Chapter One

Buy Stocks like Steaks . . . On Sale

Buy stocks like you buy everything else, when they are on sale.

"On sale" are two of the most compelling words in advertising. Imagine that you are in the supermarket, strolling down the aisles gathering your groceries for the week ahead. In the meat aisle, you discover that one of your favorites, prime Delmonico steak, is on sale—down to just $2.50 per pound from the usual $8.99 per pound. What do you do? You load up the cart with this delicacy while it's cheaply priced. When you return the next week

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and see those Delmonico steaks priced at $12.99 a pound, you pause. Perhaps this week, chicken or pork might be a smarter buy. This is how most people shop. They check the sales flyers stuffed in the Sunday newspaper and make their purchases when they spot a bargain on something they want or need. They wait until they see that dishwasher or refrigerator on sale no matter how much they want or need a new one. Every holiday, they flock to the mall to take advantage of the huge bargains that are only offered a few times during the year. When interest rates drop, they run to the bank or mortgage broker to refinance or take out new and bigger mortgages. Most people tend to look at pretty much everything they buy with an eye on the value they get for the price they pay. When prices drop, they buy more of the things they want and need. Except in the stock market.

In the stock market, there is the irresistible excitement and lure of the hot stocks everyone is talking about at cocktail parties—the ones that are the darlings of the talking heads on cable stock market shows, and the financial newsletters tell us that we must own. It is the wave of the future! It is a new paradigm! People believe that they'll miss a terrific opportunity if they don't own these super exciting stocks. It is not just average Janes and Joes who get caught up in the frenzy. When stocks climb, Wall Street research reports scream *Buy.* When stocks

fall, the experts tell us to *Hold* when they really mean *Sell*. (Sell is considered impolite in the world of stocks except under the most extreme circumstances.) Everyone seems to think that they should buy stocks that are rising and sell those that are falling.

There are reasons for this pattern of behavior: First, investors are afraid of being left behind and like the idea of owning the hot and popular stocks everyone is talking about. They also find a certain comfort in knowing that lots of other people have made the same choices (like fans cheering for the same sports team). But it's not just everyday, individual investors who fall prey to the herd mentality; it also happens to professional portfolio managers. If they own the same stocks everyone else owns, they are unlikely to be fired if the stocks go down. After all, they won't look quite so bad compared with their peers, who will also be down. This unique situation fosters a mind-set that allows investors to be comfortable losing money as long as everyone else is losing money, too.

The other reason investors fall prey to the fads and follow the crowd is that investors, both individual and professional, tend to become disillusioned when the stocks they own or stock markets in general decline significantly. They end up with a bad taste in their mouths that prevents them from buying stocks while the value of their retirement funds is falling. When stocks go down,

people lose money. The news—on the television, in the papers—seems all doom and gloom. Investors get scared.

However, buying stocks should not be so different from buying steak on sale or waiting for the car companies to offer special incentives. In fact, the Internet has made bargain buyers of everyone: You can buy used books from stores in the United Kingdom, computers from sellers in Canada, and jeans on sale in Japan. You don't really care where the seller is—you just want the bargain (often found on eBay)—and in our increasingly borderless world, the "stores" you shop at are not limited to those that are a short drive away.

The same holds for stocks. The time to buy stocks is when they are on sale, and not when they are high priced because everyone wants to own them. I have been investing for myself and clients for more than 30 years, and I always try to buy stocks on sale, no matter where the sale is. Buying stocks when they are cheap has for me been the best way to grow my money. Stocks of good companies on sale reaped the highest returns. They have beaten both the market and the more glamorous and exciting issues being chatted about at cocktail parties or around the watercooler at work.

Hot stocks (or *growth* stocks, in financial world parlance) have always been considered the more exciting and interesting form of investing. But are they the most prof-

itable? When people invest in growth stocks, they are hoping to invest in companies that have a product or service that is in high demand and will grow faster than the rest of the marketplace. Growth investors tend to own the darlings of the day—hot new products or companies with lots of sex appeal. They tend to be the best among their industry group and innovators in their field. There is nothing wrong with owning great businesses that can grow at fast rates. The fault in this approach lies in the price that investors pay. Nothing grows at superhigh rates forever. Eventually, hypergrowth slows. In the interim, investors have often bid the prices of these hot, glamour stocks up to unsustainable heights. When growth rates decline, the result can be injurious to the investor's financial well-being.

