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COMMON SENSE

INVESTMENT WISDOM *since*
THE STOCK MARKET'S DAWN

MICHAEL KEMP

FOREWORD BY SCOTT PAPE
THE BAREFOOT INVESTOR

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THE STOCK MARKET'S DAWN

MICHAEL KEMP

WILEY

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To Sandra, Andrew and Jessica

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FOREWORD

‘Where do I find a good investment analyst to hire?’ I asked a close friend.

‘Well, there’s one guy I know. He’s brilliant, but he’s kind of... intense.’

That man was Mike Kemp.

The first time we met, I felt like Mike’s eyes were burning into the back of my brain.

To prepare for our casual chat he’d read my book cover to cover, and watched two seasons of my show, *The Barefoot Investor*, on CNBC, back to back.

I’m also pretty sure he didn’t blink for the entire 30 minutes we spoke.

I count that meeting as one of the luckiest moments of my professional life.

Mike and I have worked together daily for over three years now, and in that time I’ve learned that there’s another trait that Mike has in equal measure to his intensity: integrity.

In an industry full of wonks and shonks, Mike’s the real deal.

I’ve never met anyone who’s more committed to rigorously uncovering the truth. And, as this book attests, if that means he has to go back to the dawn of capitalism to prove his point, so be it.

When you begin dipping your toe into the wonderful world of investing, you’re instantly bombarded with all sorts of opinions that are rolled up and presented as investment ‘laws’.

It’s almost impossible for the new investor to separate fact from fiction. Who could blame them? After all, as this book shows, the same investment

delusions that were whispered by shoe-shine boys on Wall Street are polished up and presented as facts today on the internet and cable TV.

So let's cut to the chase. If you're standing in the bookstore reading this, let me give you three reasons why you should pony up to the counter.

First, Mike will show you just how hard it is to convincingly beat the market over a long period of time. However, he'll also give you the intellectual building blocks to start you off on your quest to do so.

Second, this book is like a guided history through high finance—and it's surprisingly saucy: from the invention of the stock exchange, to Evangeline Adams (a spiritual mystic who was giving the holiest stock tips in the lead-up to the 1929 Crash), to the cheesy-but-true story of rat trading (seriously, a number of hedge funds got interested in the idea of rats delivering market-beating returns from trading stocks and currencies).

And finally, it'll dramatically slim down your future reading list. That's because *Uncommon Sense* takes a knife to the most common investing illusions held dear.

The end result is that you'll never look at charting, market timing or valuation in the same way again. In fact, I'm convinced that after you read this book you'll begin to see just how close CNBC is to the Comedy Channel.

Scott Pape
The Barefoot Investor
January 2015

ABOUT THE AUTHOR



Dr Michael Kemp completed an MBA before embarking on a career in corporate finance during the mid-1980s bull market. As a young financier he was awarded the Ian Roach Prize for achieving first place nationally among employees of the Australian Securities Exchange studying for the Graduate Diploma in Applied Finance and Investment.

Michael Kemp graduated from Melbourne University and has subsequently gained two master's degrees, including an MBA from Monash University.

His financial career has included working in the Treasury Department of the Australian Wheat Board, as a trader for Bankers Trust and in the Corporate Finance department of stockbroking firm Potter Warburg (both in Australia and London).

Today Michael spends his time investing on his personal account, writing articles for the Australian Securities Exchange and analysing and writing about stocks for the *Barefoot Blueprint* newsletter.

To Michael, finance has always been a passion, never a job. *Uncommon Sense* is his second investment book.

ACKNOWLEDGEMENTS

Writing this book has been a fascinating journey, one I'm sad is now over. And like any journey its completion allows me to reflect on those who I shared it with. Thanks to friends and family who showed an ongoing interest in the process. And a special thanks to those who read the first manuscript: Colin Nicholson, Robert Miles, Scott Pape, Michael Wall and my two children, Andrew and Jessica. Their respective critiques helped sculpt the final product.



Part I
**THE LIMITS
OF REASON**

0.9

START THINKING FOR YOURSELF

First up, that's not a typo. I wanted this to be chapter '0.9'. If I'd called it 'Introduction', 'Prologue' or 'Preface' you'd probably have skipped it. But it contains stuff I want you to read. So here it is: chapter 0.9.

