CHAPTER 1

Key Reasons Investors Lose Money

THE STOCK MARKET DECLINE IN 2001 AND 2002 CONVINCED MANY investors that the market is an impossible place to make money consistently over time. Nothing could be further from the truth; actually, it has never been easier. Before I tell you my secret to becoming a consistent winner in the stock market, we need to examine some of the key reasons investors lose money.

The first mistake: investing without a plan or using the wrong investment strategy. Many investors have no plan for making money in the stock market. Others use the wrong strategies because they fail to see changes in market trends. Sports teams, corporations, and organizations that achieve success always work from a fundamentally sound plan. It is no different for those who want to succeed in the stock market.

In golf, the most important part of the game is to develop a pre-shot routine that includes good balance and setup. At the golf club where I play, I frequently see PGA golfers in the exercise room working on their setup and balance. It is amazing to me just how still they can be on a small balance beam. Investors, like golfers, need a consistent routine as well. In the financial world, this is known as an investment style.

There are three basic styles of investing: value, growth, and momentum, and there are many variations within these styles.

The most common investment style is value investing. Value investing offers the lowest risk of any other style of investing. Value investors are known as bargain hunters, looking for stocks priced low in comparison to the company's historical earnings and growth prospects. The most common strategy for a value investor is to buy a stock when it is undervalued relative to its earnings history and prospects and then sell it when it is fully valued. With a long-term approach, the value investor will see many stocks go through cycles of overvaluation and undervaluation.

Undervaluation has been the key to success for Warren Buffett and his company, Berkshire Hathaway, whose shares began selling in 1967 at $12/share. The world's most famous value investor once said, "The most common cause of low prices is pessimism . . . sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."

Unlike Warren Buffett, who is a bottom-up stock analyst, I have always been more of a top-down strategist. This puts me at a disadvantage when it comes to buying depressed, undervalued stocks. I am simply not as well trained in security analysis to ferret out undervalued stocks as Buffett and his analysts are.

Analytically and financially, I am no match for Buffett. However, I have found that my knowledge of insider trading helps me make up for my lack of traditional analytical skills. When I see a stock on the new low list or one that is being panned in the media, I always look to see what insiders are doing. In the 1980s, I was perusing a friend's copy of *Value Line*. I noticed that Global Marine was listed as a 5, a strong sell signal. The *Value Line* analysis indicated that the stock had a terrible balance sheet and had negative cash flow. I was not sure at the time what that meant, but it sounded bad. In those days, I had no historical insider data on stocks and there was no Internet to check insider trading. I did, however, have access to insider trading reported to the New York Stock Exchange. I discovered that six insiders had bought approximately 275,000 shares in the $3 area. I reasoned that if these insiders were buying a stock with such bad fundamentals, maybe there was something going on that was unrecognized by traditional Wall Street research. Three years later, I sold the stock at $27, just about the time that *Value Line* had raised its rating to 1, its strongest signal, citing the company's improved fundamentals. *Value Line* was right, and the stock moved up another 30 percent. I have never been a great seller, but I like making the easy money by getting in early.

Income investing is a form of value investing that deserves mention. Also known as dividend investing, this is a straightforward strategy designed to pick stocks that provide a steady stream of income. There are two types of investors seeking income—equity income investors who buy stocks that pay dividends and fixed income investors who buy corporate and municipal bonds and other fixed income alternatives.

Typically, income investors focus on the dividend yield of well-established companies with very predictable earnings streams. The risk of buying historically high dividend paying stocks and holding them for the long term is very low. Dividend distribution and the levels of payouts, however, depend on the retained earnings of the company. It is always wise to make sure there is a large spread between a company's latest 12-month earnings and the amount of the dividend. Cushions are great to rest your head on, and a good cushion between the amount of earnings a company makes and its projected dividends can help you sleep comfortably.

Growth investing is the practice of buying fast-growing companies with high potential. The basic strategy for a growth investor is to buy a company with gains in earnings per share of 15 to 20 percent annually. Many growth investors are drawn to the high-tech industries such as telecommunications and the Internet with aggressive management, such as Intel and Microsoft, and innovative leading technology companies. Young companies with top-notch management, often creating superior brands like Internet leaders AOL and Amazon.com also attract growth investors.

Most growth stocks, however, are very risky because of the public's willingness to pay premium prices, which inflates the P/E ratios. Vulnerability to changes in perception of the growth potential or to a downtrend of investor confidence in that growth can cause the P/E ratios of these stocks to drop dramatically. The company's industry may play a part in the risk level as well due to varying growth averages and valuations. Stock selection is the most important factor in the strategy for growth investors, using screening programs filtering projected earnings growth against historical earnings.

Growth at a Reasonable Price (GARP) investing combines the two successful strategies of value and growth investing into a very sensible stock picking approach. GARP investors buy only stocks with growth at a reasonable price, operating in a more traditional mode than value investors, who look for stocks that are relatively cheap in relation to the company's earnings and book value, and growth investors, who buy stocks that tend to grow substantially fast and have high earnings potential.

