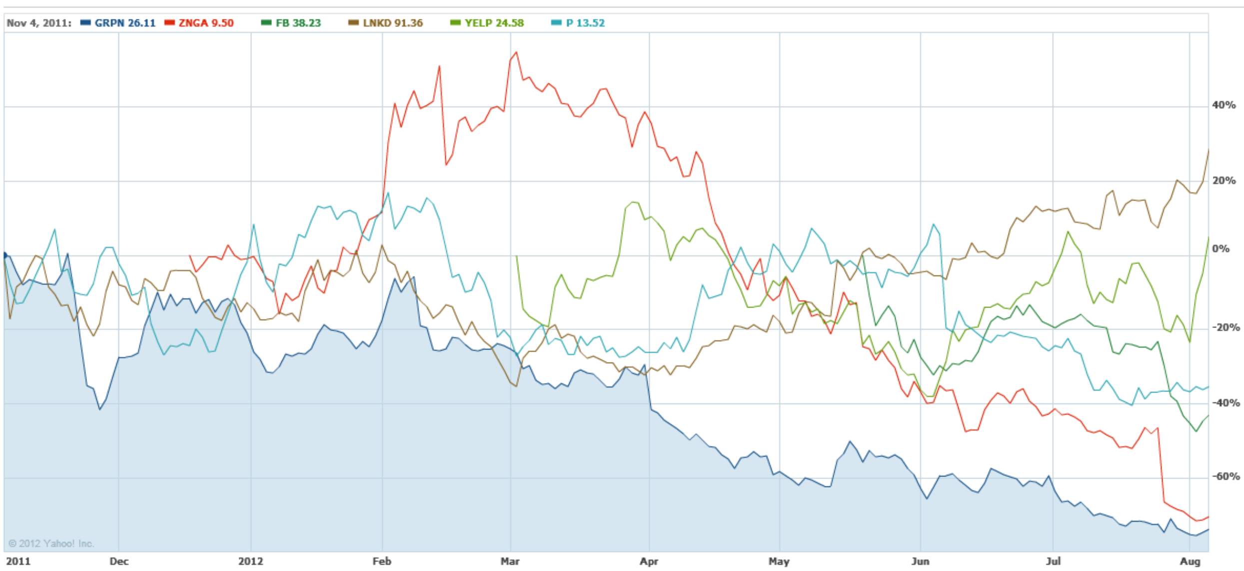
August 2012

Lessons in Wealth Destruction

In May I touched on how bad the Web 2.0/Social Media sector has performed ahead of the FaceBook IPO. Many of these firms continue to slide. Below is my updated chart from May with FaceBook's Face Plant added. A lot of wealth has recently been destroyed in some of these stocks. This month's letter is devoted to lessons learned from this sector.



Web 2.0/Social Media stock performance. Source: Yahoo! Finance

1. Investing on the day of the IPO is extremely risky. FaceBook's (FB) IPO was so overhyped that the NASDAQ exchange couldn't handle the orders coming in and had to postpone the opening. When you put in an order the morning of an IPO, it often takes several minutes to know if you purchased the shares and if so at what price because the exchange is flooded with transactions. Over 580 million shares of FaceBook traded hands on its debut. The two most popular ways to invest on the day of an IPO are to enter a market order or a limit order. The market order is by far the riskiest.

When a speculator enters a market order before the open of an IPO, the exchange will purchase the number of shares they want at the best price they can give to the investor. This is risky because there are often thousands of open market orders that can quickly bid up the price of the stock to a level that is higher than the speculator ever wanted to pay. FaceBook's recent IPO provides an excellent example of this. Some unlucky or inexperienced speculator paid $45 for their FB shares on the day of the IPO when the shares opened at $42 and closed the day at $38.23. They paid $6.77 or 18% MORE per share than someone who waited until the end of the day to make their purchase. The only advantage of the market order is that you are going to be able to buy your shares; you just can't know how high of a price you will be buying them for. This strategy works for an IPO that is initially underpriced and has a very large first day move. In my opinion, the risk of not knowing what price you will pay does not compensate you for the possible return that you could make on the first day of stock trading.

