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Five Rules for Successful Stock Investing

It always amazes me how few investors—and sometimes, fund managers—can articulate their investment philosophy. Without an investing framework, a way of thinking about the world, you're going to have a very tough time doing well in the market.

I realized this some years ago while attending the annual meeting of Berkshire Hathaway, the firm run by billionaire superinvestor Warren Buffett. I overheard another attendee complain that he wouldn't be attending another Berkshire meeting because "Buffett says the same thing every year." To me, that's the whole point of having an investment philosophy and sticking to it. If you do your homework, stay patient, and insulate yourself from popular opinion, you're likely to do well. It's when you get frustrated, move outside your circle of competence, and start deviating from your personal investment philosophy that you're likely to get into trouble.

Here are the five rules that we recommend:

1. Do your homework.
2. Find economic moats.
3. Have a margin of safety.
4. Hold for the long haul.
5. Know when to sell.

Do Your Homework

This sounds obvious, but perhaps the most common mistake that investors make is failing to thoroughly investigate the stocks they purchase. Unless you know the business inside and out, you shouldn't buy the stock.

This means that you need to develop an understanding of accounting so that you can decide for yourself what kind of financial shape a company is in. For one thing, you're putting your own money at risk, so you should know what you're buying. More important, investing has many gray areas, so you can't just take someone else's word that a company is an attractive investment. You have to be able to decide for yourself because one person's hot growth stock is another's disaster waiting to happen. In Chapters 4 through 7, I'll show you what you need to know about accounting and how to boil the analysis process down to a manageable level.

Once you have the tools, you need to take time to put them to use. That means sitting down and reading the annual report cover to cover, checking out industry competitors, and going through past financial statements. This can be tough to do, especially if you're pressed for time, but taking the time to thoroughly investigate a company will help you avoid many poor investments.

Think of the time you spend on research as a cooling-off period. It's always tempting when you hear about a great investment idea to think you have to act now, before the stock starts moving—but discretion is almost always the better part of valor. After all, your research process might very well uncover facts that make the investment seem less attractive. But if it is a winner and if you're truly a long-term investor, missing out on the first couple of points of upside won't make a big difference in the overall performance of your portfolio, especially since the cooling-off period will probably lead you to avoid some investments that would have turned out poorly.

Find Economic Moats

What separates a bad company from a good one? Or a good company from a great one?

In large part, it's the size of the economic moat a company builds around itself. The term *economic moat* is used to describe a firm's competitive advantage—in the same way that a moat kept invaders of medieval castles at bay, an economic moat keeps competitors from attacking a firm's profits.

In any competitive economy, capital invariably seeks the areas of highest expected return. As a result, the most profitable firms find themselves beset by competitors, which is why profits for most companies have a strong tendency over time to *regress to the mean.* This means that most highly profitable companies tend to become less profitable as other firms compete with them.

Economic moats allow a relatively small number of companies to retain above-average levels of profitability for many years, and these companies are often the most superior long-term investments. Longer periods of excess profitability lead, on average, to better long-term stock performance.

Identifying economic moats is such a critical part of the investing process that we'll devote an entire chapter—Chapter 3—to learning how to analyze them. Here's a quick preview. The key to identifying wide economic moats can be found in the answer to a deceptively simple question: How does a company manage to keep competitors at bay and earn consistently fat profits? If you can answer this, you've found the source of the firm's economic moat.

Have a Margin of Safety

Finding great companies is only half of the investment process—the other half is assessing what the company is worth. You can't just go out and pay whatever the market is asking for the stock because the market might be demanding too high a price. And if the price you pay is too high, your investment returns will likely be disappointing.

The goal of any investor should be to buy stocks for less than they're really worth. Unfortunately, it's easy for estimates of a stock's value to be too optimistic—the future has a nasty way of turning out worse than expected. We can compensate for this all-too-human tendency by buying stocks only when they're trading for substantially less than our estimate of what they're worth. This difference between the market's price and our estimate of value is the margin of safety.

Take Coke, for example. There's no question that Coke had a solid competitive position in the late 1990s, and you can make a strong argument that it still does. But folks who paid 50 times earnings for Coke's shares have had a tough time seeing a decent return on their investment because they ignored a critical part of the stock-picking process: having a margin of safety. Not only was Coke's stock expensive, but even if you thought Coke was worth 50 times earnings, it didn't make sense to pay full price—after all, the assumptions that led you to think Coke was worth such a high price might have been too optimistic. Better to have incorporated a margin of safety by paying, for example, only 40 times earnings in case things went awry.

Always include a margin of safety into the price you're willing to pay for a stock. If you later realize you overestimated the company's prospects, you'll have a built-in cushion that will mitigate your investment losses. The size of your margin of safety should be larger for shakier firms with uncertain futures and smaller for solid firms with reasonably predictable earnings. For example, a 20 percent margin of safety would be appropriate for a stable firm such as Wal-Mart, but you'd want a substantially larger one for a firm such as Abercrombie & Fitch, which is driven by the whims of teen fashion.