My passion for the stock market became obvious when I was in my early to mid twenties. Problem was, by then I was already a dentist. What's more, I'd studied dentistry for all the wrong reasons. Those who thought they knew me best used to say, 'Hey Mike, you're getting great grades. You're really good at science. And since you can get into any university course you want, you should study medicine.' But I didn't want to be a doctor, so I chose dentistry on the rebound. Seemed like a good idea at the time. After all, doesn't everyone choose dentistry when they decide not to study medicine? Wrong. As I later found out, dentistry is what you study when you don't get the grades for medicine.

I should have noticed the warning signs earlier. Like when I was six years old and told my mother I wanted to be a bank manager. I mean, what six-year-old wants to be a bank manager? Most six-year-olds want to be a pilot or a fire engine driver.

My mother knew all along that I'd made a mistake doing dentistry. I should have listened to her when, halfway through my degree, I broke the news that I was thinking of tossing it all in. I thought she'd break down and start crying, tell me I was giving up the chance to have a great

career and earn good money. And through her sobs she'd ask, 'Does this mean I have to stop telling my friends my son's going to be a dentist?' But she didn't do any of that. Instead she broke out into a big smile and said, 'Well, thank God for that. Now you can study economics and become a stock broker like I always thought you would.'

I got there eventually, after working briefly and very unhappily as a general dentist. Fortunately, when I finally started looking for a job in finance it was the mid eighties. The stock market was on fire and anybody in a pinstriped suit who had a pulse could get a job. I'd just finished an MBA because I thought I needed some economic credentials on top of the dental degree before fronting up to my first interviews. Turns out I'd wasted my time—Bankers Trust took me on regardless. I remember my future boss, Bruce Lugton, telling me at the interview: 'You should have come and seen us a couple of years ago. You didn't need the MBA.' He was right. A few weeks later I was in the dealing room in Sydney and the FX trader behind me had just tossed in a job delivering pizzas.

I was green to the game and needed to establish some credibility. Talking about teeth just didn't cut it on a money market dealing desk. So I learned the jargon. The Reserve Bank wasn't putting up interest rates, it was 'tightening monetary policy'. You weren't about to sell, you were 'going short'. And you weren't taking advantage of the other guy, you were making a 'good spread'.

I had trouble with the whole economics thing. It wasn't like science. Science is pretty much black and white, and I'm a black-and-white sort of guy. But that brand of thinking doesn't work with economics. While everyone around me reeled off economic commentaries like they were one job application away from becoming Chairman of the Federal Reserve, I was still trying to work out why the Reserve Bank would raise interest rates if a flood in Queensland had caused the price of bananas to go up.

For those who learned to play the game, a good economic spiel came in very handy. Econospeak goes something like this: First come up with a few terms like 'fiscal deficit', 'monetary policy' and 'quantitative easing'. Next wrap a good story around them. And finally tell it like you're dead certain you're correct. It doesn't matter if you throw in a few predictions, because no-one will ever check whether they come true or not. People will just remember you as that smart guy who had all the answers.

But enough about financial economics—there's plenty more of that later in the book. I want to introduce the reason for writing this book. To me the financial markets present the most fascinating environment I've ever interacted with. Thought-provoking, stimulating, yet an environment most people approach in an entirely illogical way. This book seeks to question commonly held beliefs about the financial markets by putting them through a sieve of logic. And in the process I hope it helps you develop a set of investment principles that works well for you.

One thing you'll notice as you read this book is that there are lots of quotes. And for that I make no apology. Quotes are great. They're an efficient use of words, distilling great ideas into pithy messages. But I know not everyone shares my enthusiasm. When I was writing this chapter I spotted a newspaper article in which the writer was condemning the use of quotes. He said their use stemmed from a lack of original thought ... and then he used a quote to strengthen his case.

I particularly love old quotes. The older the better. The fascination for me is that they show how investment principles transcend time. Century-old investment books contain exactly the same stuff as books written today—that's right, the very same principles modern writers want you to believe they thought up all by themselves. Old quotes about investing also show that investors in the past held the same fears, hopes and dreams that investors hold today. So I hope you share my passion for quotes and financial history, because you're going to get a decent dose of both in this book.

Also this is not a 'how to' investment book. The world is full of them, and in the wrong hands they are extremely dangerous. Successful people don't blindly accept everything they hear; they work things out for themselves. So if you want to be a great investor, leave the recipe books in the kitchen. As Johann Goethe wrote in *Maxims and Reflections*, 'There is nothing so terrible as activity without insight.'

So steer clear of books with titles like 'A Sure-fire System to Beat the Managed Funds by 15%' or 'How to Trade Like a Pro'. Successful investing just isn't that easy.

