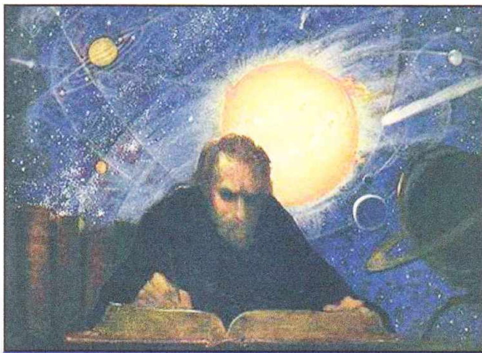

Random Thoughts

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The American Comedy

The current lesson history is teaching us is that we don't learn from history. I'm talking about the current wave of stock market / corporate scandals. The last time we had something like the 90's stock market bubble was just before the Great Depression in the Twenties. Just like now, the country was coming off of a long bull market that drove stock prices to totally unrealistic levels. Just like now, then we had a rash of market scandals and bankruptcies. Why?

Well when the market is going up no one wants anyone to do anything that might mess it up. After all we were all getting rich on stocks that went from $10 to $200 a share in 30 days. The old rules of company value and cautious financial behavior were part of the "old economy" and totally irrelevant in the "new economy" of the Internet and stocks with multiples in triple digits. The government can act to cool off a hyper active market by close scrutiny of corporate accounting and controlling interest rates.

In this case we had a President whose survival in office was based solely on the good economy. Needless to say the SEC and the Justice Department were not encouraged to aggressively pursue possible market problems. The SEC, principal market policeman, actually had its budget, in real dollars, cut. In all fairness to Mr. Clinton it would have taken someone of exceptional political bravery to have acted to cool down the market.

Unfortunately the real world has a way of intruding on human affairs and the illusionary nature of the highflying Internet companies' value became obvious as they lost billions of dollars of their investors money. In fact they lost so much money that even the most optimistic venture capitalists finally realized they were a lost battle and stopped funding them.

Suddenly companies with market caps in the billions were worth nothing. Investors took a blood bath. But that wasn't the real problem. The real problems were two fold: First all the real companies, like Sun, Corning and Intel that supplied equipment to the Internet market no longer had customers. Second a lot of otherwise solid companies had done some very stupid things, accounting wise, to try and compete with the Internet companies.

It's very hard to explain to the investment community that a solid 7% growth rate from real products is better then a 20% or 200% growth rate based on estimated earnings in five years. So otherwise solid companies run by sensible men started doing crazy things like artificially creating income by swapping hats with each other. I expect to see a lot of interesting stuff surface in the next few months.

Unfortunately we will probably get some hasty, as in repented at leisure, laws passed to make everyone feel good while very little actually changes for the good. It will get harder and more expensive to do business in this country because of the increased regulation. It won't do much to prevent real corporate fraud, which is already very rare.

What's needed is a change in attitude toward the market away from the current short-term high gain expectation to a long-term steady growth model. But that's not going to happen. We are talking about human nature after all.

WorldCom

Many people seem to be lumping WorldCom and Enron together. This is a mistake since there is very little in common between the two companies problems. Enron, it looks to me, perpetuated something very close to outright fraud to create the appearance of being a profitable company in a viable business. WorldCom was in a viable business and got caught in a serious business problem. Let me explain that.

The telecom industry thought it had died and gone to heaven when the Internet boom started. Here was a whole new market for communications that appeared unlimited. There was a new business starting every week predicting that it would have millions of customers all of whom would need to use telecom to use the companies' products.

At the same time there was a boom in the use of cell phones and long distance. It was obvious that the world was going to need a lot of communications and that meant a lot of fiber in the ground and massive physical infra structure to support all those calls and data links. It was so obvious that banks bent over backwards to loan money to telecom companies so they could build their networks. And build they did at an incredible pace.

There are two ways to build a large network. The old slow way by constructing buildings and hiring people. Or, if there are people willing to loan you a lot of money, you can do it a lot faster by buying other companies. That way you increase the size of your company while simultaneously eliminating your competitors. If you have lots of money it's a great way to grow. (As a side note: Those of you who followed my part in creating Nova Information Systems may realize this was the path we took.)

The banks didn't worry about those companies ability to pay back the loans because everyone knew they were going to make all that money off the Internet and the New Economy. Funny how things that everyone knows can turn out to show how little people know.

Two things happened at about the same time: the Internet bubble went pop and a new technology, allowing multiple wavelengths of laser light to be used on the same fiber, was developed that increased the capacity of existing fiber by orders of magnitude. Suddenly telecom companies found themselves with vast amounts of unused capacity and even vaster debts. Financial models that had showed companies making nice profits on their capital investments now hinted at the impossibility of paying back all the money they had borrowed.

This, and the critical need to fill up all that unused capacity, sparked a price war that drove company profits down toward zero. That's why you can buy AT&T for less then $10 a share. That's also why AT&T, Lucent, Northern Telecom and several other smaller telecoms have a great chance of going bankrupt. Prices are simply too low and companies have too much debt. It's not complicated.

