

# Outside The Beltstreet

July 2004

## This Issue

Now You Don't See It	1
Buffett on Stock Options	2
The Eternal Optimist	2
Technicals	3
Guitars and Picasso	3
Jan. vs. May Cash Flows	4
Intel. Where next?	4

## Now You Don't See It, Now You Don't

When it comes to stock options, corporate leadership has fought very hard since the early 90's to hide a major deceptive devise when looking at their books. The item, stock options. What would be the effect of having an expense to the corporation not show up as an expense....now or later? Believe it or not, corporations do just that with the payment of stock options. Consider this explanation in a report prepared by the Levy Institute Forecasting Center.

"Under current accounting conventions, the granting of such an option to an employee is not considered an expense. This is the case even though the value of the grant can be readily calculated and even through the grant is in lieu of the payment of a like amount of wages or other traditional forms of compensation.

Because the granting of an option is not considered an expense, it does not lower the profits of the firm. Moreover, reported earnings are not reduced in the future when the option is exercised. The exercise of the option is looked on as a stock transaction and as such it does not effect the income statement." (1)

So if you pay your executives in stock options, primarily non-qualified options, then you can inflate your earnings. But surely this is a recent discovery, right? Guess again.

"In 1993, corporate lobbyist buried a proposal that would have forced companies to reveal the cost of the stock options they were issuing to their top executives." (2)

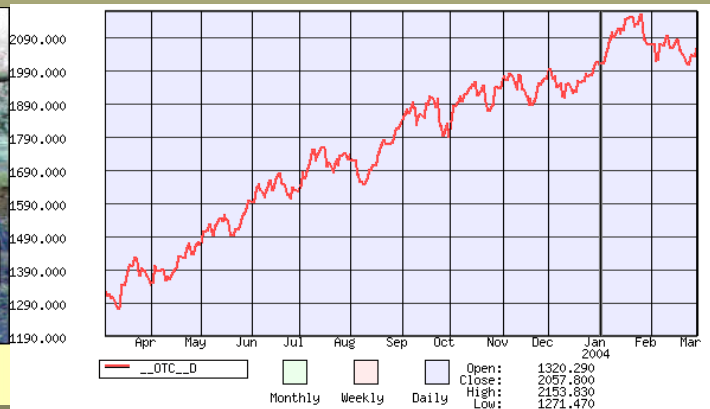
"Some of the most powerful CEO's in Corporate America had lined up to fight FASB's (the industry's accounting standard) reform. (3) Even Congressman Joseph Lieberman had introduced legislation that would have barred the SEC from enforcing FASB's proposal if and when it became a final rule." (4) The proponents for keeping the bogus bookkeeping system knew that if options were shown, "earnings would fall, and prices would follow".(5)

## Special points of interest:

- James Chanos' remarks
- Warren Buffett's remarks
- Wealthy Speak
- Advisors Speak
- Picasso Speaks!
- Cash Flows speak loudest



Photos on pgs.1,3 —Elliotwave.com



After this journey in the NASDAQ from 3/1/03-3/1/04, what do you think the next 12 month period will look like? Do you still remember 3/1/99-3/1/00? I will never forget what followed.

## Now You Don't See It, Now You Don't

So why is this such an issue today, and why should I know this as an investor. Because, once again, the FASB rules are being heatedly debated over this very issue. Starting in 2005, less than six months away, stock options are to be shown as an expense. However there is a bill in Congress to "tweak" these rules even today. Without going into details consider these remarks by Warren Buffett, who has been very vocal for years against this type of deceit.

"I've been investing for 62 years and I've yet to meet a stock that doesn't fluctuate [the current bill proposes that a fixed price is chosen and no attempt be made to estimate long term rise and fall of share prices]. The only reason for making such Alice-in-Wonderland assumptions is to significantly **understate** the value of the few options that the House wants covered. This undervaluation, in turn, enables chief executives to lie about what they are truly being paid and **overstate** the earnings of the companies they run." (*emphasis added*) (6)

So how could this affect stock prices if enacted in 2004 without the manipulation currently being attempted in Congress. According to the CSFB, the 2003 earnings of the S&P500 companies would have been 8% lower, and Bear Stearns research indicated that the NASDAQ 100 earnings would have plunged 44%! (7) Amazingly, NASDAQ investors at the end of the second quarter hit an **all time low** in the NASDAQ VXN, volatility index. (8) In other words, this is a sign that investors are very complacent.

- (1) *Levy Institute Forecasting Center, September 2001- "Two Decades of Overstated Corporate Earnings."*
- (2) *Comments of James Chanos, famous short seller, page 123, **Bull, A History of the Boom, 1982-1999**, by Maggie Mahar, pub.2003*
- (3) *Bull, page 124*
- (4) *Bull, page 131*
- (5) *Bull, page 145*
- (6) *"Buffett attacks options bill", July 6,2004 CNN.com*
- (7) *Zeal Intelligence, July 2004, page 1, by Adam Hamilton*
- (8) *Zeal Intelligence, page 1*



**"...and overstate earnings of the companies they run."**

**Warren Buffett, July 2004**

### **"I Am An Eternal Optimist."**

While being optimistic is a great way to live, it can prove fatal when it comes to investing. Since most investing is done as a member of the "herd", optimism (or the lack thereof) can give you a great clue as to long term market tops and bottoms. Consider these comments below.