If a speculator wanted to purchase a stock on the day of the IPO, but be sure that they will not pay more than a certain price, they could enter a limit order. This order tells your broker that you will buy X number of shares for $Y price or better. This is much less risky than executing a market order because you are guaranteed that you will not be paying a higher price than what you told the broker you would pay. The biggest downside of placing a limit order is that the share price could rise very quickly through your limit price and you may not get filled and the stock could continue to go up for several weeks. A speculator placing a limit order needs to be emotionally prepared for this outcome.

2. Unknown investments usually offer better value than popular ideas that everyone has heard of. Every financial media outlet that I am aware of spent a considerable amount of time pumping up the FaceBook IPO. For the two weeks before the IPO, I was fielding at least one call everyday about investing in FB the morning of its IPO. Warren Buffet is famous for advising investors to be fearful when others are greedy and to be greedy when others are fearful. Too many people were far too greedy to make quick money on the excitement of the FaceBook IPO. Below is a table from a December 20, 2011 article on CNBC.com that lists the top five performing IPOs of 2011[1]:

GNC Holdings (GNC)	74.8%
Tesoro Logistics (TLLP)	55.5%
Imperva (IMPV)	50.9%
Tangoe (TNGO)	49.3%
ServiceSource Int.	46.4%[2]

If you are like me, you have only heard of GNC and have no idea what the other four firms do. GNC opened at $23.43 and could later be bought for $19.52. Tesoro opened at $22.50 and dropped down to $21.07 the first day and then took off like a rocket. The chart below shows that the only IPO of the five companies that didn't go below its IPO price in the first few months is Imperva Inc. It opened at $23 and ran up quickly to $42. Investing is never easy and Imperva has since dropped about 40% from its peak to $25! As Mark Twain observed, "October. This is one of the peculiarly dangerous months to speculate in stocks. Others are November, December, January, February, March, April, May, June, July, August, and September."

[1] Clearly a sample size from one year and of only five companies is irrelevant. My purpose is to get investors looking at what has happened to other investments and realize that prices often drop below the initial price in the weeks/months after the IPO.
[2] http://www.cnbc.com/id/45729156/The_Best_and_Worst_Performing_IPOs_of_2011

The top five top performing IPOs of 2011. Source: Yahoo! Finance

3. Beware of the Irrelevant Authority Fallacy.[3] On May 14, 2012, I was dismayed to see a Bloomberg article quote Apple cofounder, Steve Wozniak, as having said "I would invest in FaceBook, I don't care what the opening price is." The article goes on to share that Wozniak has a possible conflict of interest because FaceBook is the largest customer of his new company, Fusion-io Inc.[4] "Talking your book" happens every day on business shows and investors have come to expect that. I was concerned that investors would assume that because Wozniak is a legendary inventor, that they would ascribe great investing skills to him and take his advice without doing their own research.

Being a great manager, rich, or famous does not make you an expert on investments. The skill set of an inventor and a successful investor are very different. Inventing great technology does not make you an expert at reading balance sheets, market sentiment, or valuing a company.

There is no way to know if Steve Wozniak has an excellent track record for his investments outside of Apple and that is not my point. The point I am making is that being pretty, rich, or an excellent video-gamer, (according to Wikipeda the Woz held many high scores for Nintendo in the 1990s.[5]) doesn't mean that the person is an expert at valuing an IPO.

I also want to point out that I often see articles that try to persuade readers that insider buying or selling has some sort of predictive power when in my experience, it is a terrible way to make investment decisions. Here is an example of one such article that cites that there was one week in October of 2010 where "insider selling to idiots" ratio to insider buying was 1,169 to 1. Seven months after the previous article, the S&P 500 had rallied about 16%. I have seen no predictive power of insider selling to buying ratios in aggregate. I do pay attention to insiders at individual companies that I am looking at, but even this is hit or miss. It is a fallacy to assume that an excellent

[3] http://tvtropes.org/pmwiki/pmwiki.php/Main/AppealToAuthority
[4] http://www.bloomberg.com/news/2012-05-13/apple-founder-wozniak-to-buy-facebook-regardless-of-price.html
[5] http://en.wikipedia.org/wiki/Steve_Wozniak

manager at a company you like with better information than you have is also a skilled investor. They are humans just like us and prone to make the same mistakes other investors do by being greedy at the top and fearful at the lows. It is also worth noting that in most cases you can't know their own personal financial situations. Maybe they are selling to diversify their wealth, are rebalancing their portfolio, or need more cash to buy a larger house.