Sticking to a valuation discipline is tough for many people because they're worried that if they don't buy today, they might miss the boat forever on the stock. That's certainly a possibility—but it's also a possibility that the company will hit a financial speed bump and send the shares tumbling. The future is an uncertain place, after all, and if you wait long enough, most stocks will sell at a decent discount to their fair value at one time or another. As for the few that just keep going straight up year after year—well, let's just say that *not making* money is a lot less painful than *losing* money you already have. For every Wal-Mart, there's a Woolworth's.

One simple way to get a feel for a stock's valuation is to look at its historical price/earnings ratio—a measure of how much you're paying for every dollar of the firm's earnings—over the past 10 years or more. (We have 10 years' worth of valuation data available free on Morningstar.com, and other research services have this information as well.) If a stock is currently selling at a price/earnings ratio of 30 and its range over the past 10 years has been between 15 and 33, you're obviously buying in at the high end of historical norms.

To justify paying today's price, you have to be plenty confident that the company's outlook is better today than it was over the past 10 years. Occasionally, this is the case, but most of the time when a company's valuation is significantly higher now than in the past, watch out. The market is probably overestimating growth prospects, and you'll likely be left with a stock that underperforms the market over the coming years.

We'll talk more about valuation in Chapters 9 and 10, so don't worry if you're still wondering how to value a stock. The key thing to remember for now is simply that if you don't use discipline and conservatism in figuring out the prices you're willing to pay for stocks, you'll regret it eventually. Valuation is a crucial part of the investment process.

Hold for the Long Haul

Never forget that buying a stock is a major purchase and should be treated like one. You wouldn't buy and sell your car, your refrigerator, or your DVD player 50 times a year. Investing should be a long-term commitment because short-term trading means that you're playing a loser's game. The costs really begin to add up—both the taxes and the brokerage costs—and create an almost insurmountable hurdle to good performance.

If you trade frequently, you'll rack up commissions and other expenses that, over time, could have compounded. Every $1 you spend on commissions today could have been turned into $5.60 if you had invested that dollar at 9 percent for 20 years. Spend $500 today and you could be giving up more than $2,800 20 years hence.

But that's just the beginning of the story because frequent trading also dramatically increases the taxes you pay. And whatever amount you pay in taxes each year is money that can't compound for you next year.

Let's look at two hypothetical investors to see what commissions, trading, and taxes can do to a portfolio. Long-Term Lucy is one of those old-fashioned fuddy-duddies who like to buy just a few stocks and hang on to them for a long time, and Trader Tim is a gunslinger who likes to get out of stocks as soon as he's made a few bucks (see Figure 1.1).

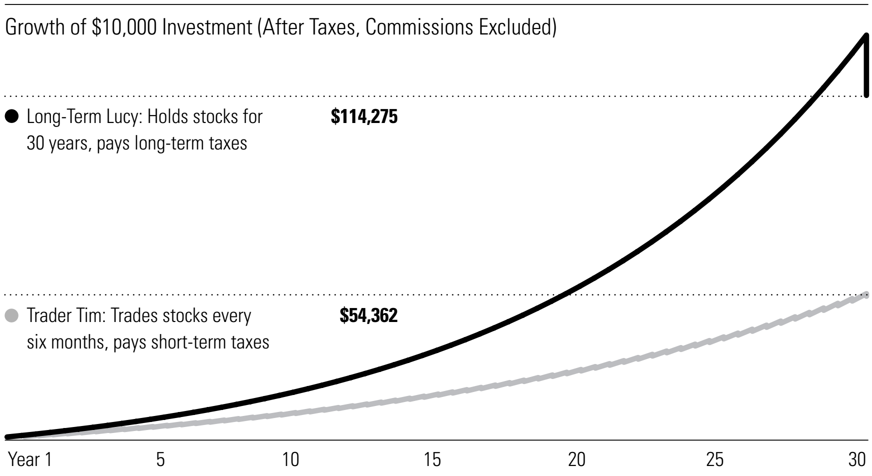

Figure 1.1 Tim turns over his portfolio every six months, incurring a 35% short-term capital gains tax. Lucy's gains are taxed at only 15% thanks to her buy-and-hold strategy, and more of her money compounds over a longer time. *Source:* Morningstar, Inc.

Lucy invests $10,000 in five stocks for 30 years at a 9 percent rate of return and then sells the investment and pays long-term capital gains of 15 percent. Tim, meanwhile, invests the same amount of money at the same rate of return but trades the entire portfolio twice per year, paying 35 percent short-term capital gains taxes on his profits and reinvesting what's left. We'll give them both a break and not charge them any commissions for now.