"It is now 228 weeks since the Dow's January 2000 peak. Despite the index's 38% decline during this period, the S&P 500's 50% decline, and the NASDAQ's 78% decline. Incredibly in all but 9 weeks bulls have outnumbered bears. That's 96% of the time!"

*The Elliot Wave Financial Forecast, May 2004, [www.elliottwave.com](http://www.elliottwave.com)*

"Wealthy Americans have grown more optimistic about the economy in the last six months, according to an April Survey, conducted by market research firm American Affluence Research Center."

*Wealth Management Letter, Wendy Davis, Editor for Trust & Estates, May 19, 2004*

**Technicals**

Beginning of Bear (Wave I Down)		
	Date	Level
Dow Jones Industrial	1/14/2000	11,722
NASDAQ Composite	3/10/2000	5,048

Last Major Low (Wave II Up)		
	Date	Level
Dow Jones Industrial	10/9/2002	7,286
NASDAQ Composite	10/9/2002	1,114

2004 Highs (Start of Wave III Down)		
	Date	Level
Dow Jones Industrial	2/19/2004	10,753
NASDAQ Composite	1/26/2004	2,153

Current Levels (In Wave III Down)		
	Date	Level
Dow Jones Industrial	7/21/2004	10,046
NASDAQ Composite	7/21/2004	1,874

Public Confidence and Market Levels		
	10/2002	1/2004
Yale Consumer C. Index	85.5	95.5
Mich. Consumer C. Index	80.6 (10 yr. Low)	103.8 (15 yr high)

**“Never Follow the Herd”** One of the ten maxims of Sir John Templeton

**Signs of optimism or pessimism? Market top or bottom?**

“One of Eric Clapton’s guitar’s fetched \$959,500 at an auction Thursday at Christie’s in New York, easily eclipsing the record set by the legendary rock musician five years ago, reports Billboard Online. At a 1999 auction, an anonymous bidder paid what was then a record \$497,000 for another of Mt. Clapton’s guitars.”  
*Dallas Morning News, June 27,2004, pg 3A.*

“In May, the art world had its biggest month since May 1990. In addition to the all-time record price for a painting , \$104.2 million for Picasso’s “Boy with a Pipe”, (see to right), new records were set for a host of contemporary artist such as Jackson Pollock and 13 others.”  
*Elliot Wave Financial Forecast, June 2004, [www.elliottwave.com](http://www.elliottwave.com)*



**Texas sunset in the Fall.**

Photo by: Grant Wakefield

**“all time record for a painting, \$104.2 Million..”**



Feel free to send any question you may have to: [doug@genadv.com](mailto:doug@genadv.com)

## Fooled by Randomness, Nassim Nicholas Taleb

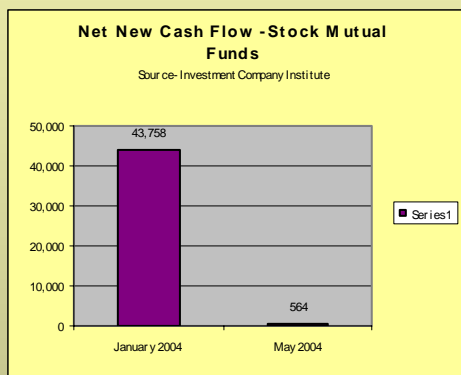
“Solon [a Greek Philosopher] was wise enough to get the following point; that which came with the help of luck could be taken away by luck (and often rapidly and unexpectedly at that). The flipside, which deserves to be considered as well (in fact it is even more of our concern), is that things that come with little help from luck are more resistant to randomness....Solon even understood another linked problem, which I call the ‘skewness’ issue; it does not matter how frequently something succeeds if failure is too costly to bear.”

### **Three Questions you should ask your advisor(s) today.**

1- *If my account declines, how long do you think it will take for the markets to bring it back up?*

2- *What strategies could I use to make money (NO, NOT REDUCE LOSSES) during a down market?*

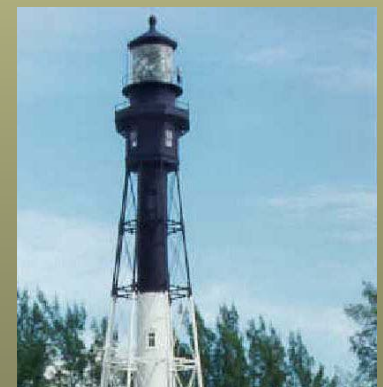
3- *I saw that Intel declined over 10% in a day on July 14 and is down 27.4% YTD as of July 20th. Should this be a concern for the overall markets, especially the NASDAQ?*



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