Real Money - Sane Investing in an Insane World

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Introduction The Art of Investing

Most investing books, like most of the mutual fund managers out there, would probably do worse for you in the stock market than if you just picked a portfolio of the SP 500 stocks.

I insist that a portion of your assets be devoted to pure speculation. That way you can be truly diversified, own some solid blue chips, some good dividend yields from many groups and yet still have that lottery ticket that can't hurt you and can make you rich in a quick stroke.

Staying in the Game

What my wife understood was discipline and skepticism: the discipline to cut losses and run winners, and the skepticism to see through the hype that surrounds us on Wall Street. She understood that stocks are just pieces of paper representing shares of companies and no more than that. Sure, the pieces of paper we trade are linked, albeit loosely, to the underlying entities that issued them, but in her eyes it was always important to recognize that everyone, from the media to veteran Wall Streeters, places too much importance on this linkage, which is frequently severed by rumors, by larger market forces, and, of course, by short-term imbalance in supply and demand – all of which can be gamed effectively.

The stock market is not a science. It is just a humbling collection of pricing decisions involving the supply of equities and a level of demand mitigated by greed and fear, two animalistic, psychological components.

Often to figure out how that market is valuing things we have to go outside the balance sheet and income statements, because the emotions of the market can blind you if you are constrained by those. If we simply limit the debate over how stocks get valued to price-to-earnings multiples or price-to-book valuations, the market will often seem completely and utterly full of baloney and impossible to understand.

Getting started the Right Way

Patience, while a virtue, can turn into a vice when you sit there and watch a good company go bad and hold on to its stock anyway under the guise of prudence.

Trading, meaning the rapid or short-term buying and selling of stocks, is something that can prove to be entirely necessary if you are to be prudent and lock in gains when the market takes stocks past their logical extremes.

All of my biggest gains came from pure speculation, which I define as making a calculated bet with a limited amount of capital that turns into a monster home run. I believe that speculation is not only healthy and terrific, but is vital to true diversification. Speculating, particularly when you are younger, is not only prudent, it is essential to making it so you don't have to be totally dependent on that darned paycheck to become rich.

All investing literature has one thing in common: it refuses to admit that great investing, long-term or short-term, has much in common not with science or mathematics, but with gambling. You have to monitor the jockey (the manager) as well as the horse (the company) as well as the track (the stock market), then you can make some sense of what you are up against and know which rules do and don't apply.

The book I like most is *Picking Winners* by Andy Beyer, the premier horse-racing columnist in the country. Because the two, horse-race betting and stock betting, are so alike that the wagering rules he lays out apply to both. Here are some rules:

- If you learn from mistakes you will not repeat them.
- Only go to tracks where there aren't a lot of good players so you can clean up.(The analogy here is only to invest in stocks where the research and info flow aren't perfect and lots of minds aren't already trying to figure it out.
- Only bet on situations where you have total conviction. Leave the rest to others; you don't have to play. You don't have to invest in everything that comes down the pike.

Owning stock itself entitles you to nothing. You only own it when things are good. When things go bad, you don't own anything but the piece of paper.

How Stocks Are Meant to Be Traded

I don't care where a stock traded, I don't care about the past, I don't care where you bought the stock, the only thing I care about with a stock is what's going to happen next. Owning stock is a bet on the future, not the past.

Always use limit orders when you buy or sell any stock, especially when you are buying in unseasoned situations.

What really matters isn't the price that you pay. What matters is the price-to-earnings ratio of each stock.

The real reason why one trades more expensively (in terms of multiples) than the other is that one grows faster than the other.

On Wall Street we care about growth, growth, and then more growth of the future earnings stream of an enterprise. That's the major determinant of what we pay. Growth is the focus and nothing trumps it. If you understand that seeking growth, or more important, seeking changes in the growth rate that may be unexpected by others, is the most important factor to focus on as an investor, you will catch all the major spurts in stocks that can be had. That's because stocks move in relation to changes in growth of earnings at the underlying company. If you can predict changes in growth in the underlying company – either through management changes, or product development cycles, or changes in the competitive landscape, or through macroeconomic concerns like lower taxes or lower interest rtes – you can predict big moves in a stock before they happen.

How is growth measured? Look at the pattern of earnings. While not always an accurate predictor of future growth, past growth is a terrific starting point for projecting a company's future growth. In business, a company is favored because is has more consistent growth over time.

For example, Maytag's PE ratio is 12 but it grows almost twice as fast as Whirlpool, which as an 11 multiple. I would argue that any company growing twice as fast as another in the same industry should sell at twice the PE ratio of the other – not 9% higher as it is now – because growth is all that matters.

The line can be wrong for a million reasons in well-known competitions like MYG versus WHR. But most investors don't look for the "games" where the line is most wrong – in younger, underresearched, and little-known companies. The imperfect line happens only when you stray away from the major players, go to the lesser tracks, in this case the companies worth $2 billion and less, and particularly the $100 million to $400 million companies. Nothing could be further from reality. The most terrible speculations, as defined by their risk-reward, are the big, well-known companies. You can't possibly get a homework edge on them; almost all the news on them is already "in", or discounted. That's why you should focus on the less well known situations, the markets with smaller, young growth companies.

On Wall Street many of the professionals simply stop when they calculate the PE and the growth rate. While I accept the simple equation that Earnings * Multiple = Price, I refuse to be bounded by it. I recognize that stocks trade and, at times, companies trade, too. The stock trades on Wall Street, but the company trades on Main Street. When a company is even the second or third largest in an industry, then the whole shooting match, the control of the company, can trade.

