The Stock Market Is NOT The Economy, Stupid!

by Peter Kilkus

I want to focus on the stock market in a bit of detail because it is a major driving force in the way corporations and clueless people behave. Breaking through the myths fed to the general public by the financial media can bring a revelation akin to that of an old time Catholic who finally realized he wouldn’t go to hell for eating meat on Friday!

The stock market is not the hub of capitalism, as some believe. In fact trading in bonds and foreign exchange dwarfs stock market trading. There are three alleged purposes for the stock market. The first is that it provides a way for some new companies to raise large amounts of capital. The second is that it provides an additional source of capital, if needed, after a company has gone public, through a secondary issue of stock into the marketplace. And third, it provides a measure of the “market value” of a company when one company decides to buy another, through an acquisition or merger.

In the first case, a company basically sells its soul in an initial public offering (IPO). This is the process of “going public.” It raises millions of dollars with the benefit of not having to pay the money back to anyone – it’s not a loan. But going public does affect the soul of the company because everything the company now does must be done in public under the scrutiny of the government and the shareholders. This is not necessarily good. The simplest example of the negative aspect of being a public company is that the managers of a private company have the freedom to make rational decisions. They can decide to lower their profit margin - to invest in new people or equipment or to avoid a layoff, for example - without causing any impact on an arbitrary stock price. I have been in situations where we did just that.

The real incentive to go public is the large amounts of money the financial backers and each employee of the company, not just the managers, can make because of their stock options. The goal of most new startup companies is to go public for that reason, and the case can be made that it creates very strong incentives for the employees to work diligently to make the company a success. But when big money is the ultimate goal, the law of unintended consequences often bares its fangs.

The case of the secondary stock offering is simple – more stock sold in the public market equals more money in the company’s bank account. But it obviously drives the company to keep the stock price high now if it plans to sell more stock later. The third purpose, providing an objective value of a company, has some relative validity in the way the game is played today. But it is not the only, nor necessarily the best, mechanism for that valuation. Consider Internet company stocks in 1999, for example. But none of the three purposes discussed above leads to significant financial activity compared to the vast amounts of money traded daily in the stock market. What no one wants you to know, and what only a small percentage of people understand, is that the stock market is nothing more than a big gambling casino with the large financial companies as primary owners, fund mangers as

the dealers, and stock analysts as the lounge singers. Large and small investors wander among the various game tables with the only real difference being the cash needed to bankroll one of the games. In the broadest sense, the stock market provides no real productive value to an economy.

1. Stocks Support Company Growth – Not: Whose IPO Is It Anyway?

Both civilians and professional apologists would probably say that the stock market raises capital for investment. *In fact it doesn't*. Between 1981 and early 1996, U.S. nonfinancial corporations retired over $700 billion more in stock than they issued, thanks to takeovers and buybacks. Most of the daily trading in the stock market is of *existing* shares, not newly issued ones. Over the long haul, almost all corporate capital expenditures are internally financed, through profits and depreciation allowances. Of course, some individual firms do issue stock to raise money, but surprisingly little of that goes to real investment either. The process we all hear about is an Initial Public Offering (IPO). However, once the IPO takes place, the stock, mostly “common stock” which often pays no dividends if the company is small, is traded in the “secondary” stock market (98% of NYSE and almost all of NASDAQ is common stock). *This means that the stock is traded among individuals with no real connection to the original company*.

I was a senior manager in a startup telecommunications company that went through an IPO. I have to admit that I felt the power of the dark side of that abstract *Homo economicus*. After almost four years of intensely hard work (often 10 hour days, 6 day weeks), every employee stood to make a lot of money, and many would become quite wealthy (a couple of dozen millionaires), at least on paper.
A company doesn’t sell its stock on the open stock market. In reality, a consortium of investment banking and brokerage firms (the underwriters) helps determine the amount of stock and the guaranteed initial price of the stock to be offered (called “taking the company public”). The underwriters then buy the stock from the company at the guaranteed IPO price (for example, 5 million shares at $25 per share for $125 million to the company). Once that happens the company, as a company, has no more special ownership of the stock – it has the money in the bank. But individual employees in the company, especially senior management, with thousands or tens of thousands of stock option shares (each at a cost anywhere from a nickel to a dollar a share), have an extremely keen personal interest in the outcome of the IPO. The final price in the market is what they will get for their shares when they are finally able to sell them (usually over a four-year vesting period).

Take a real life example. An engineer who joins a startup company may get an option for 5,000 shares at $0.05 per share. He or she works incredibly hard for 3 or 4 years (Thanksgiving, Christmas, and Easter holidays included). The stock splits once before the IPO and once after the IPO. Our engineer now has 20,000 shares at $0.0125 per share. In the boom times the stock is at $42 per share and the engineer is looking at $840,000 profit, before taxes. (However, if the stock crashes to $4 per share, as this one did less than two years later, the profit drops to only $80,000.) Perform the same calculation for a senior manager who joined the company at the same time as the engineer but got an original option for 20,000 shares! Even assembly workers and test technicians received stock options worth tens of thousands of dollars. Many people bought new cars for cash after the IPO. Although not as

extreme, normal profit sharing and stock option plans in established companies can also be very strong incentives to drive up profits and stock prices at all costs, especially for top management.

