

MANAGEMENT OUTLOOK

WHY DO COMPANIES CARE ABOUT THEIR STOCK PRICES?

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Here's the irony of the situation: companies live and die by their stock prices, yet for the most part they don't actively participate in trading their stocks within the market. Companies receive money from the securities market only when they first sell a security to the public in the primary market, which is commonly referred to as an initial public offering (IPO). In the subsequent trading of these shares on the secondary market (what most refer to as "the stock market"), it is the regular investors buying and selling the stock who benefit from any appreciation in stock price. Fluctuating prices are translated into gains or losses for these investors as they

shift ownership of stock. Individual traders receive the full capital gain or loss after transaction costs.

The original company that issues the stock does not participate in any profits or losses resulting from these transactions because this company has no vested monetary interest. This is what confuses many people. Why then does a company, or more specifically its management, care about a stock's performance in the secondary market when this company has already received its money in the IPO? Read on to find out.

1) THOSE IN MANAGEMENT ARE OFTEN SHAREHOLDERS TOO- The first

and most obvious reason why those in management care about the stock market is that they typically have a monetary interest in the company. It's not unusual for the founder of a public company to own a significant number of the outstanding shares, and it's also not unusual for the management of a company to have salary incentives or stock options tied to the company's stock prices. For these two reasons, management acts as stockholders and thus pays attention to their stock price.

2) WRATH OF THE SHAREHOLDERS- Too often investors forget that stock means ownership. The job of management is to produce gains for the shareholders. Although a

manager has little or no control of share price in the short run, poor stock performance could, over the long run, be attributed to mismanagement of the company. If the stock price consistently underperforms the shareholders' expectations, the shareholders are going to be unhappy with the management and look for changes. In extreme cases shareholders can band together and try to oust current management in a proxy fight. To what extent shareholders can control management is debatable. Nevertheless, executives must always factor in the desires of shareholders since these shareholders are part owners of the company.

3) FINANCING- Another main role of the stock market is to act as a barometer for financial health. Analysts are constantly scrutinizing companies and reflecting this information onto its traded securities. Because of this, creditors tend to look favorably upon companies whose shares are performing strongly. This preferential treatment is in part due to the tie between a company's earnings and its share price. Over the long term, strong earnings are a good indication that the company will be able to meet debt requirements. As a result, the company will receive cheaper financing through a lower interest rate, which in turn increases the amount of value returned from a capital project.

Alternatively, favorable mar-

ket performance is useful for a company seeking additional equity financing. If there is demand, a company can always sell more shares to the public to raise money. Essentially this is like printing money, and it isn't bad for the company as long as it doesn't dilute its existing share base too much, in which case issuing more shares can have horrible consequences for existing shareholders.

4) AVOIDANCE OF ACQUISITIONS & HOSTILE TAKEOVERS- Unlike private companies, publicly traded companies stand vulnerable to takeover by another company if they allow their share price to decline substantially. This exposure is a result of the nature of ownership in the company. Private companies are usually managed by the owners themselves, and the shares are closely held. If private owners don't want to sell, the company cannot be taken over. Publicly-traded companies, on the other hand, have shares distributed over a large base of owners who can easily sell at any time. To accumulate shares for the purpose of takeover, potential bidders are better able to make offers to shareholders when they are trading at lower prices. For this reason, companies would want their stock price to remain relatively stable, so that they remain strong and deter interested cor-

porations from taking them.

On the other side of the takeover equation, a company with a hot stock has a great advantage when looking to buy other companies. Instead of having to buy with cash, a company will simply issue more shares to fund the takeover. In strong markets this is extremely common - so much that a strong stock price is a matter of survival in competitive industries.

5) GOODWILL- Finally, a company may aim to increase share simply to increase their prestige and exposure to the public. Managers are human too, and like anybody they are always thinking ahead to their next job. The larger the market capitalization of a company, the more analyst coverage the company will receive. Essentially, analyst coverage is a form of free publicity advertising and allows both senior managers and the company itself to introduce themselves to a wider audience.

CONCLUSION

For these reasons, a company's stock price is a matter of concern. If performance of their stock is ignored, the life of the company and its management may be threatened with adverse consequences, such as the unhappiness of individual investors and future difficulties in raising capital.

RECESSIONS AND DEPRESSIONS

Recessions and depressions have occurred many times throughout history. To many, they bring fear and uncertainty, but **they are actually a natural part of the economic cycle.** Unfortunately, there are a lot of myths surrounding market cycles, but in order to understand them, we must look beyond these myths. In this article, we'll examine recession and depression, how they work and what they really mean for investors.

WHAT IS A RECESSION?

First, let's take a look at recessions. There are two definitions of recession: one defines a recession as two consecutive quarters of negative economic growth, and the second (according to the National Bureau of Economic Research (NBER)) defines a recession as a significant decline in national economic activity that lasts more than just a few months.