I actually believed the company was growing cheaper as it went down in price. Wall Street loathes stocks as they come down because it thinks of them only as ratios versus the growth of earnings. I love stocks as they come down, because I know the enterprise underneath may not be deteriorating as fast as the stock price. I am always on the hunt for damaged stocks where the merchandise underneath isn't that badly damaged – not damaged companies, but damaged stock prices. That's where the biggest anomalies among the established companies can be found. What Wall Street didn't realize was that instead of being bound by the two dimensions of PE and Price-to-growth rate, there was a living, breathing entity, an actual business that could be sold to the highest bidder. There has never been a case in history where a company that is not the first or second largest

player in a five- or six-company competition didn't succumb to a takeover by one of the other players that sought to become the premier largest player in order to take advantage of the tremendous economies of scale – for example, advertising and technology spending – that accrues to number one.

Some Investing Basics

We consider two streams, the necessity stream (strictly for retirement) and the discretionary stream, as very different animals. It is vital that you start saving for retirement as early as possible.

The younger you are the more important it is that you take even bigger speculative risks with that money because even if you get wiped out you have nearly your whole working life to make it back. That's why I favor the single more aggressive strategy available, accumulation of high-growth equities either through mutual funds or through your own speculation – until you are in your thirties, coupled with a percentage of assets devoted to speculation. With discretionary investments, risks predominate and rewards can be outsized. With this stream you can and must speculate with at least a portion of your money, perhaps as much as 50% when younger, in your twenties, and then dropping back by 10% every decade, but never falling below 10%.

I like to build portfolios for both discretionary money and retirement money, with the former consisting of a diversified group of stocks as well as some speculation built in, and the latter being strictly common stocks when you are younger and then gradually moving to more fixed income as you go up in years.

Diversification is the only free lunch in this whole gosh-darned business. It is not only our greatest defense against chicanery, it is also our lone defense against the fizzling out of whole companies and whole sectors. We cannot afford to put too much money in any one area because that whole area could wipe out our wealth.

I would never own a stock unless I had listened to conference calls first. This info is too vital. What are you looking for?

- When firms report, you are looking for clues about how fast the company is growing as measured by sales or revenues or how profitable the company might be – that's the earnings per share. If your company is a young company, you are looking for fast revenue growth. If your company is older, it should have been able to figure out how to monetize that growing revenue into earnings, and then into dividends. Old-line companies should be trying to maximize the cash they take in to reward shareholders. Some buy back stocks, others pay dividends.

- How can we tell if a company is doing better? The rate of revenue growth matters, but just as important is something called the "gross margin". A company has big margins when it can charge what it wants for what it makes. What determines that? Competition, cost of the items to make or procure, and the cost of doing business in general. Some businesses are high-margin businesses because they have little competition, such as MSFT and INTC. Utilities have no real competition, but not a lot of growth, either. Cable companies have natural monopolies, but those can be invaded by alternative methods of program delivery – satellite dishes – that can take down gross margins and destroy profitability. Some business, such as supermarkets, have tremendous competition and razor-thin margins. Other businesses, such as the basic materials businesses, can have hefty margins when their products are in short supply because there aren't enough plants making the products and then have terrible margins when the industries build too many factories. Still other businesses, such as drugs, have patent protection that gives them a hefty payout for 17 years on new drugs but then, when the drugs go off patent, they are almost worthless to the companies.

- Some businesses have big profit margins only when the world's economies are booming. Those are "cyclical" concerns. Some businesses, such as farming, or road building, or military spending, or aircraft building, have big profit margins when their own business cycles catch fire. Others have profit margins regardless of the world's economies. These are called "secular" growth stories, independent of the cyclicality of economies. This secular-versus-cyclical decision is at the heart of a great deal of good investing and can generate tremendous outperformance if you catch the right moment to shift or rotate between secular growth and cyclical booms.

- Each business has a metric or a series of metrics that measure how it is doing versus its peers. For the cable industry, for example, the enterprise value per subscriber; for hotels, it is the average revenue per room; for airlines, it is the average revenue per seat; for retail, it is the same-store sales. These metrics give a true measure of growth. For technology, the metric is the gross margin per product sold. For financials, it is the net interest margin, or how much money was made on each dollar that the bank or insurance company or savings and loan had in assets.

Make sure you are investing in viable companies before you measure growth. I like companies with no debt and I don't like companies that have a lot of debt. I rarely own the stock of companies that borrow a lot of money. The reason is self-evident: It is much harder to lose your money when you invest in companies that don't borrow money or are not extremely leveraged.

Assessing the risk is a question of assessing the downside. Assessing the reward is a question of assessing the upside. The upside and the downside are created by two different buying and selling cohorts. The value guys create the bottom; the growth guys create the top. I like to think about where the value guy will begin to buy a stock after the growth guy has given up on it, and when the growth guy will begin to sell the stock because the growth is slowing or no longer accelerating at an attractive enough level for the growth stock buyer.

Spotting Stock Move Before They Happen

Demand and supply determine the minute-to-minute pricing of stocks. The first and most basic is the sheer act of buying and selling a stock that doesn't have much volume.

Stocks are simply pieces of paper, to be bought, sold, or manipulated up and down by those with more capital than others. Over the 12-18-moth time frame, the fundamentals of the company play only a part in what moves a stock up or down. I believe the reason that so many professional managers fail to beat the market is that they are way too hung up on the largely artificial linkage, short-term, between a company's health and the health of the stock.

There will be lots of stocks that we will see move up by a billion dollars or more in capitalization without any real, discernible change in or development at the underlying company.

