

## Divide-and-Conquer Strategy Comes Back to Haunt

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The first American recession in a decade has been deemed history almost before it began. None other than Alan Greenspan, in testimony before Congress last week, opined that the recent data indicate that the economic recovery is now well under way.

Stock investors embraced this pronouncement as evidence that corporate earnings would soon rebound. The Dow Jones industrial average rose 2 percent last week, to 10,572.49, a level not seen since July 2001.

But even as investors prepare to bank the share gains that are supposed to result from rising corporate earnings, there is one not-so-small hitch. Because the average number of shares outstanding at many companies rocketed during the bubble, per-share earnings growth could still disappoint. And that could be the case even if the economic recovery is spectacular.

Steve Galbraith, chief investment strategist at Morgan Stanley, has done the math to make this argument. To quantify how significant and deleterious share inflation has become at the largest corporations, Mr. Galbraith took into account recent stock splits, option grants and shares issued in payment for acquisitions at companies in the Standard & Poor's 500.

In Mr. Galbraith's view, many companies diluted their shareholders' earnings to a fare-thee-well during the stock market mania because they did not believe that printing shares was the equivalent of printing i.o.u.'s. And when stock prices were flying, shareholders paid no attention to the inflation that was occurring right under their noses. That is not surprising. It is only during bear markets that the bills for free lunches enjoyed during bull markets come due.

From 1998 to 2001, Mr. Galbraith found that share growth owing to options and acquisitions averaged 16.5 percent annually at telecommunications concerns and almost 8 percent at utility companies. Information technology companies expanded share base through options and acquisitions by 5.7 percent in that period.

Although stock issuance has started to slow, many technology companies remain swollen with shares among which company earnings must be divvied. From 1997 to 2001, for example, Cisco Systems ([news/quote](#))' shares more than doubled, to 7.3 billion from 3.1 billion. A similar trend occurred at Qwest Communications ([news/quote](#)), where shares rose to 1.66 billion last year from 862 million in 1998.

Stock splits were a major force behind the big increase in share counts at major companies. According to Mr. Galbraith, there were almost 400 stock splits at S. & P. 500 companies from 1997 to 1999. For years, splits had been a powerful signal of future gains in a stock. From 1995 to 1999, shares that had split gained more than 40 percent in the subsequent 12 months. But in 2000, that trend was reversed, and companies averaged a decline of 26 percent the year after their split.

Option grants are another culprit in share inflation. While many companies brag that their option programs reward rank-and-file workers, top executives are the major beneficiaries. In 2000, according to Pearl Meyer & Partners, a compensation consulting firm in New York, more than half the nation's 200 biggest companies granted their chief executives what can only be called obscene option packages, those worth \$10 million or more. Nearly 60 percent of chief executive pay that year was delivered through option grants, Pearl Meyer said.

**Mr. Galbraith considers the outsized share issuance of recent years an ill effect of the stock market mania and says it will take time to reverse the trend. "The road back to prior peak earnings per share may be significantly steeper than the road back to prior peak earnings," he said. Put another way, it was a marvelous party. Welcome to the hangover.**