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Investing

Microsoft: Better Than Money in the Bank

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For many investors, the difference between investing in stocks and staying in cash is like night and day. These are two asset classes on completely opposite sides of the risk/reward spectrum. You buy stocks for capital appreciation and accept the potential risk of capital loss. You keep cash to eliminate any possibility of capital loss, meaning you are willing to accept little, if any, return in exchange.

It may seem almost outlandish to suggest looking at investing in shares of **Microsoft** (MSFT) as a substitute for holding cash in the bank. But considering the company's current valuation *and* the fact that this is Microsoft, after all, it may be suitable as the default cash position in one's portfolio.

You have to peel a few layers to really see how cheap Microsoft shares are today. Its stated price-to-earnings ratio (P/E) of 12 is very attractive for a business with an 80%-plus market share in its market. But the stock is actually much cheaper.

Consensus estimates forecast Microsoft to earn \$2.55 a share in 2011. Shares currently trade around \$28 and come with \$4.50 in cash per share. Since this is excess cash that Microsoft does not need to reinvest in the business, you are essentially paying \$23.50, or about 9x 2011 earnings estimates.

Plus, it's likely by year-end that earnings could come in higher than estimates. The continued sales growth in its Windows 7 software platform indicates that the PC upgrade cycle still appears to have room to run. And while **Apple** (AAPL) clearly rules the roost in the tablet computer market, continued growth in this area is a huge positive for Microsoft's products down the road. On top of that, the company's newest gaming product line extension, Kinect, is showing some excellent numbers. Earnings for the fourth quarter (ended December 2010) of \$19.95 billion and \$0.77 a share easily exceeded estimates of \$19.0 billion and \$0.69 per share.

I realize it may seem silly for some to try and compare a share of stock as a better -- and potentially safer -- investment than cash, but you have to appreciate the risks of holding cash as well, namely purchasing power risk. Of course, cash may be better and safer over the next several weeks or months if shares in Microsoft have a pullback. But intelligent investing is all about calculated risks. And right now, the risk-reward opportunity set for Microsoft is as good as I've ever seen it. First, you are buying into a company that produces over \$20 billion a year in free cash flow annually, which exceeds the gross domestic product (GDP) of many nations. Second, Microsoft has demonstrated its willingness to return cash to shareholders, and that will likely be the case for many years to come.

Here is another way to appreciate the immense value of all this excess cash: Over the past three years, Microsoft has spent about \$4 billion a year in dividend payments and \$9 billion a year buying back stock. Since 2005, shares outstanding have declined from 10.7 billion to 8.6 billion at year-end 2010. In the past five years, the company has bought back nearly 20% of itself. Therefore, even if Microsoft remains "stuck" generating its current levels of free cash flow, its continued buybacks and dividend payments will have a greater effect over the years to come. Fewer shares outstanding mean that the dividend amount per share will go up even if Microsoft doesn't up the payout ratio. For what its worth, Value Line pegs Microsoft's per-share dividend at \$0.94 with the next two to three years. At today's share price that would imply a 3.3% yield today.

You would have to lock up money for 10 years to get that type of yield today -- and even so, you would likely get burned by inflation. With Microsoft, you are in one of the most liquid of investments, as the company has inflationary pricing power, and thus, a great likelihood of capital appreciation.

Its P/E of 12 means that Microsoft trades at half of the earnings multiple of **Google** (GOOG) yet generates more than two times Google's annual free cash flow. The company's immense cash pile and entrenched market position affords