I want to spread some good news early on. Solid returns are there to be had if you develop a basic knowledge of how the stock market works, and mix it with a good dose of common sense. For example, simply leaving your money in an index fund and letting it compound over time

will serve you well. Average stock market returns can be great returns. Problem is, people don't like 'average', and they don't realise that it takes work to become 'above average'. The famous stock trader Jesse Livermore once put it this way:

Over a long period of years I have rarely attended a dinner party including strangers, that someone did not sit down beside me and after the usual pleasantries inquire: 'How can I make some money in the market?'

It is difficult to exercise patience with such people. In the first place, the inquiry is not a compliment to the man who has made a study of investment and speculation. It would be as fair for the layman to ask an attorney or a surgeon: 'How can I make some quick money in law or surgery?'¹

To beat the market you need a deep understanding of everything that investing can throw at you. That understanding is hard earned. I haven't met a good investor who wasn't driven by the need to learn and to keep learning.

Now there's an irony to all of this: the more you learn about investing, the more you appreciate how simple the process needs to be. I'm not saying that financial markets are simple, or that, given enough time and education, one day you'll find them simple, or that you can treat the process casually and win. Quite the opposite on all three counts. I'm saying that as your appreciation of financial markets develops it will become clear that they are too complex to be completely understood. So our only hope is to interact with them in a simple way. This was a truth understood by Charles Dow, the founder and first editor of *The Wall Street Journal* and a great investment thinker. He summed up how experienced Wall Street operators felt in his editorial of 20 November 1901: 'The more they actually know, the less confident they become.'

But until you appreciate the complexity, until you get your mind around the complications, intricacies and difficulties the market can throw at you, you won't have the capacity to undertake this simplification. In Goethe's words, you would be acting 'without insight'.

Despite the complexity and contradictions of financial markets, there's no shortage of people who claim to see order where there is none. You see them every night on TV offering concise explanations for the inexplicable. This does no more than perpetuate the myth that financial markets can be easily understood and described.

The aim of this book is to get you thinking. To become a serious investor you need to question and doubt; to challenge every word delivered by articulate men in pinstriped suits; to appreciate where the limits of reason lie. Then you'll be better placed to make your own investment calls.

Investment great Warren Buffett has stated that he sees little point in writing a book on investing, that everything one needs to know has already been written. There's truth in what he says. But it's also important how those insights are arranged. And I hope the words in this book are arranged in a way that both captures your interest and focuses your thinking.

Most words eventually fall from the public eye. The books that contain them either are destroyed or remain unread for years, gathering dust on bookshelves. Before this book becomes another collector of dust or lost digital imprint, I hope it leads someone, somewhere, to make better investment decisions.

As a postscript, I should add that I've pitched this book to readers who already have some knowledge of how the financial markets operate. But if you're still relatively early on that journey, you might find the glossary of financial terms at the back of the book helpful.

Now on to chapter 1!



THE PIED PIPER

Several years ago, while at an investment conference, I got to thinking about why people act blindly on the advice of others. Why do they bestow guru status on their favoured adviser, whether that trust is earned or not? It's a phenomenon I call the 'pied piper approach to investing'. What got me thinking was a presentation I attended late that afternoon. The guy on stage was trying to convince the audience that all you needed to become a stock-picking superstar was a ruler and a pencil. I'll give you a taste of what he was saying:

Now let's all get trendy. Just hold the ruler against the squiggly lines on the stock chart. Now draw a straight line with the pencil. It's so simple I could get a six-year-old doing this. If the line points up, it's a buy. If it points down, it's a sell. There you go. Now you know how to beat the market.

I don't know how many in the audience accepted his message, but there were plenty taking notes. I'd suggest that few even knew who he was. What then gave this speaker legitimacy? Was it his polished delivery and his tailored suit? I wondered if the audience would see things differently if he spoke with a stutter and dressed like Ronald McDonald. Was his argument strengthened by the simple fact that he was the one on stage, that somebody, unknown to the audience, had considered him enough of an authority to present to us that afternoon?

The reality is that we should always question ‘definitive’ financial advice. The mere fact that so much of it is contradictory should alert us to that. And in the case of this presenter I knew there were plenty of views to counter his. Let’s start with investment great Ben Graham, who wrote:

Rather extensive studies that we have made of the subject lead us to conclude that reversals of trend in every part of the financial picture occur so frequently as to make reliance on a trend a particularly dangerous matter.²

Or this, again from Graham:

Never buy a stock because it has gone up or sell one because it has gone down.³

Not only did Graham’s advice run counter to that of our ‘trendy’ presenter, but Graham delivered it in his book *The Intelligent Investor*, described by Warren Buffett as the best book ever written on the subject of investing.