To me, the landscape of investing looks like this. First, there are undiscovered companies with undervalued stocks – that's where most of the Game Breakers come from. Then there are discovered companies with undervalued stocks – that's the small-cap-to-mid-cap phenomenon, where some great gains can still be had regularly. Then there are discovered companies with fully valued stocks – that's where the vast majority of money managers play. We can make money in that cohort, but it's very difficult to make big money. Finally, there are undiscovered companies with fully valued stocks, the most dangerous sector of all for most undisciplined investors.

The secrets of successful large cap investing

- Most discovered stocks do nothing but mimic the market. For them, I find that sector analysis and specific stock analysis each explain about 50% of the moves. In other words, knowing a business cold may not be as important as knowing how the sector is doing and how it performs in a given economic cycle.

- Sector thinking is so ingrained among the "big boys" at the mutual funds that they tend to determine the marginal prices not of businesses themselves. So if you try to buy a good company in an out-of-favor sector you are most likely going to lose money until that sector comes back in favor. We call this the "best house in a bad neighborhood" thesis: no company, no matter how good, can truly transcend its sector.

- E*M = P is what drives the vast majority of stocks. If you can predict the movement of earnings or multiple, you can make money. I specialized in trying to determine whether the multiple was going to expand or contract on the same earnings.

- The first reason a multiple expands and contracts is the macro concerns that have nothing specially to do with individual stocks – top down thinking. If you can shift your portfolio toward stocks that should have a greater E when the economy is about to expand, you are going to find yourself riding a wave of multiple expansion to higher

levels. The M fluctuates in anticipation of the downshift or upshift in the broader economy.

- When you get to a recession, the stocks that have maximum multiple expansion – the stocks with the highest multiples – are those of companies with recession – proof earnings: drug, food, soap, toothpaste, beer and soda companies. At a slowdown's depth, but *before* the Fed takes any action, these companies' stocks are prized possessions because they still deliver the E in the E*M = P equation. So, if P&G normally sells at 20 times earnings, it might sell at as much as 25 or even 30 times earnings, depending upon how desperate the market participants are for growth at any cost. Just when you think that the M is going to keep expanding past where it has ever gone, that's precisely when you have to switch horses and get on the most depressed horse, the cyclical horse. I have found that stocks anticipate that money spigot by about six months. In other words, when you think the Fed is about to become accommodative, to start slashing interest rates, that's when you have to leave P&G and focus on the 'smokestack' companies that are cyclical in nature, companies that actually make things that are discretionary, as opposed to the necessities from P&G.

- If the economy is getting stronger, we have to monitor the Fed as soon as the GDP growth gets above 4%. That kind of growth rings bells at the Fed that it is time to cool things off, that it has to tighten – even if the Fed says otherwise. When the economy heats up you will began to see all things financial – real estate investment trusts, savings and loans, banks, insurers, brokers, mortgage companies – trade down. It is ritualistic. That's because the big mutual funds want out of these stocks before their earnings are impacted negatively because of rising interest rates. At the same time, the techs and the cyclicals will react well during this period. The price of money, while important, isn't as important to them, as they are usually starting to fill up their order books nicely courtesy of the growth in the GDP.

- When the economy steamrolls even higher, to 5%, you have to start selling the stocks of the retailers and the autos because the higher interest rates that are coming are going to impact consumer spending. That drag will cause the earnings estimates to get cut and the M is going to shrink in advance of the E!

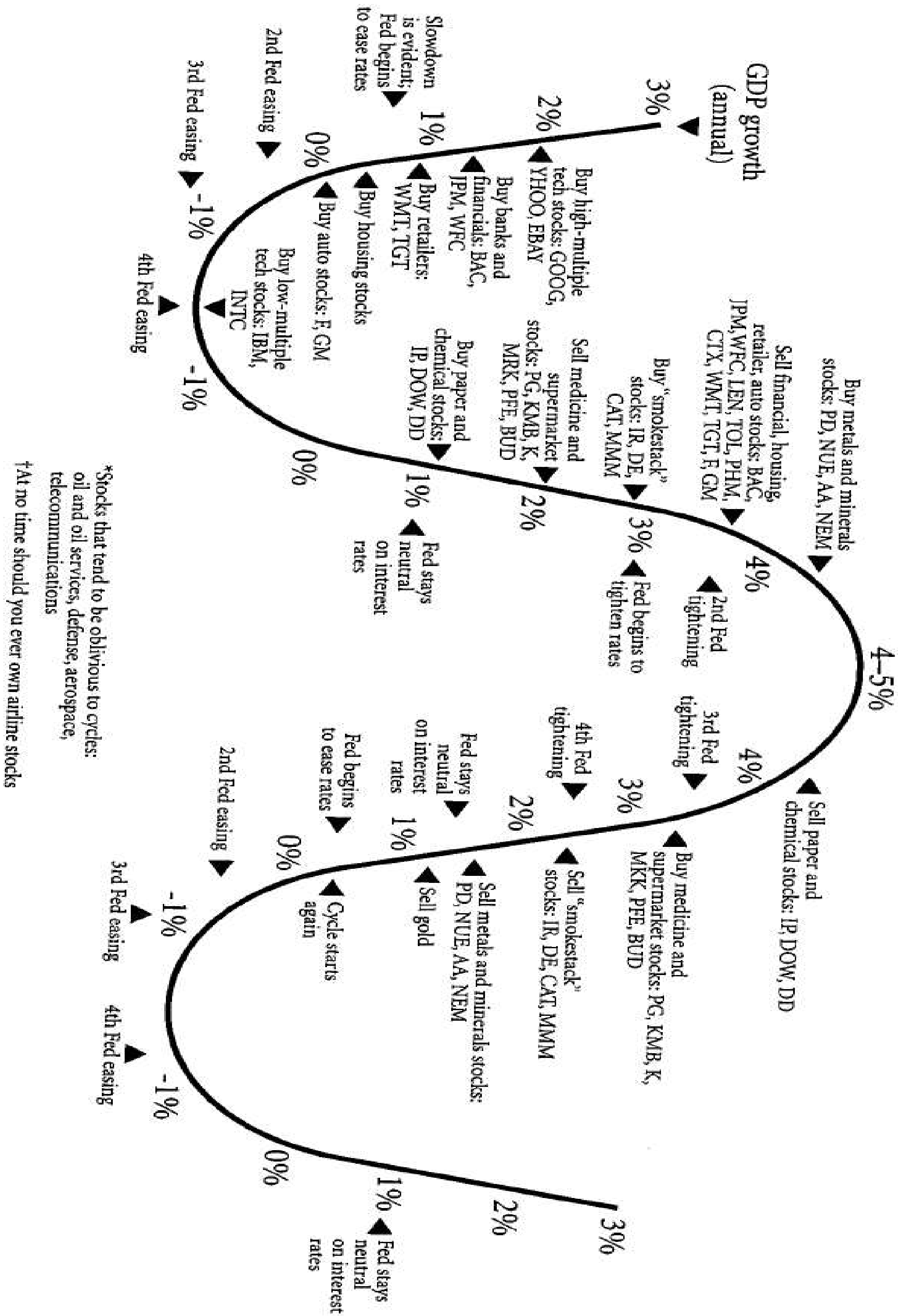
- By this point, at 6%, the Fed should have hiked once, maybe even twice or three or four times. The moment after the 3rd tightening is the most perilous moment in all investing. It is the time when I like to stay on the sidelines, build up maximum cash for all but the longest-dated of my portfolios (410k and IRA), and wait. Cash, not even bonds, is king at these junctures.