4. Wall Street does not exist to make *you* rich. I try my best to protect clients' wealth from the depraved, psychotic snakes slithering around Wall Street. It is hard for many of my moral clients in Texas to imagine the greed and selfishness of the people looking to take advantage of them. In April of 2012, Morgan Stanley, Goldman Sachs, and Bank of America were paid $15 million in fees to help insiders sell an additional 43 million shares of Zynga stock at $12.[6] As I write, the shares are less than $3! Marc Pincus, the CEO, sold 16.5 million shares for $200 million in April.

The best example in recent years of a company going public at the worst possible time for investors is the IPO of the Blackstone Group (BX). The Blackstone Group is a private equity firm staffed by some of the brightest minds in finance today. Investors in the IPO invested in the stock wanting to invest alongside some of the "smartest people in the room." The China Investment Corp, China's sovereign wealth fund, even invested $3 billion dollars in the company.[7] The IPO priced at $31 on June 22, 2007 only four months ahead of the all time peak in the U.S. stock market. By February of 2009, the shares were trading for less than $4. Companies try to sell shares for the best price they can at the best possible time for the insiders. This should not surprise anyone.

The Blackstone Group (BX) goes public right before the stock market peaked. Source: Yahoo! Finance

In poker, they say that if after the first ten minutes of playing at the table, you don't know who the sucker is, it's you. This applies to Wall Street as well. I hate to be so dark, but that is the reality of the world we live in. Consider that in 2010 Wachovia (now part of Wells Fargo) paid a $160 million fine when they got caught laundering Mexican drug dealer's money. In June of 2012, ING paid $619

[6] http://www.businessinsider.com/zynga-insiders-cashed-out-just-before-stock-crashed-2012-7
[7] http://articles.marketwatch.com/2007-05-21/news/30807281_1_private-equity-private-equity-forex-reserves

million to settle a case that they violated US sanctions against Iran and Cuba. In July of 2012, HSBC, Europe's largest bank, apologized for their "mistakes" in helping drug dealers launder millions of dollars![8] Who can forget Senator Carl Levin's grilling of Dan Sparks of Goldman Sachs where he read an internal email stating "Boy, that Timberwolf [a $600 million investment they sold to clients] was one sh#@*y deal"? I could go on longer than you will want to read.

There are great investments out there and clearly everyone on Wall Street is not slime. There are many examples of IPOs that were very kind to investors and I have clearly cherry picked a few of the disasters to try and help my readers develop a healthy skepticism of Wall Street and business television. I believe the average investor buys a stock thinking that they will quickly make 20%. Investors would be better off if they spent most of their time thinking about what they will do if the investment thesis turns out to be wrong *before* clicking the buy button.

Michael Lewis' *The Big Short*, made Danny Moses of FrontPoint Partners famous for correctly betting that the world would experience a subprime crisis. One of the best anecdotes of the book is:

> When a Wall Street firm helped him to get into a trade that seemed perfect in every way, he asked the salesman, "I appreciate this, but I just want to know one thing: How are you going to f@#* me?" Heh-heh-heh, c'mon, we'd never do that, the trader started to say, but Danny, though perfectly polite, was insistent. "We both know that unadulterated good things like this trade don't just happen between little hedge funds and big Wall Street firms. I'll do it, but only after you explain to me how you are going to f@#* me." And the salesman explained how he was going to f@#* him. And Danny did the trade.[9]

Moses is an experienced and successful investor and we don't have to be that skeptical, but a healthy dose is important when dealing with the propaganda put out by the street.

