Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors July 26, 2010

A listless dull trading session came to life late on Friday as stocks staged a healthy rally amid light trading. A month or two ago, a late afternoon selloff triggered by nothing would have left investors in a foul mood. Friday's action was just the opposite. Whatever the cause, and I doubt there was a fundamental one, stocks are now near the upper end of their recent trading range. Bulls will be looking for new interim highs to encourage them to believe the May-June correction is over. Bears will be watching closely and if the rally stalls, they may step in and push stocks lower.

Of course, fundamentals matter. Almost 190 S&P 500 companies will report earnings this week. We got a pretty good sense of what earnings season looks like last week but any deviation in pattern this week will be market moving. As for economic data, it is a fairly light week. The biggest data point will come Friday with the first look at second quarter GDP. First quarter GDP was originally estimated to have grown 3.7% but two revisions later that figure has been cut by a full percentage point and final sales apparently grew by less than 1%. In the second quarter, the housing tax credit expired after one month and the BP oil well disaster began at the end of April. Thus, it would appear likely that Q2 growth was less than Q1. Most economists now forecast a gain of just 2%. Any major deviation from that forecast on Friday could be market moving.

On Thursday evening, Microsoft announced great results that exceed estimates on both the top and bottom lines. Yet on Friday, its share price fell despite the strong overall market. General Electric raised its dividend 20% a week after it reported earnings and announced that it would begin to use its roughly $25 billion cash hoard to begin to buy back stock. Its shares responded with a 4% gain.

Microsoft holds a big analyst meeting on Thursday. Perhaps it will detail its intended use for a cash balance roughly twice the size of GE's. You know our view. This morning I would like to embellish that thought a bit.

Microsoft is doing very well right now. Windows 7 is finally the huge success that Microsoft had hoped previous versions of its operating system might have been. New server software and new versions of its Office applications timed to coincide with the Windows 7 introduction have Microsoft on a path for solid double digit earnings growth at least through 2012. Because its business is not very capital intensive and margins are very high, almost all of its earnings become "excess" free cash flow. Since most of its future business opportunities are not very capital intensive, the company will be able to build cash reserves for the next several years at a very rapid rate.

Because of its immense size and market share within the PC space, the U.S. and European governments carefully monitor Microsoft and would be very reticent about allowing Microsoft to make a large acquisition that would allow it to gain further concentrations within the PC or small computer space. That limits how the company might be able to invest capital. Some companies it might be allowed to buy, like Yahoo, aren't particularly appealing. That suggests that Microsoft can acquire a non-aligned business, which makes little sense, sit on the cash, buy back stock, or increase its dividend.

We have long advocated the dividend route. The company has long chosen either to sit on the cash and let the balance grow or to buy back stock. What do they see that we don't or visa versa?

I will start with what we see. We see a maturing growth company. Decelerating growth tends to increase free cash flow which, in turn, suggests a higher dividend payout ratio. It is the natural path of maturing businesses, even the most successful ones. Eventually, the law of large numbers catches up. For all of Microsoft's success in the past, essentially the company has been built around the core PC business. Over the years, discrete desktop PCs have become interconnected. They have gotten faster. The birth of the Internet created enormous opportunities. Microsoft capitalized via Internet Explorer.

But, as always, technology shifts. The PC isn't as centric today as it was. Applications are moving from the desktop to Internet-based clouds. Phones and other hand held devices are not only key points of network entry, they are now more active processing nodes as well. As happens all too often in the tech world, change creates new opportunities and, often, new sets of leaders. The old leaders are too slow to adapt, too concentrated on saving their legacy foundations. Microsoft proved itself that attacking the core operating systems from a small-sized base helped it to gain massive penetration. Windows was far easier to use than Unix and millions of end users grew up with Windows familiarity. While Windows can't do all that Unix does, and Unix can't do all a full mainframe system can do, it covers almost all the bases and it can do some little things better.

Yet when it came time to look at a world dominated by hand held devices, Microsoft chose exactly the wrong path. It tried to trim down Windows to fit. Apple and Google decided to build an operating system from the ground up with a strong focus on connectivity, efficient size and Internet-centric features. Microsoft instead wanted its operating system to look familiar to existing PC and Windows users. Microsoft's customer was the corporate IT department. Apple's customer was the end user. Guess who won. Google won the search battle with a simple white screen and speed. By the time Microsoft figured that out, it was too late.

The bottom line is that Microsoft can still ride the crest of the wave created by Windows 7, but that wave will only last for another year or two. Meanwhile, it has blown great opportunities in phone operating systems and search while still struggling with how it can effectively build up opportunities in cloud computing.

Microsoft sees things differently. Although late to phone operating systems and search, it thinks it can still make lots of money there. It believes in its cloud strategy. It thinks it will not only grow at low double digit rates this year and next but for the next many years beyond. It is unwilling to accept the notion that it is a mature growth company.

But even if the company is right, it will still be spewing cash. Indeed, if the company is right, it should buy stock back in massive quantities right now because it will be worth a lot more in the future. However, as with many maturing companies, as they get larger, they become less bold, not more. They become more conservative and listen to lawyers more. That's just the way it is.

I have a very clear view in my head what is the right direction and it definitely includes a higher dividend. Look how GE got rewarded on Friday for raising its dividend to $0.12 quarterly from $0.10, down from $0.31 less than 2 years ago. Microsoft has a big investor meeting on Thursday. Clearly cash management will be a subject for discussion. Sitting on tens of billions of dollars earning one basis point makes no sense at all. I think the near term and even the long term direction of the company's stock price will depend heavily on how it defines itself and its future uses for free cash. A company is the present value of future cash flows. One basis point on $40+ billion in cash doesn't generate much value.

Today Sandra Bullock is 46. Kevin Spacey is 51. Mick Jagger turns 67.

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