explosive growth, let’s review the published facts of the company’s financial performance. I went back and looked at Cisco’s annual reports and SEC filings to see just how

great its performance was.

If you had owned Cisco the Company since the end of 1999, you would have earned cumulative profits of \$63.7 billion. (source: Cisco annual reports). But, if you had invested in Cisco the Stock on December 31, 1999, you would have lost 63% of your money. The stock was \$53.37 at the end of 1999 and \$16.30 on June 2, 2011 (source: finance.yahoo.com). How can that be? The company earned (after tax) over \$63 billion over 10 years, while shareholders who purchased back then lost over \$200 billion in market value. There is often a major disconnect between the intrinsic value of a company and the *perceived* value assigned by the buyers of its shares.

This gets down to our reliance on “expert advice.” One group of perceived experts are the stock analysts. They pour over financial statements and talk with the company executives about their products, plans, etc. (publically available only – unless they want to go to jail). The analysts interview suppliers to try to ascertain the amount of product being built, and they evaluate – predict – the total market, market share, etc. From all that *fundamental* research they divine near and future profits, discounted cash flows, and finally a target price per share. Given all that research, and mathematical modeling, they must be accurate. Right?

Well, maybe not. I have been reading a

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fascinating book, *Future Babble: Why Expert Predictions Fail – and Why We Believe Them Anyway*, by Dan Gardner. The author documents many studies that indicate that expert advice, in most any field, is rarely any more accurate than the average person's opinion. Since here we are talking about a stock, and analysts' estimates (remember, an estimate is based on a *prediction* of a future amount of sales, earning, or stock price), let's think about one point he puts forth. Typically an analyst will issue a written report in which he estimates Cisco's earnings for the current quarter, and for the current and coming year. On the basis of that estimate, and the estimates of other prognosticators, the stock is bought and sold by those who depend, at least in part, on those reports.

But, you may have noticed the all-too-frequent reports of analysts who "revise" their estimates during the quarter, as well as reported results of companies that miss the "consensus estimates". When an analyst, after all his research, revises or misses the results, what does that say? It says "he was WRONG." Yet, we rarely hear what percentage of the time these people are wrong. There may have been a change in circumstances like the earthquake and tsunami in Japan. Maybe some company announced a new product that took significant market share from the one the analyst was recommending. But regardless of the reasons – the excuses – much of the expert opinion was inaccurate.

Then there are the pundits and newsletter writers who make their money convincing you that they *know* when a stock is a great buy, or a dog that should be sold. They entertain (ever see Cramer on CNBC with his bells and sirens?) Other "experts" are brought on to tell you what "will happen if..." They crow when they are

right, but rarely say anything when they are wrong. But they keep their jobs. Why? Gardner maintains it is because human beings want to believe that the person being paid to give them advice actually knows what *will* happen. But, there is a great deal of difference between foreknowledge and personal opinions – educated or not.

Humans are wired for certainty. We know the sun will come up in the morning, even if we can't see it behind the clouds. We know that if we jump up, gravity will bring us back to Earth. We want someone to tell us what Cisco's earning will be, so we can make what we perceive will be an "informed decision." It was partly on the basis of analysts, pundits, gurus, and others that investors large and small bought Cisco the Stock at unsustainable prices. If they say it is a good buy, it must be so.

The second case in point is our tendency to want to feel close to celebrity. Today a pair of sports shoes might cost \$75, but if they are *Air Jordan*, they might cost twice that. The shoe may not be that different, but people will pay to own something with Michael Jordan's name on it. When Michael Phelps set records at the Olympics, his image was all over Wheaties and other products. Do we really believe that if we eat Wheaties, we'll be a champion swimmer? Companies pay millions of dollars each year for these endorsements, so many people must be buying the products endorsed by their "role models." Of course these product endorsements are usually harmless, but our belief in the ability of celebrities to tell us what to buy can be very harmful.