- It is at the moment when the economy still appears to be roaring that I switch to buying the most boring consumer staple stocks, the ones that do best without economic strength, the Procters and Colgates. Then, when these stocks are all at their 52 week highs for several months, you sell them and buy the homebuilders, the REITs, the brokers and insurers and the mortgage companies.

Predict change in E:

- Try to anticipate spending cycles, particularly capital expenditure cycles, and ride the stocks from undervalued to overvalued. E.g., when I detect that Boeing sees cyclical upturn, I load up on the stocks of all of the companies that make parts for Boeing, all of which tend to be through the floor at the bottom of the cycle. I buy the stocks of companies that make fasteners or screws (Fairchild) or seats (BEA(r cockpit instruments (Honeywell) and I wait until they see the orders and then the earnings that those orders provide and then, when everyone starts touting the stocks – I begin to sell into strength.

- The market only likes "consistent" growth during an economic downturn or when the economy is doing nothing. Its first love affair is with "inconsistent growth" during one of its periodic explosions. When the economy is growing between 1 and 3%, you should own all of the Coke or Pepsi you can get. You should load up on the Pfizers and Mercks and Heinzes. When the economy is growing at a 3-6% clip, you have to own the cyclical stocks because they will have the best year-over-year comparisons. Most people who determine prices in the stock market have no real knowledge of history. They simply look at the number that is reported, and when they see PD \$0.86 v.s. \$0.38(last year same quarter), the market will go crazy for Phelps Dodge regardless of whether it will slip back to 0.38 of not by this time next year.


CYCLICAL INVESTING AND TRADING
GDP growth (annual)
3%
2%
1%
0%
-1%
-1%
0%
1%
2%
3%
4%
4–5%
4%
3%
2%
1%
0%
-1%
-1%
0%
1%
2%
3%
Buy high-multiple tech stocks: GOOG, YHOO, EBAY
Buy banks and financials: BAC, JPM, WFC
Slowdown is evident; Fed begins to ease rates
Buy retailers: WMT, TGT
Buy housing stocks
Buy auto stocks: F, GM
2nd Fed easing
Buy low-multiple tech stocks: IBM, INTC
3rd Fed easing
4th Fed easing
Buy paper and chemical stocks: IP, DOW, DD
Sell medicine and supermarket stocks: PG, KMB, K, MRK, PFE, BUD
Buy "smokestack" stocks: IR, DE, CAT, MMM
Sell financial, housing, retailer, auto stocks: BAC, JPM,WFC, LEN, TOL, PHM, CTX, WMT, TGT, F, GM
Buy metals and minerals stocks: PD, NUE, AA, NEM
Fed stays neutral on interest rates
Fed begins to tighten rates
2nd Fed tightening
3rd Fed tightening
4th Fed tightening
Fed stays neutral on interest rates
Fed begins to ease rates
2nd Fed easing
Sell paper and chemical stocks: IP, DOW, DD
Buy medicine and supermarket stocks: PG, KMB, K, MKK, PFE, BUD
Sell "smokestack" stocks: IR, DE, CAT, MMM
Sell metals and minerals stocks: PD, NUE, AA, NEM
Sell gold
Cycle starts again
3rd Fed easing
4th Fed easing
Fed stays neutral on interest rates
*Stocks that tend to be oblivious to cycles: oil and oil services, defense, aerospace, telecommunications
†At no time should you ever own airline stocks

The Importance of the Fed

- Interest rates matter intensely when you are trying to anticipate big moves in stocks. Rates matter as a cost of buying stocks; the lower the rates, the more speculative people tend to be because you can borrow money cheaply to buy stocks.

