DiNuzzo Index Advisors, Inc.

FEE-ONLY WEALTH MANAGERS

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An IPO to Post Home About

We're hearing a lot about the Facebook initial public offering, so this might be a good time to experience a moment of laughter about our newest cultural phenomenon. Click this link for your own special guide to good Facebook manners: http://www.youtube.com/watch?v=iROYzrm5SBM.

Later this week, investors will have the opportunity to pay between $28 to $35 a share to own a piece of the addictive social networking service. People everywhere are clamoring to get at least a few of the 337.5 million shares that will be offered by Morgan Stanley and 30 other underwriters.

Most of you know that an initial public offering, or IPO, is the first time a company sells its stock to the public at large. "To the public" is something of a misnomer, however. Most of the time, the large brokerage firm that serves as the IPO underwriter will only make these new shares available to its largest institutional customers. The rest of us have to buy on the open market (Facebook shares will trade on the NASDAQ exchange), and therein lies the rub. In many cases, those initial buyers can make a significant profit simply by flipping their shares at much higher prices to people like you and me. All too often, this buying frenzy leads to long-term disappointment.

The numbers tell an interesting story. Research by University of Florida finance professor John Ritter shows that from 1980 through 2010, the three year performance of IPOs that had been bought on the first day has lagged the broad market by an average of 20%.

Recent social media IPOs have not even done this well. Yandex, Russia's most popular search engine company is down 20.8% from its IPO price last May. Zynga, which raised $1 billion, last December, is down 5%, while Renren ("the Facebook of China") has so far lost 76.4% of its IPO investors' initial outlay. Pandora Media is down 37.4% from its June 2011 IPO price. LinkedIn and Groupon are the exceptions to this depressing story; they are up 37.2% and 13.1% respectively since their IPOs.

But these figures only apply to those who were fortunate enough to buy at the initial price. Ritter has calculated that ordinary investors who aren't on the investment bank's speed dial have paid much higher prices for their shares--and, of course, suffered correspondingly higher losses. When institutions flipped their shares on the first day of trading for the 1,096 IPOs sold from 2001 to 2011, ordinary investors paid, on average, 11.7% more than the IPO price offered to institutions and friends of the brokerage underwriter. (11.7% in one trading day translates into roughly a 3,200% annual return.) In the frothy 1999-2000 period, ordinary shareholders had to pay an astonishing 64.5% premium to get in "on the ground floor." You don't even want to know what that would look like on an annualized basis. Going back a little further, from 1990 through 1998, the premium that mortals paid for IPO shares averaged 14.8% above the initial share price. This is not a short-term trend.

There are a few other warning signs to consider. If the Facebook IPO comes in at the widely-reported target price of $35 a share, those institutional investors will be paying a whopping 143.71 times the company's earnings per share, based on its 2011 net income of $668 million. If the share price bumps up, the aftermarket buyers might be paying closer to 200 times earnings per share--or about nine times the PE level of the stocks that make up the Standard & Poor's 500 index.

To put that price difference in perspective, consider whether you would go to the grocery store and buy any of the various cartons of eggs for 99 cents, or those cartons on the side that cost $8.91 apiece--or about 75 cents an egg. Would you buy a quart of your regular brand of milk for $1.50, or load up your shopping cart with the special new brand at $13.50 a quart? If its IPO goes well, Facebook, as a company, will be priced at a higher total market value than Visa, Inc., McDonald's, the Walt Disney Company, Home Depot or American Express. It would be worth more than Starbucks, Dow Chemical and Panasonic COMBINED.

Obviously, no company is worth this kind of valuation unless investors are pretty sure it will grow its revenues rapidly in the future, the way Amazon did after its IPO almost exactly 15 years ago. That's why it is so interesting to read in Facebook's most recent S-1 filing with the Securities and Exchange Commission that the company's income actually *fell* in the first quarter of 2011. Net income and earnings per share have also taken a tumble. This may be one more example of the truism among professional investors, that not all good or interesting companies are good or interesting investments. You won't get access to Facebook shares at the IPO price, but even if they were offered to you, you should probably take a pass. And then post your decision on the wall of some of your closest friends.

Whale-Sized Losses

Large investment banks and brokerage firms are in the news again, with word that J.P. Morgan Chase suffered a $2 billion loss while trading for its own investment portfolio. If you're inclined to be amused by such things, word had apparently leaked out weeks before the losses were spotted that a mysterious individual dubbed "The London Whale"--who we now know is Bruno Michel Iksil--was taking strangely large positions in credit default swaps linked to corporate bonds. Other traders reported the unusual market activities to the Wall Street Journal, and four days after the article was published, on April 14, J.P. Morgan executives stepped in and stopped the trading activity.

