



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

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Investing Illusions

The field of investing is full of illusions that distort reality, especially for human brains that are desperate for certainty in a world full of risks and unknowns. This week I wrote about some that you may have never considered.

First, most people fall for [the Money Illusion](#), which is the practice of measuring their income and wealth in nominal terms instead of real (inflation-adjusted) terms. So they think a dollar today is worth the same as it was a year ago. National governments take advantage of this by printing currency and using it to pay some of their expenses. The natives don't revolt due in part to the Money Illusion. The upshot is that even if the value of your securities have appreciated over time, the appreciation may still be less than the rate of inflation during that period (especially the real rate, not the rate put out by the federal government, the purpose of which is to get politicians reelected).

Second, although the value of stocks change over time based on the supply and demand provided by investors, they can also change if a company issues new shares (often as a result of executives exercising a lot of stock options) or buys back shares (often to goose the price of the stock before executives exercise their stock options). I view both events unfavorably (especially the dilution that results from issuing more shares), as I believe executives should not be compensated with stock options, which limits their downside;

instead, they should own shares just like the common shareholders. The number of shares outstanding can fluctuate quite a bit from these shenanigans (which are not in the interest of the shareholders), resulting in price distortions.

On the massive spreadsheet I use to track about 2,400 dividend paying stocks, I dedicate one column to the 10-year trendline change (quarterly) in diluted shares outstanding, which give me an idea of how reliable my high and low prices are for each stock. A few stocks have been prolific diluters (this is especially common among companies that mine precious metals, as management is often more interested in mining the equity of the company via stock options), so I have removed them from consideration for this reason alone, as significant dilution is a tough hill to climb.

Additionally, the prospects and financial condition of companies are constantly changing, so 100 shares of ABC Corp. is probably not worth the same as it was a week or a month ago. As the saying goes, "Price is what you pay, value is what you get." Just because the price of a stock declines significantly, that doesn't necessarily mean it's a bargain, because its fundamentals could have also declined significantly or even more than its price.

Conversely, a stock that has appreciated significantly in price may still represent great value if its fundamentals have also greatly improved. The vast majority of investors focus primarily on price because it's readily available and easy to understand. I rely on several services that quantify and distill a company's fundamentals, which make them much easier for me to understand and compare to the current price of the stock.

Finally, dividend-paying stocks become more valuable as time passes (assuming the dividend remains safe and management remains willing to pay it) because there is less time to wait until the dividend is paid. Once the record date for that dividend has passed, however, the stock goes "ex-dividend" and the price drops by an amount that is equal to the dividend that will soon be paid, because any new investors will not receive that dividend. This cycle repeats every payment period. So if the stock of XYZ Corp. pays a dividend, its value today will be different than it was say a week ago or a week from now due solely to the eligibility for and timing of its dividend.

In conclusion, when investing, you need to take all of these considerations into account so you won't be the victim of static illusions.

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