- When interest rates are moving higher (lower), the multiple you will pay for earnings shrinks (expands). When interest rates spiked dramatically in 2004, 1994, and 1990, the PE multiple shrank for all stocks because that discount rate went up. In the beginning of 2004 the story was the incredible shrinking M, because the E didn't go down, but the price did. People who didn't understand the relationship between stocks and interest rates, misinterpreted the price decline of stocks to mean that perhaps a recession was coming and that the E in the equation, the earnings estimates, wouldn't be made. That was nonsense. It was just the discounting mechanism bringing down prices and chiseling away at the multiple. I call such a contraction in the multiple the silent stock killer because so many people can't see the cause of it – higher rates – until it is too late and stock prices are obliterated.

- When the CPI registers four straight upward moves, I think you should expect that the Fed will have to tighten. The essence of investing is anticipation.

- We care more about the perception of rising and falling of rates on future earnings than we care about what occurs to the companies, because the perception dictates the price movements.

- Undiscovered stocks of unknown companies. Some firms don't have E. We can make a fortunate, but we must be much more careful. We need both a buy and a sell price; we can't simply buy and forget about them. Many of these unseasoned stocks will poison our portfolios if they stay there too long. I don't like to focus on small cap stocks; I like to focus on stocks that have a small cap that shouldn't be small because the companies underneath them have too much potential to be stuck with such an appellation.

- The academics believe that the market will exert rational pricing on all securities, but the market is rational only for the thousand or so largest stocks. After that, emotions and psychology play a large role, which you can profit from.

- John Maynard Keynes wrote, "Markets can remain irrational longer than you can remain solvent." I stand that logic on its head and say that irrational markets can last long enough for you to get in and make hefty profits before you have to get out.

- My method to finds unknown company/undervalued stock: in the initial stages, I examine which companies have a modicum of revenues, decent bloodlines when it comes to managements and scientific prospects that sound somewhat legitimate. Then, I try to find out whether I am early enough – judged by whether any major Wall Street firm yet covers the group – I pounce. If there is a lot of coverage of the group, particularly by the main firms based in New York, not just the regional firms from the hinterlands, I skip it. As soon as the companies in the cohort get some critical mass, the investment bankers at the regional brokers prowl the world for companies that look alike with the hopes of getting some of their business down the road. It is important at this moment to own as many stocks in the same industry as you can. I continue to accumulate the stocks until the analysts at the major firms start their promotion and I stay long the group until the group is fished out, producing some of the best gains imaginable. I let the Street's greed – almost as good a yardstick as its myopia in measuring stocks on earnings growth – tell me when to get out. I can always tell when the frenzy's about to crash, though, by measuring supply and demand.

To look for huge gainers:

- **40% management**. This includes speaking with the company and evaluating management ownership and recent changes in ownership, ability to sell the story, and accessibility of info on the company.

- **30% fundamentals**. That means cash-flow growth, earnings growth/potential, balance sheet, liquidity.

- **15% technical analysis**. This includes stock momentum, support levels, simple chart reading.

- **15% alpha factor** – I create based on the stock's float, low volume relative to the float, how the stock has reacted to strong news in the past, and the short interest ratio.

Stock Picking Rules to Live By

The Ten Commandments of Trading

- Never turn a trade into an investment. When I plan to buy Kmart, **I have to declare right up front whether I am buying it for a trade or an investment**. A trade means that I am buying it because of a specific catalyst, a reason that will drive it higher. That catalyst is a data point, a recommendation, a belief that things are better than expected when the earnings come out, some news about a restructuring, or something material that could occur. There is a moment to buy and a moment to sell. But you must declare first before you buy. When I want to invest in a firm I buy a small amount of it to start and then hope the market will knock the stock down so I can buy more. When I want to trade, I put the maximum on at the beginning because I believe the data point is about to occur. I never buy anything for a trade without that catalyst. I never buy anything for a trade just hoping it will go higher; there can be no hope in the equation. I buy down when I am investing. I cut my losses immediately when I am trading if the reason I am trading the stock doesn't pan out.

- **Your first loss is your best loss**. If you buy a stock for a trade and it starts going against you in a meaningful way, perhaps a decline of 50 cents or more, you may have a real problem on your hands. When it comes to trading I am an extremely disciplined person. I like to cut my losses quickly and get over them quickly.

- It's okay to take a loss when you already have one. A loss is a loss, realized or unreazlied, and most of the time it is better just to take it than to act as though you don't have one.

- **Never turn a trading gain into an investment loss**. A trade is just a trade, and when you turn it into an investment you have overstayed your welcome.

- You don't have a profit until you sell. Gains not taken can be losses.

- **Control losses; winners take care of themselves**. It takes only one or two loser to wreck a portfolio.

- Don't fear missing anything. **Discipline is the most important rule in winning investing**. Always remember that the best time to buy is when it feels most awful, not when it would relieve the incessant pain of fearing the next big rally, especially given that that rally invariably has already occurred.

- Don't trade headlines. They can't understand how they could be wrong because the "tape" just said that the quarter was better. Typically, the reality is that there is something else, some other metric that might be important, or that the quarter is finagled with one-time gains.

- Don't trade flow. When you have no idea why people are buying, when you are just operating on the buys and sells of others, you are trading on ignorance.