The story prompted some to speculate that the firm's crack risk management department stayed diligently on top of the firm's speculative trading activities by carefully reading the newspaper.

But the lesson that was lost, amid the calls for new regulation and pronouncements that banks were too big to fail and too reliant on bailouts, is that once again a large brokerage firm was making huge bets and also advising customers on their investments. When a large institution trades into and out of the markets for its own profit, it sets up the most basic conflict of interest in its dealings with the investors who are receiving the advice of its brokers. If the firm made the mistake of investing in a dog stock that isn't likely to go up in value, or if the research department determines that a certain company whose stock the firm owns is about to report unfavorable news or deteriorating financials, then the brokers are told that what the company wants to unload is a wonderful "investment opportunity" for their customers.

Some resist acting on these blatant attacks on their customers, but--as evidenced by the actual volume of trading for the brokerage community's own accounts--many do not. It's a little like the real estate broker who spots a nice piece of property selling at a terrific bargain. Is he more likely to call his customers, or find a way to buy the property for himself?

Fortunately, registered investment advisors with the Securities and Exchange Commission--unlike brokerage firms--are strictly prohibited from these kinds of conflicts, and we embrace that position. It genuinely would not occur to most financial planning professionals to bet against clients or try to sell you something that we wanted to get rid of in our own portfolio, not because the regulators might find out, but because it is visibly the wrong way to serve the public and the community.

When the 2008 meltdown swept through the financial world, former Federal Reserve Chairman Paul Volker proposed that brokerage firms and lending institutions be banned from trading in their own accounts and the so-called "Volker Rule" bounced around Congress for a full year. Industry lobbyists finally convinced our elected representatives that it was a very bad idea to force brokers to stop speculating in exotic securities and simply give good investment advice to their customers, or to require banks to lend their money to businesses and consumers instead of making wild bets with it. What we didn't realize then, what J.P. Morgan's London Whale may have taught us, is that the consumer protections proposed in the Volker Rule might also be a great way to keep these large organizations solvent.

Safe Savings Rates

Here's a deceptively simple question: how much of your income should you save during your working years if you want to enjoy a comfortable retirement?

To answer the question definitively, you have to know how long you'll be working (and saving), how long you'll live in retirement, and what the investment returns will be both during the accumulation period and also throughout your retirement years.

Wade Pfau, a researcher who is currently director of macroeconomic policy program at the National Graduate Institute for Policy Studies (based in Tokyo, Japan), conducted an interesting study that tries to help us sort out the possibilities. To start with, Pfau assumed that a hypothetical person (let's call him Fred) would work for 30 years at a salary that goes up with the inflation rate, and then retire for 30 years. Each year, Fred would save the same percentage of his salary. Pfau also assumed that Fred would need 50% of his final year's income--on top of Social Security and any pension resources--to pay for retirement living expenses out of his portfolio.

In the first year of retirement, Fred would draw out 4% of his portfolio. After that, to maintain buying power, he would take out ever-higher amounts based on the inflation rate in each of the subsequent 29 years. For the entire 60 years, Fred's money is invested in an unsophisticated (but easy to calculate) portfolio consisting of 60% stocks and 40% bonds with a six-month maturity.

Then Pfau considered what would have happened for every rolling 60-year period from 1871 to the present and, looking backwards, calculated the percentage that Fred would have had to save to reach his goal.

The results? Pfau found that if Fred struggled to save and accumulate during a relentless bear market, he would often have a better-than-average chance of catching a bull market in retirement, and vice versa. The highest required yearly savings rate when he took into account the full 60 year period came to 16.62% for the unlucky person who entered the workforce in 1918. The more normal scenarios require Fred to save anywhere from 12% to 15% a year.

Of course, people who delay setting aside retirement money to later in life--if, for example, they start saving in their 40s and expect to retire at age 60--will see this savings percentage go up accordingly. Toward the end of his research report, Pfau discovered that if Fred only saved for 20 years, and expected a 30-year retirement, he should be prepared to set aside at least 30% of his annual income during this truncated savings period. On the other hand, if Fred set aside money for 40 years, his minimum savings rate drops dramatically, to between 6% and 14% percent.

It is important to recognize that this is a model, not a prediction of what will happen in the future. We don't know what future returns will be, either while people are putting money aside or during their golden years. Beyond that, we know that some people will spend more in their retirement years than their pre-retirement income, simply because they have more free time to enjoy.

Each person, and each sequence of years, is different, and requires more precise individual planning than any researcher can do in a broad study. But this study offers us a pretty good look at how the different variables can play out in the long lifespans we are enjoying today, a window into how easy, or hard, it can be to save for the third stage of our lives.

Sincerely,

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President, Founder, and Chief Investment Officer

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