This is why WorldCom stock dropped from over $50 a share to about $1.18. Not fraud by company execs or lies about revenue and cost. It was a real business problem. The same one that may get AT&T.

A very important point: While Enron execs were selling stock like crazy, WorldCom's CEO borrowed millions of dollars to buy stock. His faith in the company will probably cost him every penny he's ever made. In the interest of full disclosure, I should mention that Bernie Ebbers was on Nova's board of directors so I have talked with him and like him.

So here we have a company with massive debt, falling profits and a market that's cooling off rapidly. Even worse they have several large debts coming due and need to raise lots of money to stay in business. When things are a mess the stress can get really bad and people make bad decisions. In this case it seems the WorldCom CFO, who I only meet once, moved some money from the expense column to the long-term capital column on the corporate balance sheet.

That made the companies profits look better then they really were so that banks would be more willing to extend it credit. In a pre Enron world it might even have worked.

Was that the only financial irregularity in the company? Not a chance! They did a lot of acquisitions and never really digested any of them. WorldCom has multiple billing systems, hundreds of contracts with vendors, thousands of contracts with customers and employees scattered all over the world.

There are bound to be problems lurking in that mess. At a guess things like: misstated income, customers billed wrong, expenses capitalized when they should have been expensed, violations of government rules. All the things you will find at any large company if you look hard enough but magnified by the incredible rate at which WorldCom grew.

On the bright side, bankruptcy could free WorldCom of its debt and turn it into a profitable company. If that does happen, I predict a rash of telecom bankruptcies as other companies shed their debt so they can compete with the new WorldCom.

Do I sound sympathetic toward their problems? Disinterested? Balanced? What you may not realize reading this is just how balanced I'm being as I write it. WorldCom accounts for over 90% of my loses in the market. I knew the company and it's people and I held a large position in it's stock. Bankruptcy will wipe that investment out and leave me with a total lose in six figures.

This is the "risk" part of being an investor in a company. The part the people who complain about all the money the "rich" make in the market tend to forget about. Oh, well.

The Enron 401(k)

I've read quite a bit about the Enron 401(k) mess and believed very little of it. All the wild charges like "the employees were forced to buy company stock" and "the Enron managers looted the 401(k) plan" simple did not seem realistic to me. Even the greediest of corporate executives usually make sure they stay just this side of any action that can result in a prolonged, involuntary, stay in one of the Federal Governments many "resorts."

Mind you there have been lots of events over the years that I found hard to believe but turned out to be true. In this case my skepticism came from knowing how these plans work and, most of all, not seeing any possible motive for the Enron execs shafting their employee's.

Oh, I know some people do awful things just for the fun of it, but most of the time there's a profit motive hiding in there somewhere. In this case I just couldn't see one.

Public companies in this country have very little privacy so it's possible for a determined individual to find out almost anything about their inner workings. In this case there has been so much publicity generated by the companies problems that the data turned out to be very easy to find. Let me summarize the facts as I found them.

The plan. The Enron 401(k) plan was pretty vanilla. It offered the employees about 20 options for investing in the fund one of which was Enron stock.

Company contributions. The company had a matching program where they would contribute stock equivalent to 50 percent of the employee's contribution up to a maximum of 6% of the employee's salary. This free stock could not be sold until the employee turned 50.

This is all pretty standard. The investment options for the plan members were diverse and included "safe" money market funds. Enron stock was only one option. The restriction on selling the companies matching stock was not at all unusual. Many companies place restrictions on the stock they contribute to 401(k) plans.

So what about all the things we've been hearing? Let's take them one at a time:

Employees were forced to buy Enron stock. There was nothing in the plan that forced any employee to put one penny of their 401(k) contributions into Enron stock. They could choose any of the plan options. Watching testimony on CSPAN I heard one Enron employee state that he had been advised, by a plan manager, not to put so much of his money in company stock. He had ignored the advice.

Employees were "encouraged" to buy Enron stock. This one is tough to prove or disprove. There were somewhere around 11,000 employees participating in the plan many of whom were 'over invested' in Enron stock and each one of them probably has his own story. Typically the employees of a company, especially the senior ones, feel like they work for a good company and that owning it's stock is a good thing. What I think we can say is that there was no systematic program to push Enron stock to its employees. Nor can I imagine any way in which the company could have benefited from selling stock to its employees. The public market was buying every share that came on the market.

Enron looted the 401(k). This one is simply not true. There is no evidence that one penny was taken out of the 401(k). In fact, I can't find any basis for this accusation anywhere. It seems to have been entirely made up.

Enron employees were not allowed to sell Enron stock. Other then the matching stock contributed by the company, employees could sell Enron stock in their 401(k) accounts anytime. Interestingly many choose not to even after the companies problems came to light.