One of the best ways to look at which method of investing will give us the best results is to review real-world results of mutual funds. Almost everyone invests in mutual funds these days, frequently through retirement (401(k) or IRA) accounts. There are many kinds of mutual funds, but the two most popular are *growth funds,* which invest in hot new companies, and *value funds,* which buy stocks on sale. The research service Morningstar does a great job of tracking fund results and ranking them by category. The funds are divided into categories according to their investment strategy—whether they invest in large, medium-size, or small companies (large, mid, and small caps, in Wall Street

jargon)—as well as whether they favor a growth or value style. What Morningstar statistics show is that no matter what size company the funds invest in, the value funds earn the best returns over the long term. This turns out to be true not just among funds investing in U.S. companies but funds that invest in companies all over the globe.

Over the past five years, value funds have outperformed growth funds by 4.87 percent annually compounded. This is remarkable when you consider that the press frequently hails professional investors who beat the markets by a penny or two. There are those who would have you believe that it is impossible to beat the market over long periods. They write off the track records of stock market legends such as Warren Buffett, Bill Ruane, or Bill Miller as lucky accidents. This is based on a theory, known as the *efficient market hypothesis,* that is taught in many college classrooms. The theory basically claims there are no "cheap" or "rich" stocks, that the market is a rational, intelligent entity that perfectly prices each stock every day based on the known information. Anyone who beats the market is just plain lucky.

Warren Buffett sees it otherwise. In a now legendary speech he made in 1984 on the fiftieth anniversary of the publication of *Security Analysis* (and later printed in *Hermes,* the Columbia Business School magazine) as

"The Super Investors of Graham and Doddsville," Buffett used the example of 225 million Americans each betting one dollar on a coin flip. Each day, the losers drop out and the winners go on to the next round, with all winnings being bet the next day. After just 20 days, there will be 215 people who have won just over a million dollars. The proponents of the efficient market hypothesis would have us believe that those who outperform the market are nothing more than lucky coin flippers. Mr. Buffett furthers the analogy, swapping orangutans for people. The result is the same: 215 furry orange winners. But what if all the winning orangutans came from the same zoo? This would raise a few questions as to how these giant fur balls learned this amazing skill. Was it luck, or did all the orangutans have something in common? Buffett then looked at the world of investing and examined the record of some of the most successful investors of all time. The seven super investors were all found to be from the same zoo, so to speak. Several of the investors cited by Buffett had either taken Graham's course at Columbia Business School or worked for him at his investment firm. All were committed value types in the mold of Graham and subscribed to the basic concept of buying businesses for less than they are worth. And all had made better returns than the overall stock market and their more growth-oriented peers.

Each of these alleged lucky coin flippers did not apply value principles in exactly the same way. And they did not own the same stocks. Some owned a lot of stocks. Others owned only a few. Their portfolios were quite different. However, they all had a common intellectual grounding, and they believed in the basic concept of value investing—buying a business for far less than it is worth. This is not lucky coin flipping but buying stocks on sale.

This concept is supported by rigorous academic studies of value investing versus growth, or as some call it, "glamour investing." These studies make a compelling case that buying the cheapest stocks based on simple principles produces better results. From 1968 to 2004, value portfolio characteristics produced superior returns. In many cases, the degree of outperformance in these studies was several percentage points greater. But don't just take my word for it. In "Don't Take My Word for It" at the end of this little book, there is a quick tour through the empirical evidence. You don't have to read all these studies, but understanding the research and results will help you better appreciate the tremendous advantage that value investing provides.

A few percentage points of better performance can have a huge impact on your net worth. Suppose you invested $10,000 in your retirement account, and it compounded at 8 percent for 30 years, the average time one

saves for retirement. By the time you were ready to retire, you would have just over $100,000. A tidy sum! However, if you could compound that same $10,000 over the same 30 years at 11 percent, your nest egg would grow to nearly $229,000. That would make a big difference in the way you would spend your retirement years. Just as it makes sense to buy steaks, cars, and jeans on sale, it makes sense to buy stocks on sale, too. Stocks on sale will give you more value in return for your dollars.