The original underwriters also have a deep interest in the IPO because they were the ones who actually paid the initial price and will only make a profit if the price of the shares increases (for example, to $35 per share, for a $50 million profit on the original five million shares) as they are sold into the open stock market. Of course, the members of this investment group are also usually members of the initial capital financing of the IPO company and so may also own millions of low-priced stock option shares from their initial investment in the startup. For example, if the IPO is for five million shares, there may be an additional thirty million shares, at an average cost of $1, in the hands of employees and the financial backers. (Exercise: multiply thirty million by $35.) Although the company makes a significant amount of money in the initial round, the large financial market players are the big winners in the game.

How the IPO stock is initially priced is somewhat esoteric, but is based on the company's multi-year plan for revenue and profit growth. The more rapid the revenue and profit growth projected over the following three to five years, the higher the IPO price. In our case, the revenue and profit projections were so "aggressive" that it would be extremely difficult to grow the company as fast as the plan required - *doubling* in size every year for several years - which is known in the trade as a "stretch objective" or BHAG (Big, Hairy Ass Goal). Therefore, the employees of the company, including the managers, were trapped in a multiyear business plan primarily driven by the stock price desires of the large financial corporations, even though abetted by their own personal desires.

To be fair, we all took part in the planning process, and we knew it would be tough. However, aside from the "rah-rah" of how much better we were than the competition, of how well we could meet the "challenge" of an "aggressive growth plan", of exciting and interesting career opportunities for all employees, the final driving force which shaped all "reality" was the stock price and how much money everyone personally would make over a relatively short time frame. The stock price did increase beyond our wildest dreams, but wild dreams can lead to wild actions. Working all night for days is common near the end of a quarter. To guarantee high revenues, there were times the V.P. of Engineering tested circuit boards in the Test Department, and the CEO helped pack boxes in the Shipping Department. And it wasn't because of egalitarianism or because the customer necessarily needed the product. Customers were often asked to accept shipments early so the quarterly numbers could be met. This type of activity is not unique in the corporate world.

This is one example of how the short term profit requirements of financial markets control even relatively environmentally benign telecommunications companies, including the intelligent and usually socially-conscious people in those corporations. It gives an insight into the forces driving extractive industries like lumber and mining or the cultural-imperialist corporations of fast food and fashion.

2. The Small Investor: Gambler/Sucker/Believer (Choose One)

Despite the stories about delivery drivers getting rich off stocks traded online, the boom has bypassed most Americans. As of 2015, 40 percent of households owned stock directly and indirectly - including

through a mutual fund, individual retirement account and defined contribution pension plan, for example. This is a significant increase from 32 percent in 1989, but still less than half of all households.

A growing number of Americans own stock, but most still don't own much. Less than one-third of households (29 percent) owned stock worth more than $5,000 in 1995. Almost 90 percent of the value of all stocks and mutual funds owned by households was in the hands of the top 10 percent. Wealth projections through 1997 suggest that 86 percent of the benefits of the increase in the stock market between 1989 and 1997 went to the richest 10 percent of households, with 42 percent going to the top 1 percent alone.

But what drives individual stocks? Again, especially since it's a casino, it's simply a perception of a company or industry segment. If I think a stock will go up because I think other people will think it will go up, I buy now. When it does goes up, I sell, take my profits, and look for something else I think will go up. If it goes down, I sell, take my losses against my income tax, and look for something else I think will go up. Since it's so simple, a ritual has grown up around this activity to make it seem complex, scientific, or logical. The mythmakers will say that a company has a value based on its future revenues and profits. This is called determining the "market fundamentals" of a company.
Through "analysis" the "professionals" will judge the future sales projections in a company's "target market", their potential profitability based on their "efficiency", the capability of their "management team" to meet their plan, and peg a stock price. Any stock price is essentially arbitrary. The final driver for the stock to go up or down over time is primarily the change in short term profitability of the company which drives the herd mentality of the market players.

So why do normal people invest in the stock market? Many have no choice since their pension funds and 401K money is invested in stocks but not controlled by them. For others with a choice, it's not just raw greed, but a "reasonable" desire to have more. If others have done it, why can't I? But there are risks. Say you have $10,000 in a CD at 5%, you make $500 interest in a year with no risk. With a CD from a bank you actually get the $500 deposited in your bank account at the end of the year, as well as your principal back, for a new total of $10,500. Then you can decide to buy another CD or not.

But the financial media tell you that only conservative little old ladies own CDs and you can get twice the return by buying stock. If you buy 500 shares of some stock selling at $20 per share, you've now fully invested your $10,000. If you're lucky, the stock goes up $2 (or 10%) during the year and you "make" $1,000 (instead of the CD's $500). But remember you only get the money if you now sell the stock. And typical stocks are notorious for movements of several dollars at a time. At the end of the year the stock may just as likely be selling for only $18 per share and your original investment is now down to only $9,000. You lost $1,000 by trying to make an additional $500. Some gamble if you really need your money! Mutual funds do limit your risk by spreading it over many more stocks, but the principle is the same.