Twenty-five investment Rules to Live By

- Bulls and bears make money; pigs get slaughtered. I use the market's irrationality and randomness in my favor to accumulate more stock, to the point where I am perfectly willing to have up to 25% of my portfolio in one name if I think it is absurdly valued.

- It's okay to pay the taxes. Never consider taxes as reason to hold a stock if the stock has gone up too far tto fast and can head back down hard. *Never* hold on to something not worth holding on to or something that has gotten dangerously overvalued simply so you can wait until the gain goes long-term.

- **Don't buy all at once;** arrogance is a sin. I never buy all at once. I buy increments on the way down, space out gingerly to avoid emotion. Similarly, I never commit a lot of capital at one level, and I space out my capital commitments. For my retirement account, my 401(k), I like to put aside a twelfth of my commitment every month. But if I catch a market break, a substantial market break of 10%, I speed up the next month's contribution. If I catch a break in excess of 15% I put in the next quarter's contribution. And twice in the last 10 years, when there was a 20% decline, I invested all that I had left to contribute. Similarly, when I wanted to build a position, a sizable position in a stock, I never bought it all at once.

- Look for broken stocks, not broken companies. Don't buy damaged goods, buy damaged stocks of companies that are on the mend or improving.

- Diversification is the only free lunch.

- Buy and homework, not buy and hold. What does the company do, what PE multiple does it sell for, and whom does it compete against?

- No one ever made a dime by panicking. When you sell into the maw, when you join the rout, you never get a good price. In almost every panic sell, the stocks were up the next day and up greatly a week later. That doesn't mean that they weren't substantially lower a month, a quarter, or even a year later. It does mean that it was the wrong time to execute the sell strategy. Typically the panic comes at the end of the sell-off, not the beginning or even the middle. The panic marks the capitulation of all of those who tried to stay the course.

- Own the best of breed; it is worth it. The biggest bargains tend to be the best of breed. When the choice is among two or three companies in an industry, always go for the one that's the best of breed regardless of the price.

- He who defends everything defends nothing. Or why discipline trumps conviction. I believe **that when in doubt, discipline trumps conviction**. You have to have a discipline, a discipline that ranks all of your stocks so that you know which ones you are willing to buy right now and which ones you are willing to sell if you need the capital to sell. I developed a four-step system of ranking every stock I own: 1 is a stock I want to buy more of right now, 2 is a stock I want to buy more of if it goes lower, 3 is a stock I want to sell if it goes higher, and 4 is a stock I want to sell now. In a serious sell-off, the 1s become the only stocks I will own, and I will sell off all the others.

- The fundamentals must be good in takeovers. You are a fool if you speculate on takeovers. What you must do is buy undervalued good companies that are doing well. If you buy stocks with poor fundamental betting that someone will take you out with a high price, you are going to be wrong far more often than you will be right. Funny thing about the fundamentals: if the market doesn't like them, the potential acquirers won't, either.

- Don't own too many stocks

- Cash and sitting on the sidelines are fine alternatives. Cash is the most underrated of investments because nothing feels as good as cash when that market comes down.

- No woulda shoulda coulda. To second-guess decisions is to put yourself in a loser mind-set.

- Expect corrections; don't be afraid of them. Corrections are to be expected; when they happen they are not a reason to panic.

- Don't forget bonds. Pay attention to interest rates and bonds; ignore them at your own peril.

- Never subsidize losers with winners. The first thing that gets sold are the best ones because "they can be sold." There's always a bid for the good stocks.

- Hope is not a part of the equation. Hope, pray, love, rooting – these are all the enemies of good stock picking. Hard work, research, being realistic about the prospects is the stuff of good stock picking. I never took action on a stock, going from buy to short sell, unless I heard from the company first that things had gotten less predictable or that business had softened.

- When high-level people quit a company, something is wrong. I will not own a stock when a CEO or a CFO leaves suddenly. I just sell it. I might buy it back later, even if it is higher, but I don't like to own stocks where either of these two heads suddenly departs. People don't quit for family reasons when they are needed at companies.

- Patience is a virtue – giving up on value is a sin.

- Just because someone says it on TV doesn't make it so. I can't tell you how unimportant performance is to the media.

- Always wait thirty days after an earnings preannouncement before you buy.

- Never underestimate the Wall Street promotion machine. When Wall Street gets behind a stock, that stock can go much farther than if the fundamentals were doing the driving. That kind of sponsorship is what I like to sell into.

- Be able to explain your stock picks to someone else. One way to cut down on your mistakes is to force yourself to articulate why you would like to buy something.

- There is always a bull market somewhere. The Fidelity Sector Fund Report, which is the single best text about which sectors are doing what and why.

Creating Your Discretionary Portfolio

- You will do the time-consuming, sometimes tedious homework. You have to listen to the conference calls – they are very time-consuming and dense – read the articles, get the annual the quarterly statements and reports and understand them.
- You must spend a minimum of one hour per position per week doing the research.
- You must be interested in business. You must be curious about how a business makes its money, what its metric is that has to be beaten – gross margins, revenues, seat miles, average selling price per unit, etc. – and how much growth you think a company may have.
- You must have someone, you can bounce an idea off of, someone whom you trust, so you can get a second opinion on the stock before you buy it.
- Finally, I can't have you get discouraged and quit. The whole process is a game of endurance. Think long-distance running.

To get started

- Your first pick should be a stock of a company from your neighborhood, something that you know or can relate to, a company that employs people close to you or you can ask around about.
- Your next pick should be an oil stock.
- You need a brand-name blue chip that currently sells at a 2.5% yield or greater. Consider one of the major chemical companies or conglomerates if you are having a hard time choosing. Try to get one with a history of raising dividends when possible. Don't buy the stock of a company that is borrowing to fund the dividend.