The Enron 401(k) was frozen to stop employees from selling stock. Some time in early February 2001 Enron decided to transfer the management of its 401(k) to an outside firm and requested proposals from 3rd party management firms. During the transfer employee accounts would be frozen. Just how long the lock out period was is the subject of some debate, not to mention a few lawsuits, but it was approximately 12 trading days from Oct 26th to Nov 12th. Employees where notified on Oct 4th by mail and could have made trades before the lockout took affect.

The timing was awful since the stock fell from $13.81 to $9.98 during this time. Note that it *did not* go to zero. Testimony indicates that Enron discussed the possibility of postponing the transfer due to the problems the company was having but decided they had no choice since it had already been announced to it's employees. In hindsight not a very good decision.

Enron execs were allowed to sell when employees were not. The lock out affected everyone in the plan there *was no exception for executives.* Both executives and employees could have sold Enron stock they owned outside of the 401(k).

Enron employee's lost "everything" in the 401(k). Not true. Enron stock comprised somewhere between 60 to 65% of the total value of the 401(k) plan. The rest consisted mostly of mutual funds. The 35-40% of the fund not invested in Enron stock was not affected and is still there. Yes, some very unwise individuals chose to put all their money in Enron stock and lost all of it. More prudent investors lost only the company matching stock that they never paid for to start with.

Enron executives profited from freezing the 401(k). This one is a little mind boggling since there really isn't anyway stopping employees from selling stock made money for anyone else. With all the selling that was going on in the general market, the 401(k) stock would have been a drop in the bucket.

Enron employees would not have lost their money if they could have sold stock. Well based on other companies whose stock has plummeted, like Lucent and Ford, the majority of the people would have ridden the stock into the ground and lost their money anyway. *Remember, the stock had already fallen by something like $70 a share before the lock out and was still worth $9.98 when it ended.* If they didn't sell while it dropped down to $13.81 why do we assume they would have sold when it dropped from $13.81 to $9.98? Yes they could not have sold the company contributed stock but neither could the execs and *it was free to start with.*

To sum up in one sentence: Almost everything you've heard about the Enron 401(k) was false or very misleading!

The Enron 401(k) seems to have been run as well, if not better, then most and, as of 6/7/02, there has been no evidence of any wrong doing associated with the plan. It was almost exactly what I expected to find. Almost, there was one very interesting point that no one seems to have mentioned.

Where did all that money the good employees of Enron lost due to the evil executives actions come from?

Lets start with a little simple arithmetic. Enron came into existence in 1985 but was a very small company until around 1990. So let's assume you joined the 401(k) plan in 1990 and contributed the maximum amount allowed by law to your plan. By 2001 you would have put $115,500 into the plan. Not many people can afford to put $10,500 a year into savings so the real number is probably closer to half that or about $58,000.

So where did the people, the ordinary employees shafted by the evil executives, get all those "hundreds of thousands" of dollars they lost?

The market? Maybe, but assuming a really exceptional growth rate of 20% a year for the entire time and a contribution of $5,250 a year, the account would only be worth about $210,000. Sounds good? Yeah, too good, you have to take into account that the mutual funds making those wonderful gains in the 90s lost a lot of that money in the 2000-2001 time frame. If you came out of it with half, you would have done pretty well.

More realistically, you might have earned 7% a year off of investments that still had some value at the end of 2000. That means your account would have been worth about $94,000. Still pretty good but not "hundreds of thousands of dollars."

Oh, if they had put their money in the general market, they wouldn't have lost it in the Enron collapse because they wouldn't have owned much, if any, Enron stock. So that's not where all the lost money came from.

The money was there, some of the employee accounts where worth hundreds of thousands. So where did it come from?

"Wait a minute" you say, "It was in all that Enron stock. It grew by much more the 20% a year."

Well you got me. It was in Enron stock. Enron stock who's value was grossly inflated by the, possibly criminal or fraudulent, actions of all those evil executives. ***Or to put it another way, the money the employees' lost was only there because of the, possibly criminal or fraudulent, actions of all those evil executives!***

If they had all been honest and played strictly by the rules, the employees would not have lost their fantastic gains because the money would never have been there in the first place.

Enron stock hit it's high of about $90 a share some time in August 2000. It then slowly fell until March 2001. The infamous "401(k) lock out" was only 10 days of that time period. During the entire rest of that time employee's could have followed the company executives example and taken their profits off of the Enron stock, bought with their own money, in their accounts. The selling by execs was not secret; it was public record. The analysis qualms about Enron's income were widely talked of on popular cable financial shows and reported in major newspaper's financial sections.

Instead they hung onto their stock hoping for even more unrealistic gains. It didn't work and they lost their investments in Enron stock. That is the usual result of showing poor judgment and/or being too greedy. Not some evil plot by company executives who want to destroy their employees lives just for the fun of it.

Of course, "Greedy employees lose risky investments" wouldn't sound nearly as good as "Greedy executives loot employee savings while making millions." Pity the truth makes such a poor headline.