After the dot-com crash, GARP became the popular acronym on Wall Street. The aftermath of the Internet sell-off presented some good buying opportunities, but the bottom for companies like Cisco and Yahoo!, classic growth stocks, hit further down the road. Traditionally, GARP investors seek growth companies with solid growth prospects and share prices that are somewhat lower than their intrinsic value, stopping short of looking at the company's business in detail. However, by November 2000, Cisco had lost more than 50 percent of its value, and Yahoo! had dropped from $120 to $15. Even though there was nothing fundamentally wrong with these companies, market conditions at that time could not help a GARP investor. The Magic T discussed in Chapter 13 is designed to identify market tops and bottoms, which can help GARP and other investors with market timing.

The world's most famous growth investor, Peter Lynch, defined growth at a reasonable price without ever even calling it GARP in his strategic practice to pay no more than one times the growth rate of earnings per share over the past three to five years as well as the projected earnings over the next three to five years. Similar to value investing, the analysis of insider trading of individual growth stocks can help investors discover which stocks to buy. When insiders purchase the shares of growth stocks at higher and higher prices, good news usually follows. Good or better than expected news is the fuel that keeps growth stocks growing. Insider trading will be discussed in greater detail in Chapter 5.

The third broad investing style and probably the most popular with younger investors is momentum investing. The fundamental tenet of momentum investing is that investments, whether they are stocks or industries that have already outperformed the market in the past, are likely to continue their winning ways. This belief builds on the notion that most investors are like cattle and will tend to herd with the most recent winners. Momentum investors chase the hot stocks and funds, and they do not mind swinging from the fences. For them, 15 percent or 20 percent returns in a year is not worth talking about. They want doubles and triples within a few months.

Most momentum investors will tell you that they focus on companies with accelerating earnings, better than expected earnings, analyst upgrades, and stocks that are increasing faster than the market. Many momentum investors have strong disciplines, and I know some money managers who use this strategy very profitably. It is fine, in my opinion, to let them manage your money if you are so inclined—just not in a bear market.

It is the bear market that clobbers momentum investors and puts them into hibernation. In 2000, for example, investors discovered that markets can and do become simultaneous and illiquid, which killed the notion that momentum players can get out at any time. When bad news hits a momentum stock or industry, the door shuts just as everyone is trying to escape.

In early 2004, I was increasingly concerned with the lack of insider buying and the fact that just about everyone I spoke to was charting stocks and talking about momentum. I recall one of my firm's young money managers telling me that his approach was simple. As a proponent of William O'Neil, who many consider the father of the momentum style, he bought every stock that broke out of a base on high volume and added to his position when it pulled back to support levels on light volume. I muttered to myself that it seemed like déjà vu all over again. Hadn't anyone learned from the bursting of the bubble in 2000?

The problem with momentum investing is that it works best during the early to middle stages of a stock increase or overall market advances. At some point in time, there will be a final breakout to new highs that most likely will be the top for the cycle and could be the top for many years. How does a momentum investor know whether the last breakout to new high ground is not the top?

One thing I know for sure, though: You can always count on the return of momentum investors. Most have short memories and the next bull market will bring them back in force again. Greed is human nature and, in my opinion, momentum investing personifies greed.

No discussion of momentum investing would be complete without discussing CANSLIM. This is a philosophy developed by William O'Neil, co-founder of *Investors Business Daily*, focusing on earnings and overall strength of momentum companies. The acronym spells out the criterion for this stock selection process.

- **C**urrent quarterly earnings must be up at least 18 percent.
- **A**nnual earnings per share should show growth over the past five years.
- **N**ew highs in price are achieved as a result of new significant industry conditions.
- **S**hares outstanding should be at a small and reasonable number.
- **L**eading the industry or, better yet, the market.
- **I**nstitutional sponsorship from firms with above average recent performance.
- **M**arket indexes and the market's overall current direction have been determined.

These are the fundamental characteristics of historically successful stocks. The CANSLIM strategy is strict; all the above criteria must be met to warrant an investment. It includes practices from all the major investment strategies but does not support investing into high-risk companies.

My investment style is simple; it is a top-down strategy. I want to be in the stock market when the odds are in my favor and out when the odds are against me. For picking stocks, I buy both growth and value stocks, but only if there is insider buying to support the picture. I want to be a partner—not an adversary—with the men and women whose companies I invest in.

As we examine some of the key reasons investors lose money, here is the second mistake: following investment market letter writers and so-called experts who appear in the media, especially in television. Most market letter writers and other experts are wrong more than they are right, especially at key market turning points. Following them is a prescription for disaster.

The third mistake: investing at the wrong time. Believe it or not, starting an investment plan in certain months will almost always guarantee failure. The good news is that in other months, investors are almost guaranteed success, given the right plan.

Clearly, if you can correct these mistakes, you will be well on your way to being a consistent stock market winner.