- You need to own shares in a financial, one of the largest portions of the SP 500. I like to own local. I have had phenomenal success over a 20 year period owning a local bank or a savings and loan. Every down has some publicly traded banks. If you have a good experience, go buy shares in it, provided that it has a good history of earnings and dividends.

- With 20% of your money, buy something that you think could be a terrific investment, a hunch, a potential home run. I make these bets whenever a sector falls so out of favor that even if the stocks fall from where they are, the loss will not be of great magnitude.

- Technology companies are risky; but not to have a technology company has proven to be a terrible risk. I like tech companies with yield. That means they are mature enough to be steady growers and you haven't necessarily sacrificed double-digit growth.

Spotting Bottoms in Stocks

- I am a classic bottom fisher. Bottom fishing requires incredible patience and a sense that just when you are about to give up is the moment that greatness strikes.

- I divide the patterns into two kinds of bottoms, investment bottoms and trading bottoms. Trading bottoms don't last but are so juicy that I don't want you to miss them. Investment bottoms are long lasting and you can get in some fantastic prices for discretionary savings or retirement.

- The vast majority of bottoms occur simultaneously with market bottoms. That is because there is so much money 'indexed', that if you can pick a bottom in the index, you can pick a bottom in most stocks. There are two exceptions. The gold stocks don't trade with the index; they represent an industry that tends to do well when the index does badly. Same with the oil stocks; they are a counterindex.

Market sentiments:

- **The pain makes the front page of the *New York Times***. I found dozens of articles about pain and losses in these sections that were written before some of the biggest parts of declines occurred. But all bearish bets are off when the *New York Times or USA Today* puts the market's pain in a prominent place on the front page of their papers. If the market-woes stories aren't on the front page, then simply wait; the bottom hasn't been reached yet.

- **Investors Intelligence survey of money managers**. When a majority of money managers polled dislike the market. When the bull-bear ratio shows a definitive majority of bears or even a plurality of bears with less than 40% bulls, you are in the safety sentiment zone.

- **Mutual fund withdrawals**. Consistent, repeated outflows of several months in duration accompany all the big bottoms.

- **VIX:** a reading above 40 in the VIX – a measure of pure panic in the marketplace – indicates a market bottom.

- **Oscillators**

Capitulation

- A crescendo bottom is a bottom where a great many sellers converge at once to take stocks down to unusual levels versus the fundamentals. The accompanying detail that has marked all crescendo sell-offs is a dramatic imbalance in the amount of new highs to new lows. At all of the bottoms that I have found to be investible, you have between four hundred and seven hundred new lows and only a handful of new highs.

- A second characteristic of a crescendo bottom comes from the bizarre forced-selling method that the brokers apply at all major brokerage houses. Throughout all sell-offs, speculators attempt to call bottoms. Their meager efforts are often a sign that we are not anywhere near the bottom. That's why we have to monitor their selling closely to see when it comes to an end and they are washed out of the picture. Fortunately, their **telltale selling comes almost entirely between 1:30 and 2:30 in the afternoon**. That's because brokers are on the hook for trades done by clients in violation of margin rules. The rules state that unless the customer borrowing from the firm puts up more equity when

positions go against him to the point where his collateral no longer meets the requirements, the positions must be cashed out. The brokers badger these customers all morning, but the brokerage house finally stop fooling around and **after the Federal wire System closes at 1PM, the margin clerks swing into action and brutally sell out the common stock of overly margined players. The selling lasts until about 2:30.** You will see during prolonged downturns that the selling during this margin-clerk hour is by far the most brutal of the day. **If you have to buy a stock during a downturn, you would always be wisest to wait until the forced-selling period is over.**

- You can always wait until the SEC releases the monthly margin debt numbers, but I have found that before every radical decline in margin buying has occurred, you can spot that decline simply by focusing on the 1:30 to 2:30PM margin-clerk selling. Mind you, this indicator only works on down days. You need to see no selling to speak of during that hour after a series of declines, or even weeks of decline, before you know that the market has bottomed out.

- A third characteristic of a crescendo bottom is a dramatic spike in volume on the exchanges. Not to sell into the big volume after a long decline. That's the time to buy, not sell.

- Another sign of capitulation involves the flow of underwritings. When deals just fail from the moment they come out, that's a sing of a weak market, one the underwriters will still pummel with greed. Don't be tempted to buy yet. That's a false bottom. It's only after deal after deal breaks down that the pipeline of new equity at last dries up. That's when the speculative juices are being wrung out of the market and liquidity is building up. But one or two months after the flood of new deals ceases – never longer – you begin to see a few terrific IPOs that come public and the stocks don't go down. That's the sign that you are now past the crescendo and should be in there buying stocks. You must wait until the whole cycle plays out, though. Moving in before the new set of deals goes to a premium is suicidal.

Catalyst

- In 1991 and in 2003, we got the same exact catalyst: the start of a war with Iraq. In both cases, as is often the case with what I call the "Big Bad Event Syndrome," where

a news event that so dwarfs others is about to occur, the stock market factored in all of the negatives and none of the positives. The catalysts are always different, but in each case we had priced in all the negatives and none of the positives.

My checklist of what to look for to detect a bottom in an individual stock

- First, a stock needs to lose most if not all of its sponsorship to form a true bottom. Amazon, Yahoo!, together among the best-acting stocks in the market, each received multiple downgrades and were even the recipients of sell recommendations at the bottom. That's a classic tell, when a stock loses whatever support it has left on Wall Street. At the bottom in 2002-2003, almost every great stock that had been hit by the temporary slowdown of the economy had sells on it.