Take the recently reported case of one of Donald Trump's "Signature" developments. On May 12, 2011 Michael Barbaro reported in the

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*New York Times* what happened in a waterfront project in Fort Lauderdale that Mr. Trump described in marketing materials as “my latest development” and compared it to the Trump Tower on Central Park in Manhattan. “*There was no disclaimer that he was not the developer*” [emphasis added]. The building, where construction was halted when a major lender ran out of money in 2009, sits empty and unfinished, the outlines of a giant Trump sign, removed long ago, still faintly visible. People were buying into this upscale development based on wanting to have a “Trump” property, while Trump was just licensing his name to the development. If it had been successful, he would have shared in profits, but even in its failure he was paid for his name. The investors who believed in him lost. Regardless of the frequency of this kind of thing happening, people *want* to believe that if Donald Trump puts his name on something, it will be first class and he will put his name (and money) *behind it*, not just on it. Just another Case in Point.

## Another Bubble?

While it is very nice to know that people are again excited about some initial public offerings (IPOs), my earlier comments about the differences between a good company and a good stock to purchase is in the forefront of the business sections of many newspapers. The incredible first-day surge in the price of LinkedIn, which went public in mid-May is a stunning example of, in my opinion, irrational exuberance.

On Monday, May 31, 2011 Julie Creswell wrote in *The New York Times* that “LinkedIn is trading at about 554 times last year's earnings of \$15

million....That compares with a price-to-trailing-earnings ratio of 149 when Google made its debut in the markets...” She went on to point out, “...LinkedIn is selling at around **25 times this year's expected sales** [emphasis added].” If an investor buying today wanted to double his investment over six years (about 12% per year) the stock would have to climb to \$188/share. At an aggressive P/E ratio of 50 times earnings, the net profit in six years would need to be \$360 million, 22 TIMES last year's earnings (source: finance.google.com). On June 2, 2011 the stock was at \$77.45, down 37% from the top price of \$122.70 in the euphoric first day of trading after its IPO price of \$45. Any public buyer of the stock paid at least \$80 on the first day of trading. For anyone who bought at the top on the first day, the stock needs to go up 57% just for that purchaser to break even.

In my February, 2000 newsletter I wrote:

*"I have been fascinated by the number of analysts that recommend buying Yahoo! at its current level. At its recent high of \$500 it had a market cap of \$115 billion, more than half that of IBM, even though IBM's net profits are more than 12 times YHOO's gross sales! The market value was more than twice that of GM. YHOO was more than double the value of Phillip Morris, while MO earned \$6 billion and yields over 8%. At some point Yahoo! will mature and be a stable part of the new internet universe. But to support a \$100 Billion market value, even at a P/E of 70 (Microsoft's P/E). It will need to earn \$1.5B – that is three times more than its current sales. Yahoo! will likely earn that much some day, but how can those buying the stock today make real*

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*returns on their money..."*

It is worth noting that Yahoo!'s current market value is about \$21 billion according to [finance.google.com](http://finance.google.com), or just over twice LinkedIn's valuation. However, its net income was \$1.2 billion last year, not \$15 million. I'm not sure why some people think this time is "different" than last. Regardless of the excitement, value really needs to reflect actual earnings, and reasonable assumptions of future earnings. How much longer might it take to grow earnings over **80 times -- 8000 %?**

The Facebook frenzy will be very interesting. In January, [nytimes.com](http://nytimes.com) reported that Goldman Sachs

was raising money from private investors to invest in Facebook based on a valuation of \$50 billion. According to [mashable.com](http://mashable.com) its 2010 revenues were estimated at \$1.86B. By comparison, Google has a market valuation of \$170 billion, with revenue of \$29B and net profits of \$8.5B (source: [finance.google.com](http://finance.google.com)). For the investors that just invested this year at the \$50B valuation to make a significant profit, wouldn't Facebook's *profits* need to be a multiple of today's *revenue*? How long might that take?

While if you've been reading my articles over time, you know I don't make predictions, I think it is fair to say that it will take quite a while for actual profits to justify today's price at a more "normal" P/E ratio. Only time will tell.

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