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The Wealth Trap

Loading up on stocks for retirement requires unloading them later

By THORNTON PARKER

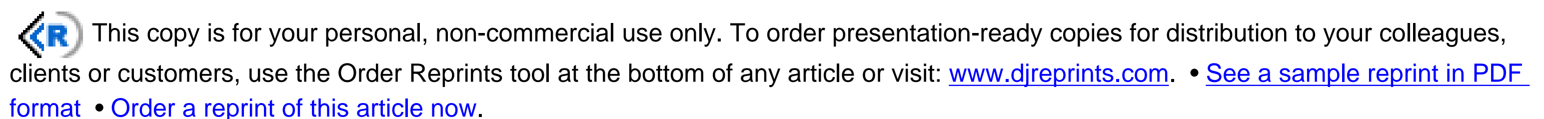
WHO SELLS THE STOCKS that retirement plans buy? If stocks are as good as baby boomers are told they are, why does anyone sell them? Boomers have been taught to save for their retirements and use the money to buy stocks. Doing that, they are told, provides capital that companies need to grow, so their stocks will grow and eventually pay the boomers' retirement incomes. The advice is neat, understandable and wrong.

Serious investors can learn why the advice is wrong by analyzing Table F.213 of the Federal Reserve Board quarterly Z.1 Flow of Funds Report, which shows the net issues and purchases of stocks by major issuing and holding groups, and Table L.213 which shows the market value of stocks held by these major groups. The tables are on the Fed's Web site[1], and go back for decades. Data for this article are in then-current dollars from the March 6, 2003, report. Dividends are not considered.

Adding the net stock-issue numbers for the years 1982 through 2002 shows that during the period companies retired $178 billion more stock than they issued. This means that little of the money that flowed into pension plans, mutual funds, and direct stock purchases during the bull market went to companies as a whole. Of course, capital was moved around, but $178 billion went out of stocks.

In spite of the retirements, the total market value of stocks increased from $1.38 trillion to $11.74 trillion. Market action produced this gain -- a compound annual-growth rate of 9.7% over the 21 years.

While net issues and retirements largely offset each other, there was a clear pattern of changing ownership, with one group of stockholders being net buyers and another group being net sellers. The net buyers were mutual funds, life insurance companies, foreign investors, state and local pension plans, and others, in that order. The buyers were largely retirement-related. They started out with $249 billion worth of stocks, bought $3.51 trillion worth, and ended up with $5.82 trillion worth. Their growth due to market action was just under 6% per year.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The net sellers were households, company pension plans, and bank trusts and estates. They started out with $1.13 trillion worth of stock, sold $3.69 trillion and ended up with $5.92 trillion worth. Their growth due to market action was 13.7% per year. Households, the largest selling group, started out with $780 billion worth of stock, sold $2.98 trillion, and ended up with $4.19 trillion worth. Their growth was 15.1% per year.

To put those growth rates in context, a dollar invested at the buyers' rate of just under 6% compounded annually would grow to $3.37 in 21 years, while a dollar at the householders' rate would grow to $19.27.

How was this possible?

There are at least two sources of clues, and both point to corporate insiders. The annual Forbes articles on the world's and America's richest people are the first source. Bill Gates headed the list in March 2003 with a fortune of $46 billion, based largely on his Microsoft stock. He is reported to have sold about 2 billion shares (adjusted for splits) and still owns 1.2 billion. When Microsoft had its initial public offering, he retained 45% of the shares, and he still has enough to continue selling 20 million shares a quarter for 15 years. His cost was probably less than a million bucks, $0.001 per share, so virtually all of his receipts and the value of the shares he still owns are profit.

Gates is the extreme example, but he and the other 243 Americans identified in Forbes had total fortunes, based largely on stocks, of $700 billion, or a sixth of all the stocks held by American households at the end of 2002. In addition, there are the corporate insiders, including employees who received stock directly from companies as grants or through options. There were an estimated 10,000 "Microsoft millionaires" before the bull market collapsed.

The second source is the weekly table of Insider Transactions published in each issue of *Barron's*. The tables show the huge amount of money that insiders take out of stocks in relation to the amount they put in. For example, the Feb. 23, 2004, table[2] showed the largest reported sale was 32 times greater than the largest purchase, while the reported sale at the bottom of the table was more than 100 times greater than the corresponding purchase. The amounts vary, but the basic pattern has been consistent for years.

Taken together, the Fed data, the Forbes lists and *Barron's* tables show that the households of corporate insiders must have been the primary sellers of the stocks that were bought by mutual funds and other retirement-related portfolios. The extreme gains that households received as a group may well have been driven by the insiders' low acquisition costs.

The hard conclusion must be that retirement-related portfolios absorb the large blocks of stocks that corporate insiders acquire directly from companies at low cost. The portfolios buy many of the shares the insiders sell and help price the stock they retain. Many insiders probably understand this, but most retirement savers are outsiders who do not. The role of insiders has not yet become a national issue, but is important for several reasons.

Insiders who have the lowest costs get the largest profits. When later buyers acquire insiders' stocks on secondary markets, most of the profits the stocks will ever produce have already been made. As a group, retirement savers who buy on secondary markets will always earn less than the insiders.

It is getting harder to make money by buying stocks on secondary markets with the passage of time. Insurance companies illustrate this. Among the net buyers, they came to the game late, bought most of their stocks during the go-go years of the 1990s, and managed to lose money during the full twenty-one year period.

There has been a symbiosis of retirement plans and insiders since 1981. The plans needed stocks and insiders wanted their money. Anyone who looks ahead can see that when boomers' retirement plans need cash to pay retirement incomes, they will have to sell stocks, and most of the domestic buyers will have to be the relatively smaller number of younger workers. That has been known for years.

But few understand that when the plans need to switch from buying to selling in order to pay benefits, the symbiosis will end. The plans will switch from supporting insiders to competing with them for the purchasing power of younger workers. A prolonged bear market is likely, and many of the insiders will be able to make money at prices that will destroy the retirement plans.

The wealth gap between America's middle class and its richest people is growing, and has become a political issue. So far, the way that retirement plans literally transfer money from middle-class workers to corporate insiders and inflate the value of the insider's portfolios has not been recognized. But unless this analysis is wrong, it is only a matter of time until that happens.

THORNTON PARKER is the author of *What If Boomers Can't Retire? How to Build Real Security, Not Phantom Wealth*, published in 2001 by Berrett-Koehler and also available in paperback. His e-mail address is Tipparker@aol.com[3].

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