Redefining Shares

based on

Economics in the Present Tense

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I need your help

- To reform corporate control
- To return power to the shareholders
- To immunize the markets against bubbles

By putting equity valuation at the
Center of the stock market

To reform corporate control

- Today, it is the Board of Directors that
  - Announces profits for the quarter or the year
  - Declares a dividend to be paid out of profits
- I have a question:
  - Couldn’t they pay the whole profit as a dividend?
  - After all, what does “profit” mean except free cash after all costs?
- I have another question:
  - Why do we even let them decide?

To return power to the shareholders

- They have no control over the accuracy or even the legitimacy of reported earnings
- They should be the ones to claim their dividends
- There is no need for every shareholder to choose the same dividend payout
  - Let each shareholder put in for some part of his *pro rata* portion of profits.

To immunize the markets against bubbles

- Within market cycles, reported profits just follow trend
  - 7% to 8% profit growth on average
- Huge variation in market levels reflects almost equal variation in the price / earnings multiple
- Why such volatility?

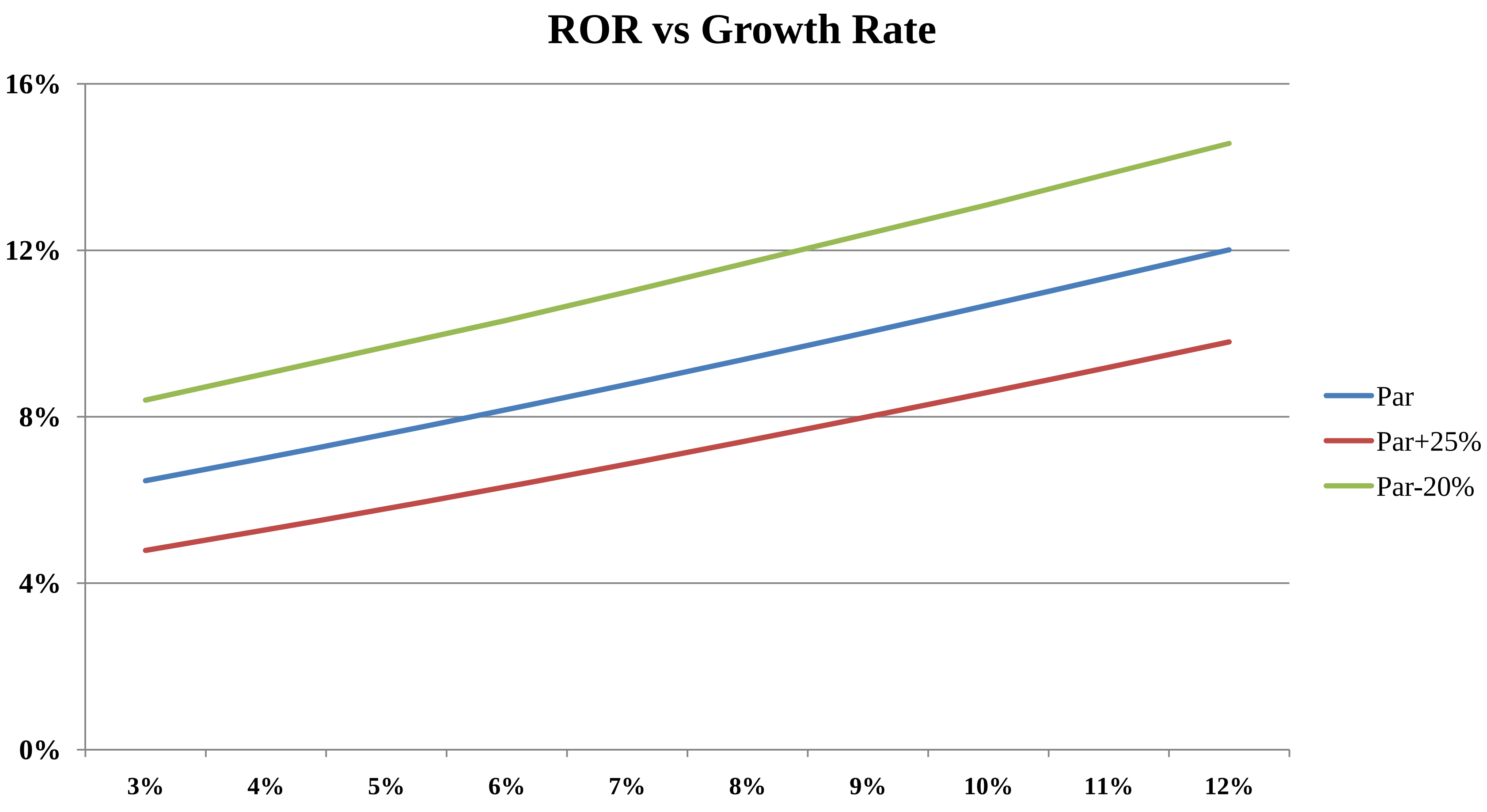
Speculating or Investing?

- In today’s market, almost everyone is in fact a speculator

- Even though they are not very good at it

- Wall Street profits; Main Street pays
  - Ex.: Typical daily volume of Intel shares runs around 65 million shares. At a bid / ask spread of five cents, that generates more than three million dollars of commission each day: $731 million per year. That equals 10% of profits.
  - For what? Intel hasn’t gone anywhere for years.

Most shares will trade in a maximum range of $.80 to $1.25



Specifically, what is the proposal?

- For simplicity, assume profits are reported each quarter, on a known day selected by the management
- On the day profit for a quarter is announced, each shareholder enters his claim for part or all of his shares
- Whatever he does not take as a cash dividend is paid out to him in new shares, at $1.00 per share.
  - If the company reports a loss, the shareholder loses some existing shares, at the rate of $1.00 per share. If his share of the loss is $1,200, he loses 1,200 shares.

The shareholder’s calculation

- If the shares will be selling above $1.00 per share after the dividend distribution, take no dividend and take all new shares

- If below, take the cash

- The shares can trade above $1.00 if the corporation earns a rate of return higher that its cost of capital. But in any case, the price will always be rather near $1.00.

No Bubbles

Can Shares Trade above $1.00?

- Yes, definitely. It depends on the rate of return on the corporation's investment.

  - If the ROR exceeds the cost of capital – i.e. if it is a growth business – shares will trade above $1.00
  - If the ROR is less than the cost of capital, investors will take the cash

Asset Valuation

- Stable Business
  - Earns its Cost of Capital
  - Present value of $1 invested = $1.
  - Since shares cost $1, they are also worth $1
- Growth Business
  - Shares cost $1 in foregone dividend
  - So they are worth more than $1
- Declining Business
  - Shares are worth $1 or less
  - Losses are coming

Adjustment for Accrual Accounting

- Profit includes cash and non-cash items
  - The corporation might have to borrow to meet dividend demands
  - Unlikely, since large positive non-cash profits almost always signal a growth company

- In general however cash flow exceeds profits

- Cash is conserved in the event of reported losses

Can the Corporation Underreport Profits?

- This would force shareholders to reinvest the difference

- It is however already illegal, since tax liability would also be evaded

- If the I.R.S. permits separate tax and financial books, the shareholder option must be based on tax books

How to Implement This

- I think any corporation can replace its existing shares with new shares on this basis.
  - Does the SEC forbid this kind of shares?
- These shares can’t coexist with conventional ones.
- OR the SEC can mandate a changeover to these “Red” Shares.

Model of the firm for ROR calculations