This example of diametrically opposed advice is just one of many to be found in the finance industry. Why do they exist? If one of two views can be proven to be correct, then only the correct view should be held. And if neither has been proven, then neither should be held passionately and to the exclusion of other views. Where doubt exists nobody should hold any view too strongly. Yet they do.

The problem stems largely from the fact that in the world of finance most things are difficult to prove beyond a shadow of a doubt. And where doubt exists, however small, there will develop a divergence of opinion. The conflict this creates is confusing for those new to investing. We have a natural aversion to contradiction, so to resolve it we choose a single view. Once we’ve chosen it, we support it with a fervour befitting the one-eyed support of a football team. That’s why outspoken pied pipers are so dangerous to follow. They’ve chosen their team and, armed with their definitive answers, they’ve become the font of all financial wisdom. But there are two types of people who run a heightened risk of losing money in the stock market: those who know nothing and those who know everything.

Let’s extend the whole line-drawing/trend-following argument a bit further.

Drawing straight lines on stock charts supposes that stock prices trend. There are plenty of great minds who've researched trend-following techniques only to find they've come up short. Louis Bachelier, Alfred Cowles, Maurice Kendall, Harry Roberts, Maury Osborne, Holbrook Working, Paul Samuelson, Eugene Fama—the list of researchers who've looked at this issue is nearly endless. All of the aforementioned concluded that 'getting trendy' is a waste of time. None found enough of a link between historical price data and future price direction to deliver trading profits.

And what about the following comment from Jesse Livermore? His speculative brilliance allowed him to pull millions from the market (and sadly later deliver it all back). Although he died in 1940, Livermore remains a cult hero among traders today. Ironically, this hero of charting zealots had the following to say about charts: 'Personally, charts have never appealed to me. I think they are altogether too confusing.'⁴ Which means you would never have found a pencil and ruler guiding Livermore's stock trading decisions.

It seems to me this whole investment game is terribly confused. Professional disciplines such as science and law assume nothing until proven. Yet most 'investors' are prepared to accept anything stated by someone standing on a stage or presenting on TV.

WHY THE CONFIDENCE?

Why is it that pied pipers appear so confident of their views? Is it an act aimed to establish public acclaim, or do they believe deep down that what they're saying is correct?

I raised this one day with a friend who had an interest in behavioural finance. 'Why', I asked, 'do you think those in the public eye hold such definitive views in such a "grey" area as investing?' He couldn't offer a reason.

So a week later I put the question to another friend, a financial adviser with decades of experience. He, too, struggled to deliver an answer. I don't think he'd ever really given the issue much thought.

A plausible answer was delivered just weeks later. I was reading *Thinking, Fast and Slow*, by psychologist and Nobel laureate Daniel Kahneman.

Kahneman referred to the illusions of skill and validity supported by a powerful professional culture. He commented:

We know that people can maintain an unshakable faith in any proposition, however absurd, when they are sustained by a community of like-minded believers. Given the professional culture of the financial community, it is not surprising that large numbers of individuals in the world believe themselves to be among the chosen few who can do what others cannot.⁵

Or as Demosthenes said, ‘Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true.’

There it is. I reckon Kahneman’s right. Put someone on a pedestal, shove a microphone in their face, and they believe they’ve got the answer to every question asked of them.

Deep down we’re all born suckers, which is a problem, because it means many of us are pied piper bait.

Remember *War of the Worlds*, that early sci-fi book by H.G. Wells? In 1938 his near namesake, actor and director Orson Welles, decided to broadcast part of the book as a radio dramatisation. Orson thought it would be a bit of fun to throw this story about a Martian invasion out onto the airwaves. Unfortunately he hadn’t factored in how gullible the public can be.

Welles’ trick was to deliver the broadcast in the form of live news bulletins, as if the events were unfolding as he spoke. The reaction was phenomenal. *Time* reported that in Newark, New Jersey, 20 families wrapped their faces in wet towels in anticipation of the Martian gas attack. Fifteen people were treated for shock at Saint Michael’s Medical Center. A Tennessee newspaper recalled all its editorial staff and began to prepare a special edition on the bombing of Chicago and St Louis. A Pittsburgh man was barely able to stop his wife from swallowing poison. The angry mayor of a midwestern city telephoned the radio station to report mobs in the streets of his city, violence, looting and masses seeking safe haven.