After 30 years, Lucy has about $114,000, while Tim has less than half that amount—only about $54,000. As you can see, letting your money compound without paying Uncle Sam every year makes a huge difference, even ignoring brokerage fees.

And since holding a single stock for 30 years may not be realistic, let's consider what happens if Lucy sells her entire portfolio every five years, reinvesting the proceeds each time. In this case, she winds up with about $96,000—which is not much less than $114,000 and is still much more than Tim's $54,000 (see Figure 1.2).

These examples look at just the tax impact of frequent trading—things look even worse for the traders once we factor in commissions. If we assume that Tim and Lucy pay $15 per trade, Tim nets only about $31,000 after 30

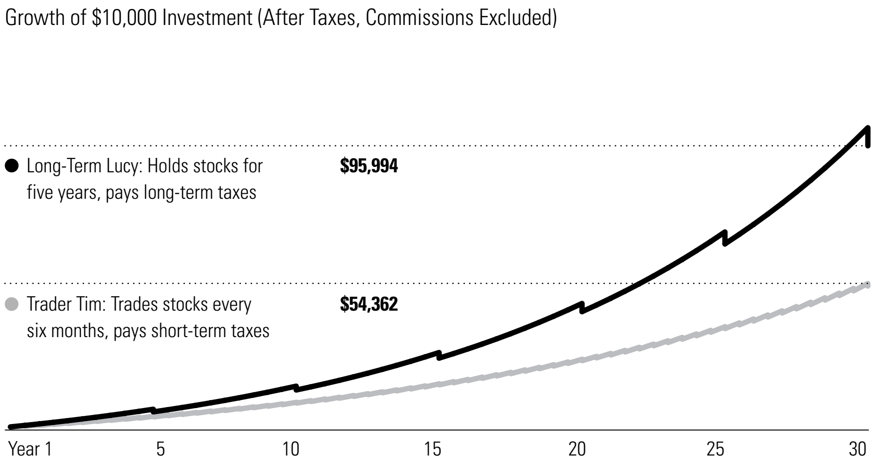

Figure 1.2 Lucy decreases her holding period to 5 years from 30 years, but the benefit of lower taxes and a longer compounding period still nets her significantly more than Tim. *Source:* Morningstar, Inc.

years and Lucy nets $93,000, again assuming she holds her stocks for five years (see Figure 1.3).

The real-world costs of taxes and commissions can take a big bite out of your portfolio. Extending your average holding period from six months to five years yields about $62,000 in extra investment returns. Lucy gets a lavish reward for her patience, don't you think?

One final thought: To match Lucy's $93,000 portfolio value, Tim would need to generate returns of around 14 percent each year instead of 9 percent. That's the true cost of frequent trading in this example—about five percentage points per year. So, if you really think that churning your portfolio will get you five extra percentage points of performance each year, then trade away. If, like the rest of us, you were taught some humility by the bear market, be patient—it'll pay off.

Know When to Sell

Ideally, we'd all hold our investments forever, but the reality is that few companies are worth holding for decades at a stretch—and few investors are savvy enough to buy only those companies. Knowing when it's appropriate to bail

Growth of $10,000 Investment (After Taxes, Commissions Included)

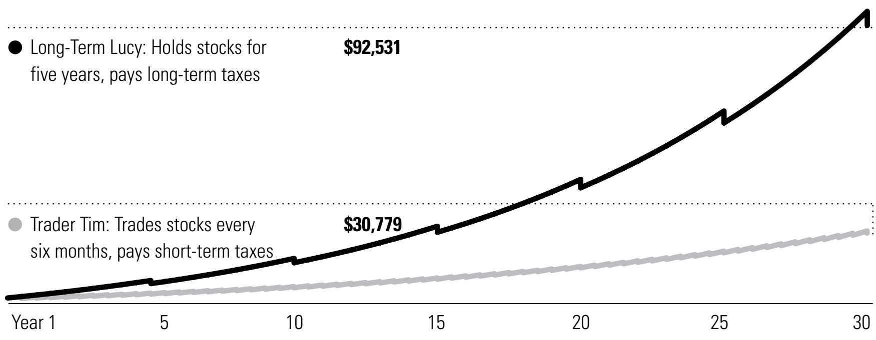

Figure 1.3 When commissions are taken into account, Tim's returns suffer far more than Lucy's.
Source: Morningstar, Inc.

out of a stock is at least as important as knowing when to buy one, yet we often sell our winners too early and hang on to our losers for too long.

The key is to constantly monitor the *companies* you own, rather than the *stocks* you own. It's far better to spend some time keeping up on the news surrounding your companies and the industries in which they function than it is to look at the stock price 20 times a day.

Before I discuss when you *should* sell a stock, I ought to point out when you *shouldn't* sell.