Conclusion

The most important thing in investing is to know yourself followed closely by being able to control your own emotions. There are many excellent and moral humans in the investment business. There are also a great deal of people that want to extract your wealth from you. Investing is full of risks and hiding your money under your mattress carries its own set of risks. A lot of money has been lost recently in the Web 2.0 stocks. I sincerely hope the four lessons that I highlighted help you in your investing success in the years to come.

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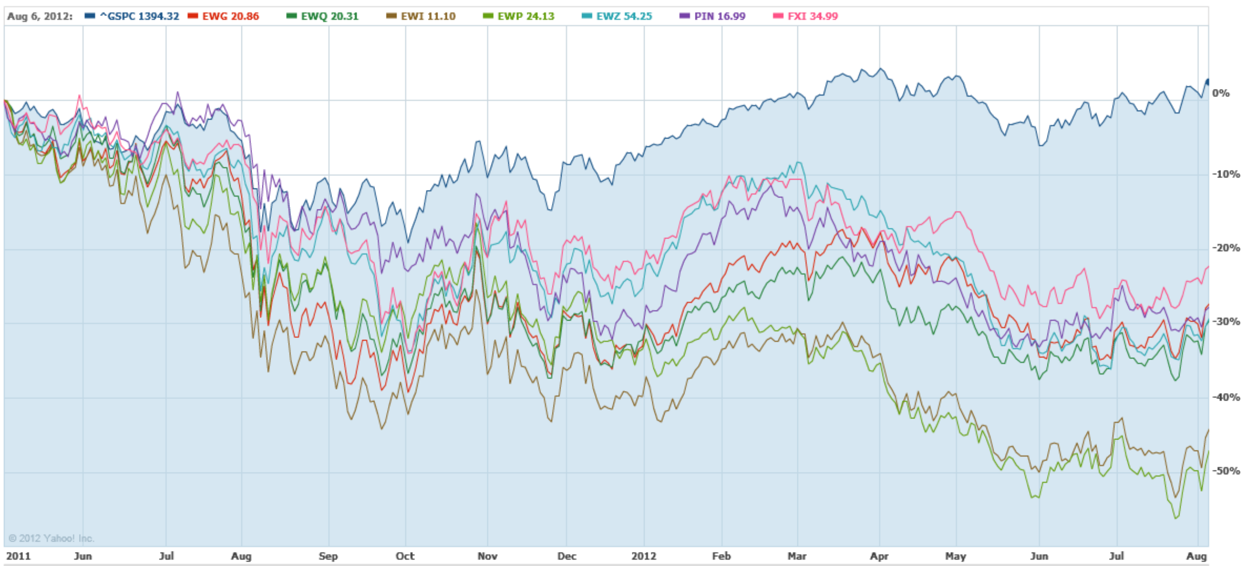
[8] http://www.bbc.co.uk/news/business-18866018
[9] http://www.speroforum.com/a/32697/How-Wall-Street-Destroyed-Main-Street

Markets

Diversification into foreign stocks has not been kind to U.S. investors recently. Below is S&P 500 compared to ETFs that represent other country's stock markets from May 2, 2011 to August 6, 2012. Germany is represented by the red line, France the green, Italy brown, Spain light green, Brazil light blue, India purple, and China pink.



The US stock market has walloped a lot of foreign stock markets. Source: Yahoo! Finance

The United States has clearly been the best market to invest in since the May 2011 peak of the Dow Jones World Index. Much of Europe is already in recession and the emerging markets are either in recession or having significant slowdowns. One of the biggest questions for investors is can the world's largest economy continue to grow while much of the world contracts. Right now, it seems very reasonable that the S&P 500 can go up 2% more to take out the April 2, 2012 multi-year peak of 1,420. If 1,420 is surpassed, investors will then be looking to see if the all-time high of October 9, 2007 at 1,565 will be challenged.

One of the major differences between 2007 and now is that at the 2007 top almost everyone was bullish. Today, just 12% below the all time high, I still see a healthy amount of fear out there. This business is never easy.

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