



# FINANCIAL PREPAREDNESS

*"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen*

Issue #222  
May 16, 2025

## How Shares Outstanding Can Change

Among investors, there's a small group known as [chartists](#) who use charts of a securities historical prices to forecast its future trends. They employ technical analysis to look for price patterns and trends to identify signals. There are two major problems with this approach.

First, either they ignore or are not aware that the number of shares outstanding can (and does) change over time. For example, let's say the market capitalization of a company (the market's current judgement of a company's true intrinsic value) is \$100 million. Market cap is equal to the number of shares outstanding times the current market price of the stock. Let's say there are 1,000,000 shares outstanding, so the market price of the stock would be \$100 per share. Now let's say the number of shares increase to 1,200,000 (kind of an extreme example) and everything else remains the same, so the market cap of \$100 million shouldn't change. Since there are now more shares on the market, they are not as scarce, so the price must decline to \$83.33 (\$100 million divided by 1,200,000 shares). A chartist would interpret this as a dramatic event even though nothing changed except the number of shares.

The second major problem with technical analysis is that it assumes (or ignores) that nothing else is changing, such as investor sentiment, the company's performance and

prospects, the economy, interest rates, consumer preferences, competition, etc. Of course these factors are the primary determinants of securities prices, though for this issue, I will focus on the first problem above (changes in the number of shares outstanding).

I can think of three reasons why the number of a company's shares outstanding would increase (which is known as *dilution*). First, it's very common for companies to award stock options (calls) to management as part of their compensation, which gives them the right (but not the obligation) to buy a set number of shares at a fixed price (called the *strike price*) during a certain period of time. If the stock price rises above the strike price, the holders can exercise them at a profit. Let's say the market price of the stock is \$150 and the strike price is \$100. The option holder pays the company \$100 per share and receives the number of shares in the option grant. In this way, existing shareholders are diluted by the difference between the market price and the strike price.

Another reason a company's shares outstanding could increase is if it acquires another company and issues more shares to pay for some or all of the purchase price. Now if the purchase price is equal to the true intrinsic value of the acquired company, it shouldn't affect the stock price. However, acquiring companies almost always overpay (this almost always happens near the top of the market when times are good and sentiment is very high, and it's a way for a CEO to increase his compensation package [because he now has a lot more responsibility], plus it's a massive ego stroke). So overpaying for an acquisition is usually very dilutive to existing shareholders, which is why the stock price of an acquiring company usually drops when the deal is announced.

Finally, a company's shares outstanding would increase if it made a secondary offering to raise a lot of capital. Ideally, a company would do this when its stock price was very richly valued and investor sentiment for its stock was very high. However, in practice, often (or usually), a company does this as a last ditch attempt to avoid bankruptcy, when its stock price and investor sentiment are low, which would be very dilutive for existing shareholders.

Oftentimes a company will use its free cash flow to buy back some of its own shares, thus reducing the number outstanding and driving up the price. Why would a company do this? Well, a CEO might tell you that the company's stock is very undervalued, so using free cash flow to buy back shares (instead of say, using it pay dividends) would have the highest return on investment for that money. But remember those stock options from above? CEOs (and the rest of the management team) typically have at least some of them, sometimes a lot. And management can use share buybacks to drive up the price of the stock just before they exercise their stock options. It happens all the time, which is why I prefer equity-based compensation (where the manager/owners are also exposed to the same risks as the rest of the shareholders) instead of stock options (which have no risk).

During most of the years following the Great Financial Crisis in 2008, the Federal Reserve kept interest rates at close to 0%. These artificially low rates allowed companies to borrow massive amounts of money, and many of them used the loan proceeds to buy back their shares so executives could exercise their stock options at artificially high prices. Those executives are now retired, but most of the debt is still on these companies' balance

sheets.

So as an investor, I would prefer it if the number of shares outstanding would never change, either up or down. Before I buy a stock, I at least need to know what I'm getting into, so I have started keeping track of how much each company's shares outstanding have changed in recent years. I look at the percentage change of the diluted average trendline of the shares outstanding on a quarterly chart for the last decade. On the massive spreadsheet I use to track about 2,500 stocks, I keep this number close to the five- or ten-year high and low prices for the stock, which allows me to determine how seriously I should take those prices. The more that the number of shares outstanding have changed over the last decade, the less meaningful those prices are.

I should note that it's possible that the shares outstanding could increase due to say exercise of stock options, but also reduced by share buybacks, resulting in a number that makes it appear that the shares outstanding haven't changed much. I don't know of any practical way to detect this, but I do know that a large number for the slant of the trendline (either positive or negative) is *prima facie* evidence that there has been a significant change in the number of shares outstanding.

In a world of uncertainty and risk, the human brain is desperate to find a number—any number will do, no matter how irrelevant, as psychological studies have shown—and cling to it. Investors also almost always succumb to [the Money Illusion](#), where they assume that the value of say a dollar is the same as it was years ago. These factors make price charts appealing, because they seem to help make sense out of a chaotic world. But underneath those orderly charts, things are constantly changing, a small bit of which are the number of shares outstanding. For some reason, I have never seen a price chart that has been adjusted to reflect the number of shares outstanding.

I do think price charts have some value since securities prices are somewhat “sticky”; it could be said that prices have memory. This is due to the fact that the human brain is loss averse, so it doesn't like to realize losses. So most investors who suffer an unrealized capital loss will wait for the price to reach their cost basis before they sell, even if the underlying fundamentals of the company deteriorate and/or the dollar loses value in the meantime.

In conclusion, to the disappointment of this quantitative investor, investing must be more art and less science than I would prefer. Fortunately, my intuition can rely on my experience (investing since 1990, professionally since 1995) to help do what charts and spreadsheets can't.

## News You Can Use

[The Great Reset Just Got a North American Enforcer](#)

[Rogue Devices Found Hidden in Chinese Solar Panels](#)

[Newsletter Archive](#)

I would love to hear from you! If you have any comments, suggestions, insight/wisdom, or you'd like to share a great article, please leave a comment.

## Disclaimer

*The content of this newsletter is intended to be and should be used for informational/ educational purposes only. You should not assume that it is accurate or that following my recommendations will produce a positive result for you. You should either do your own research and analysis, or hire a qualified professional who is aware of the facts and circumstances of your individual situation.*

*Financial Preparedness LLC is not a registered investment advisor. I am not an attorney, accountant, doctor, nutritionist or psychologist. I am not YOUR financial planner or investment advisor, and you are not my client.*

*Investments carry risk, are not guaranteed, and do fluctuate in value, and you can lose your entire investment. Past performance is not indicative of future performance. You should not invest in something you don't understand, or put all of your eggs in one basket.*

*Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.*