Now if people could swallow this stuff, they’ll swallow pretty much anything. When Joe Citizen is sitting in his lounge room with his TV dinner on his lap and Eddie the Economist tells him how things are going to be, he’s sure to believe it.

It doesn't even need to be an economist or a stockbroker who's spinning the fiction. At the tail end of the Global Financial Crisis (GFC) in early 2009, a friend of mine was watching one of those tabloid 'current affairs' shows on TV. You know the type—they sneak into dental surgeries with a hidden camera to get footage of the dentist returning from the bathroom without washing his hands.

For this show they'd consulted a psychic about where the stock market was heading. I have no idea whether it was the cards, the tea-leaves or how Jupiter and Mars were aligned, but the psychic delivered some pretty bad news. After watching the show my friend became worried sick about her stock portfolio.

Even hardened investment professionals can get suckered in. On 11 April 1997 a *Financial Times* story reported that a fund called Czech Value Fund (abbreviated to CVF) had invested in fraudulent companies and was facing big losses. The news, upon reaching the US, caused Castle Convertible Fund (stock ticker symbol CWF) to plummet. Trouble was, Castle Convertible Fund had no relationship with Czech Value Fund beyond the chance sharing of the three letters 'CVF'.

And what about this one? In the late 1890s a Baptist minister, Prescott Ford Jernegan, claimed he'd received a 'heavenly vision' that enabled him to extract gold from seawater. Jernegan saw the opportunity to convert his God-given skill into a profit-making scam. But first he needed to give it some credibility, so he enlisted the aid of lifelong friend and confidence trickster Charles Fisher, who was a professional sea-diver.

Jernegan had constructed a box he called the 'Accumulator'. He claimed his invention could collect gold when dropped into the sea. It supposedly worked by sending a current of electricity through wires, resulting in detectable deposits of gold forming in the box within 24 hours. Jernegan then invited an unwitting jeweller, Arthur Ryan, to test his 'gold from seawater' claim.

Ryan and an associate dropped the Accumulator off the end of a pier at Narragansett Bay, Rhode Island. While Ryan was waiting for the gold to 'accumulate', Jernegan's accomplice, Fisher, donned a diving suit, swam under the pier and slipped a few gold nuggets into the submerged box. Ryan retrieved the box and confirmed the gold was genuine. Word of Jernegan's magic Accumulator spread quickly.

Off the back of his now legitimised business model, Jernegan set about establishing a listed company. Stock in the Electrolytic Marine Salts Company was offered at \$1 per share. The first tranche of 350 000 shares sold out in three days, and investors demanded more. Within weeks \$2.4 million worth of stock had been subscribed.

To keep the scam rolling, Jernegan and Fisher commenced the planning and construction phase for a new commercial facility based on Accumulator technology. But they didn't stick around to supervise construction; they shot through with the \$2.4 million from the capital-raising without so much as a goodbye. And if you think that couldn't happen today, that hardened professionals are too market-savvy to fall for con men and tricksters, I'll give you just two words—Bernie Madoff.

If it makes you feel any better, this whole rip-off thing isn't always about trying to outsmart the common punter. Anyone is fair game. Sometimes investment professionals even turn on their own kind.

Nineteenth-century Wall Street stock trader Daniel Drew was renowned for plenty of scams, but one that served him particularly well was his handkerchief trick. Drew famously once used it to pump up the price of Erie Railroad stock. After dining with fellow stock traders at a New York club, Drew wrapped a note in his handkerchief. It was a list of (fictional) reasons why Erie was a great buy. He placed the handkerchief in his pocket, then, when pulling it out, allowed the note to fall to the floor. After Drew had left, the traders swooped on the discarded note. Acting on Drew's false tip, they bought Erie stock and in the process pushed its price north. Drew was on the other side of the trades, madly selling at the inflated prices.

While Drew might have been cunning, he can't claim that his handkerchief scam was original. Author and businessman Joseph de la Vega traded stocks on the Amsterdam Exchange back in the 17th century, and in his 1688 book *Confusion de Confusiones* he writes:

If it is of importance to spread a piece of news which has been invented by the speculators themselves, they have a letter written and [arrange to have] the letter dropped as if by chance at the right spot. The finder believes himself to possess a treasure, whereas he has really received a letter of Uriaiah which will lead him into ruin.

Hey, we live in the digital age now. No longer the need for notes scribbled on pieces of paper. Just find a thinly traded stock and get to work on the