



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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A Stock Tip From a Shoeshine Boy

It's time to get out of the market when your shoeshine boy starts giving you stock tips. ~ attributed to Joseph P. Kennedy Sr. in 1929

My contrarian antennae are constantly attuned for anecdotal signals that may be a subtle sign that either danger or an opportunity is near. A few days ago I received the following stock tip from an acquaintance who apparently started investing within the last year or so:

"Ubiquiti (ticker UI) Government forced US to only use US-based routers because [spying] software was hidden in some brands. So over the last year or so it's up like 250% as a stock. I bought under \$100 and it's now \$1K."

OK, let's analyze this. Why did he tell me this, and why now? A charitable explanation would be that he thought he had discovered a great investment opportunity and wanted me to be able to benefit from it too. A different explanation is that he (perhaps subconsciously) wanted an ego stroke; it's proof that [anybody can do this game](#). If you saw this tip posted online, it may well have been written by someone who owns a position in the security but is trying to sell at a good price.

Why now? Inexperienced investors brag about their best investments towards the top of

the market. Around the bottom of the market (which would actually be a great time to invest), they're so depressed and despondent that they don't even open their account statements for months or even years because the cognitive dissonance is too painful.

Now Ubiquiti is actually one of the ~2,250 stocks I track on my massive stock-tracking spreadsheet, because it pays a dividend (though its yield is only 0.3%). So I checked it out. The first thing I looked at was its current Beneish M-score, which is a measure of the likelihood that management is manipulating its reported earnings. Unfortunately, the weird scale that professor Beneish used for his score doesn't make it easy for a layman to interpret, but Ubiquiti's current score of -1.46 implies that its management is likely manipulating reported earnings.

So why would they do that? Well, I noticed that over 96% of the shares are owned by insiders! This is easily the highest insider ownership I've ever seen. I prefer stocks that have high insider ownership, but you can get too much of a good thing. In this case, management's entire fortune and fate are wed to the company that also provides them with a paycheck, so they have a strong financial incentive to do whatever it takes to keep the stock price high and rising, including possibly cooking the books.

The next thing I noticed was that despite the massive insider ownership, short sellers (who [are generally Smart Money](#)) have sold short nearly 9.1% of the shares, which is very high, especially for a stock that has skyrocketed in price. The fact that the shorts can maintain such a painful position in the face of large, rapid losses leads me to believe that they know something that the less sophisticated longs don't.

My tipper said that he had paid less than \$100 per share, but when I looked at the chart, I noticed that the stock hasn't traded below \$100 since the end of 2018. Hmm.

Note how the tip is based on [a story](#) (which the human brain LOVES) and the stock's recent return. The story “explains” the return and justifies any subsequent purchase of more shares. The true (unconscious) purpose of the story, however, is to justify an action that is obviously based on [Recency Bias](#), which is one of the most common of the over 100 known cognitive biases that prevent the human brain from making rational decisions in a financial laboratory. The overwhelming majority of investors who listen to stories and trade based on price momentum have never even heard of Recency Bias, much less the much broader field of [Behavioral Finance](#).

Also note what is *not* included in the tip: anything about the company's fundamentals (such as revenue, expenses, free cash flow, dividends, debt load, etc.). The value of a company (or any asset) is the present value of its future cash flows, discounted at an interest rate that reflects its risk. For most investors, however, the fundamentals are never even considered.

Why is that? Most people who receive stock tips value them because they're a heuristic, which the dictionary defines as “Of or relating to a usually speculative formulation serving as a guide in the investigation or solution of a problem.” They're a mental shortcut that saves a great deal of time and energy (which your body still believes is scarce, as it was for

millennia), so your lazy brain appreciates them. One of the most popular (but incorrect) heuristics about investing is that markets are always perfectly efficient, so you should just invest in index funds. Trust me, analyzing decades' worth of a company's financial statements and related ratios takes work. Unfortunately, there are very few free lunches in the investment world (though diversification is one of them).

Why did this investor not tell me about his other investments, virtually all of which almost certainly had a lower return (perhaps negative)? If his investment process is based on stories, was the story about them inaccurate? If so, how do I know whether the story for Ubiquiti is valid? How does he decide which (conflicting) stories to listen to? Stories sell ads in the financial media, but they generally don't have much to do with a security's return.

All of the story about Ubiquiti could be true, and its prospects could be extremely bright, and yet it could still be a poor investment. How is that possible? Well, price is what you pay, and value is what you get. If you overpay for value, your return will be negative. Again, the vast majority of investors have never heard of or thought about this crucial investing concept.

Shiller PE Ratio



In conclusion, the Shiller 10-year, cyclically-adjusted price/earnings ratio for the S&P 500 index now stands at the nosebleed level of 41.7. This means that investors are currently paying \$41.70 for every \$1 of reported earnings (which is not the same as free cash flow) from the S&P 500. Since 1870, it has been higher only once—during the Dot Com bubble. At the top of the market in 1929 when Joe Kennedy warned about listening to stock tips from exuberant novice investors, it was 31.5. Given the market's current valuations, the fact that giddy newbies are giving stock tips is pretty alarming. Don't say I didn't warn you.

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