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Holiday Gifts 2005

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Still looking for a Holiday gift for a child or grandchild? Consider giving a few shares of stock. While I generally favor passive index investing, I believe young people benefit in numerous ways from owning stock in companies they are familiar with.

Pick a stock, or better yet, work with the child to pick a couple of stocks of interest to them. Immediately, companies like Apple Computer (iPod), Microsoft (X-Box 360), Motorola (cell phones) and Disney come to mind.

I think having a personal stake in the market; making and losing real money is important. This helps hold any individual's attention and very little money is needed for this initial introduction.

I know this first hand. When I was about 10 years old my parents gave me 5 shares of Pan American World Airways, one of America's most prestigious companies. It wasn't clear to me that this would be more fun than the truck I was hoping for, but right away I started asking questions.

"What is a share? What does Pan Am's price mean? How and why does it change? How do I find this information in the paper?"

Let's use Apple's stock to look for answers. Owning a share of Apple means the child actually owns part of Apple Computer. When shareholders vote to decide who will lead the company, they get to vote their shares - as each share gets one vote. Apple currently has over 28,000 shareholders holding 843 million shares.

Apple's price is \$72, why? A stock's price is the point where buyers and sellers are willing to transact and it moves up and down as opinions about the company change. If there is good news, the stock moves up as buyers are more willing to pay higher prices; and simultaneously sellers will be holding out for a better price. Bad news has the opposite effect. The stock moving higher or lower in reaction to supply and demand is called price discovery.

Stock markets were invented to facilitate price discovery while allowing buyers and sellers to remain anonymous. Apple's stock movement last week was a good example of how price discovery works. On Tuesday, the stock closed at \$74.98. But before the

market opened the next morning, two prominent analysts changed their outlook for Apple's shares and downgraded it from positive to neutral. Given this new information, buyers were no longer willing to pay \$74.98. The market then works to discover the new price at which buyers and sellers will meet.

Very quickly a clearing price, a level where some buyers and some sellers would agree to trade, was found at \$72.53, \$2.45 lower than the previous day's close. The important point is that the collective judgment of the marketplace set the price, not the stock exchange or the company.

One question investors inevitably ask: "Is Apple a good buy at \$72?" I answer with what I call the "Bill Gates" approach. When deciding if a stock's price is fair, pretend you have enough money to buy the whole company to see if it is worth it.

Apple has 843 million shares. If "Gates" paid \$72 for all of them, that is a little over \$60 billion. Is that a good deal, or are there better investments?

To a large extent the answer depends on how much Apple will earn in the future. Investor should ask questions like "Will Apple have a killer product like iPod every few years?" "How many years will Steve Jobs stick around?" "How long can a consumer electronics company stay on top?" Remember the electronics giants of the past that could "never be caught" - like RCA, Phillips, Panasonic and maybe Sony (does anyone still use a Walkman?).

The two analysts who downgraded Apple last week said the company's business was great, but felt the stock was expensive at \$75. Their comments lowered the company's price by over \$2 billion. Other analysts continue to like the stock.

A few closing remarks:

- This article is not intended to encourage investors to buy or sell Apple or the other companies mentioned.
- If you open new accounts to buy stock make sure they are "linked" to larger accounts to avoid maintenance charges.

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