The Stock Has Dropped

By themselves, share-price movements convey no useful information, especially because prices can move in all sorts of directions in the short term for completely unfathomable reasons. The long-run performance of stocks is largely based on the expected future cash flows of the companies attached to them—it has very little to do with what the stock did over the past week or month.

Always keep in mind that it doesn't matter what a stock has done since you bought it. There's nothing you can do to change the past, and the market cares not one whit whether you've made or lost money on the stock. Other market participants—the folks setting the price of the stock—are looking to the future, and that's exactly what you should do when you're deciding whether to sell a stock.

The Stock Has Skyrocketed

Again, it matters little how those stocks have done in the past—what's important is how you expect the company to do in the future. There's not *a priori* reason for stocks that are up substantially to drop, just as there's no reason for stocks that have tanked to "have to come back eventually." Most of us would be better investors if we could just block out all those graphs of past stock performance because they convey no useful information about the future.

So when should you sell? Run through these five questions whenever you think about selling a stock, and you'll be in good shape.

Did You Make a Mistake?

Did you miss something when you first evaluated the company? Perhaps you thought management would be able to pull off a turnaround, but the task turned out to be bigger than you (and they) thought. Or maybe you underestimated the strength of a company's competition or overestimated its ability to find new growth opportunities. No matter what the flub, it's rarely worth holding on to a stock that you bought for a reason that's no longer valid. If your initial analysis was wrong, cut your losses, take the tax break, and move on.

Have the Fundamentals Deteriorated?

After several years of success, that raging growth company you bought has started to slow down. Cash is piling up as the company has a tougher time finding profitable, new investment opportunities, and competition is eating away at the company's margins. Sounds like it's time to reassess the company's future prospects. If they're substantially worse than they used to be, it's time to sell.

Has the Stock Risen Too Far above Its Intrinsic Value?

Let's face it: The market sometimes wakes up in an awfully good mood and offers to pay you a price far in excess of what your investment is really worth.

There's no reason not to take advantage of other investors' good nature. Ask yourself how much more the market is willing to pay you than your estimate of the value of the stock and how likely it is that your estimate of its value could go up over time. You don't want to sell wonderful companies just because they get a little pricey—you'd incur capital gains and wouldn't be taking advantage of compounding. But even the greatest companies should be sold when their shares sell at egregious values.

Is There Something Better You Can Do with the Money?

As an investor, you should always be seeking to allocate your money to the assets that are likely to generate the highest return relative to their risk. There's no shame in selling a somewhat undervalued investment—even one on which you've lost money—to free up funds to buy a stock with better prospects.

I did this myself in early 2003 when I noticed that Home Depot was looking awfully cheap. The stock had been sliding for almost three years, and I thought it was worth about 50 percent more than the market price at the time. I didn't have much cash in my account, so I had to sell something if I wanted to buy Home Depot. After reviewing the stocks I owned, I sold some shares of Citigroup, even though they were trading for about 15 percent less than what I paid for them. Why? Because my initial assessment of Citigroup's value had been too optimistic, and I didn't think the shares were much of a bargain any more. So, I sold a fairly valued stock to purchase one that I thought was very undervalued.

What about my small loss on the Citi stock? That was water under the bridge and couldn't be changed. What mattered was that I had the opportunity to move funds from an investment with a very modest expected return to one with a fairly high expected return—and that was a solid reason to sell.

Do You Have Too Much Money in One Stock?

This is the best reason of all to sell because it means you did something right and picked a winner. The key is to not let greed get in the way of smart portfolio management. If an investment is more than 10 percent to 15 percent of your portfolio, it's time to think long and hard about trimming it down no matter how solid the company's prospects may be. (These percentages are a rough guide—you might be comfortable with more money in a single stock, or you might want to be more diversified.) It simply doesn't make sense to have too many of your eggs in one basket.

Investor's Checklist: Five Rules for Successful Stock Investing

- Successful investing depends on personal discipline, not on whether the crowd agrees or disagrees with you. That's why it's crucial to have a solid, well-grounded investment philosophy.
- Don't buy a stock unless you understand the business inside and out. Taking the time to investigate a company before you buy the shares will help you avoid the biggest mistakes.
- Focus on companies with wide economic moats that can help them fend off competitors. If you can identify why a company keeps competitors at bay and consistently generates above-average profits, you've identified the source of its economic moat.
- Don't buy a stock without a margin of safety. Sticking to a strict valuation discipline will help you avoid blowups and improve your investment performance.
- The costs of frequent trading can be a huge drag on performance over time. Treat your stock buys like major purchases, and hold on to them for the long term.
- Know when to sell. Don't sell just because the price has gone up or down, but give it some serious thought if one of the following things has happened: You made a mistake buying it in the first place, the fundamentals have deteriorated, the stock has risen well above its intrinsic value, you can find better opportunities, or it takes up too much space in your portfolio.