- A second "tell" of a bottom occurs when bad news hits and the stock ceases to go down. It is common in every single bottom. That's because there is no one left who cares about the new negatives to want to dump the stocks. This works only with a good balance sheet.

- **A third indicator is consistent, large insider buying**. Insiders sell for a myriad of reasons: taxes, estate planning, divorce, prudence. They buy for only one reason: to make money. Don't bite when you see small dollar amounts of buying by individuals at the top. They could be "painting the tape" with their buys. You need to see buys in the millions of dollars to be sure that someone isn't trying to trick you into the stock, or con some reporter. Buy only **when you see multiple buys**, too. There's always one board member with a lot of cash around. But multiple and repeat buyers of significant amounts shows you the insiders mean business. It's a great tell and often signals the absolute bottom in an enterprise's stock.

- A fourth indicator occurs when a stock is rumored upon negatively and nothing happens.

- The final kind of bottoms are bottoms based on macro considerations. These are sector-rotation bottoms. There is a simple theme to these rotations. When you believe that the tightenings are beginning to have an effect, you will see a sudden rush of money over a four- or five-day period into the Kelloggs, Gillettes, Avons, Procters, the stuff that is in

your kitchen and your medicine chest. I used to like to place these bets close to the midway point in the tightening portion of the cycle, but these days so many people anticipate the Fed's moves that I think you would be best to start buying right at the time of the first tightening. The opposite happens when the Fed does its first loosening. Traditionally you need to switch into a sector that does well with the economy, typically companies like the autos and the retailers. You rotate into the heavier cyclicals as the easings go on, until in the end you are stuck with the dirtiest of stocks out there, such as, steel, copper, and aluminum.

Spotting Tops

Basic reasons you should abandon stocks you know and love

- Competition: The new competitor, if it means business, will destroy your company even as your company pretends that such a thing can't happen, or doesn't even know that a competitor is lurking because it is watching only the existing players, not anyone off the radar screen. Rule number one when you are riding a great long: Always assume that there is someone out there who could come in and make your company's product for less with lower margins. A committed competitor moving into your company's area with overall gross margins that are lower than the margins your company has signals the time to run, not hide. No one-product or two-product company with high margins can withstand a well-capitalized lower-margined competitor.

- Vagueness. Whenever a management is vague about specifics, whenever a management tells you it isn't worried about the numbers, or that it doesn't want to be constrained by the projections or by the forecasts because it is talking and thinking about bigger things, sell the stock. There are no bigger things than the numbers. This is not a liberal arts bull session. It is a business of hitting the numbers. When management goes vague in an interview – any interview – run for the hills. When someone who talks up his business at every turn, who is incessantly upbeat, suddenly won't talk about the numbers and won't brag about the business, and instead wants to talk about the heart monitor for dogs, you can tell that the business has gone sour. Or, a company that formerly wanted to

tell you everything about its future no longer wants to give guidance, or says it can't forecast its business. Or, when a company won't give you breakdowns of sales when it used to, especially when it is saying it can't do this for competitive reasons.

- Overexpansion. Nothing defeats a company's dreams like overexpansion. If you can't create growth organically you either have to buy growth or you have to use steroids to grow. Knowing when a company is overexpanding and expanding too quickly, the functional equivalent of steroids, is integral to spotting a top ahead of a train wreck. If a firm cannot grow numbers fast enough on Wall Street, it has to go buy the numbers or succumb to downgrades, and those are often too much for unseasoned managements to recover from. Whenever you hear management talk about "integration problems" as in "integration problems are slowing our ability to merge these two entities," run, don't walk, to the exit. All deals have integration problems; they are a given. If they are affecting the numbers to the point that management has to acknowledge them, believe me, that's fatal. Of course there will be companies that make intelligent acquisitions that don't signal the end of their growth. P&G has made several acquisitions that have boosted its bottom line successfully; so has GE. But they were measured and considered and incremental to their core businesses, not roll-the-dice mergers done one after another to throw you off the scent. When you see retailers put up a phenomenal number of stores all at once relative to their base, I think you have to shoot first and ask questions later. It just isn't possible for a management to maintain the quality control through that kind of expansion. It is a sign of weakness, not strength. It is why, when a company is in extreme growth mode, I look at same-store sales, not total sales, to detect a fiasco.

- Government blindside.

Rules for using put options

- The Business Week cover rule. If your short involves a company great enough to be on the cover of Business Week, forget it. Even is you have insight, just forget it. Great companies shouldn't be shorted.

- Can the company be taken over? If yes, just do it in puts.

- Never short because of valuation. Expensive stocks have a way of getting more expensive. You never ever try to call an irrational top based solely on multiples of sales earnings. The long-side players simply ignored the near-term P/E consideration and focused on the out years. You need a better, more rigorous answer about why a stock will come down than “it is too expensive”. Chartists will ride these winners until something fundamental happens to break the overvaluation. If you don’t know what that is, don’t short. You may not live long enough to collect the gains.

- Use puts when you can instead of borrowing and selling short stock. If you are sure something is going to go down but don’t know when, use deep puts going out many, many months.

- Never be part of what I call a gang tackle short. If you ever hear of a bunch of people shorting the same names that you are shorting, I can tell you that you are a dead man. That’s because there could be people much bigger than me shorting the stock and then covering to wreck the short when they grew impatient. Too many short sellers means too little stock to borrow means too much of an opportunity for a buy-in to occur.