HOW IT WORKS

The growth of our economy rests upon the balance between the production and consumption of goods and services. As the economy grows, so do incomes and consumer spending, which continues the cycle of growth. However, because the world is not perfect, at some point, the economy has to slow. This slow down could be caused by something as simple as an oversupply, where producers manufacture too many goods. When this happens,

the demand for those goods will drop. This causes earnings to slow, incomes to drop and the equity markets to fall.

WHAT IS A DEPRESSION?

A depression is a severe economic catastrophe in which real gross domestic product (GDP) falls by at least 10%. A depression is much more severe than a recession and the effects of a depression can last for years. It is known to cause calamities in banking, trade and manufacturing, as well as falling prices, very tight credit, low investment, rising bankruptcies and high unemployment. As such, getting through a depression can be a challenge for consumers and businesses alike, given the overall economic backdrop.

HOW IT WORKS

Depressions occur when a number of factors come together at one time. These factors start off with overproduction and decreasing demand and are followed by fear that develops as businesses and investors panic. The combination of excess supply and fear causes business spending and investments to drop. As the economy starts to slow, unemployment rises and wages drop. These falling wages cause consumers to cut back spending even more, putting additional pressure on unemployment and wages. This begins a cycle in which the purchasing power of consumers is eroded severely making them unable to make their mortgage payments; this forces banks to tighten their lending standards,

which eventually leads to bankruptcies.

HISTORICAL EXAMPLES OF DEPRESSIONS

Throughout history, there are several examples of depressions. **The most well-known is the Great Depression of the 1930s.** However, this one title actually covers two depressions that took place during that time. The first depression occurred from August 1929 to March 1933, during which GDP growth declined by 33%. The second depression ran from May 1937 to June 1938, during which GDP growth declined by 18.2%. In addition, the Great Depression was preceded by another economic depression, which occurred from 1893 to 1898.

WHAT CAN WE LEARN?

Recessions and depressions provide us with both negatives and positives that we can use to gain a greater understanding of how they work and how to survive them.

NEGATIVES OF RECESSIONS AND DEPRESSIONS

There are many negative consequences of recessions and depressions. Let's take a look at a few:

1. RISING UNEMPLOYMENT

Generally, rising unemployment is a classic sign of both recessions and depressions. As consumers cut their

spending, businesses cut payrolls in order to cope with falling earnings. The difference between the two is that the unemployment rate in a recession is less severe than in a depression. As a basic rule, the unemployment rate for a recession is in the 5-11% range; by contrast, the unemployment during the first period of the Great Depression (1929-1933) went from 3% in 1929 to 25% by 1933.

2. ECONOMIC DOWNTURN

Recessions and depressions create a massive unwinding in the economy. During times of growth, businesses keep increasing supplies to meet consumer demands, but at some point there will be too much supply in the economy. When this happens, the economy slows as demand drops. Recessions and depressions allow us to clear out the excesses of the economy, but the process can be painful and many suffer during this time.

3. FEAR

Recessions and depressions create high amounts of fear. As the economy slows and unemployment rises, many consumers become fearful that things will not improve anytime soon. This fear causes them to cut back on spending, causing the economy to slow even more.

4. SINKING VALUES

Asset values sink in recessions and depressions because earnings slow along with the economy. This causes stock prices to fall because of the slowing earnings and

negative outlooks from companies. In turn, these falling prices cause new investments for expansion to slow and can affect the asset values for many people.

POSITIVES OF RECESSIONS AND DEPRESSIONS

There are many positives that take place as a result of recessions and depressions. They include:

1. GETTING RID OF EXCESS

Economic decline allows the economy to clean out the excesses. During this process, inventories drop to more normal levels, allowing the economy to experience long-term growth as demand for products picks back up.

2. BALANCING ECONOMIC GROWTH

Recessions and depressions help keep economic growth balanced. If the economy grew unchecked at an expansionist rate for many years, this could lead to uncontrolled inflation. By having recessions and depressions, consumers are forced to cut back in response to falling wages. These falling wages force prices to drop, creating a situation in which the economy can grow at normal levels without having prices run away.

3. CREATING BUYING OPPORTUNITIES

Tough economic times can create massive buying opportunities in huge asset classes. As the economy runs its course, the markets will readjust to an expanding economy.

This provides investors with an opportunity to make money as these low asset prices move back to normal.

4. CHANGING CONSUMER ATTITUDES

Economic hardship can create a change in the mindset of consumers. As consumers stop trying to live above their means, they are forced to live within the income they have. This generally causes the national savings rate to rise and allows investments in the economy to increase once again.

CONCLUSION

Clearly, both recessions and depressions have many effects on the overall economy. To survive and thrive in these environments requires that you understand what causes them and how those causes create positive and negative effects on the overall economy. Some of the positive effects include taking the excesses out of the economy, balancing economic growth, creating buying opportunities in different asset classes and creating changes in consumer attitudes. The negative effects include rising unemployment, a severe slowing in the economy, the creation of fear and the destruction of asset values. It is by carefully understanding what recessions and depressions are that we can learn how to spot them - and protect investments from them.