Part One

YOUR NEXT GREAT STOCK

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Chapter 1

You Should Own Stocks

You probably already know this. After all, you're reading a book called *Your Next Great Stock*. But you should own stocks.

There's nothing abstract or exotic about a stock. It's simply a piece of a business. Stocks are born when companies sell shares of themselves to investors. Sometimes they do this because the original business owners want to cash in part of their stake. Sometimes companies issue shares because they want to raise money for expansion.

Many stocks trade freely among investors after they're issued. Their prices are determined by investor demand, which is, in turn, determined by how valuable investors think these businesses are or will become.

If you own stocks, you own businesses. If you pick good businesses—ones that grow and become more valuable—the price of your stocks will rise. Your businesses might also distribute part of their profits to you in cash. They might make big, one-time distributions when the opportunity arises or little, periodic ones, in fairly regular amounts. These payments are called *dividends*. The combination of share

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price increases and dividend payments make up, for the most part, the total return you receive from your stocks. The purpose of this book is to show you how to find businesses that are likely to produce large total returns.

Owning stocks, even ones that produce average returns, is the best way to build wealth over long time periods.

I know; right now seems like an uncertain time to buy stocks. There's that scandal in the news about the boss who stole money and made his stock price plummet. There's that big economic report due out tomorrow—something about interest rates—that will show whether we're okay. Also, over the past year the stock market (1) fell, so it might keep falling, (2) rose, so it might be expensive, or (3) did nothing, while everyone else got rich in real estate. Plus, the guy on the financial channel who's reporting live from the floor of the stock exchange seems particularly frantic today.

That's what it always looks like.

That boss who stole money is an exception among thousands of honest bosses who can grow your businesses. Whether they want to or not, bosses leave clues as to how reliable they are in their financial reports. We'll see how to find those clues later.

There's a big economic report every day. Ignore them. The reports can't tell you how the stock market will react to the reports. Sometimes the market goes up on miserable news because investors were expecting worse news. Sometimes it goes up because the news is so miserable it causes everyone to figure that someone in charge will finally do something to fix things. You can't use economic news to predict the market's short-term performance, and there's no need to predict the market's long-term performance. Spoiler alert: It's going up.

I'm confident that stock prices will increase significantly over the next 20 years and that stocks will outperform other investments such as bonds, gold, and real estate. I base that belief on two things: past performance and logic. (The importance of using both past performance and logic when developing stock-picking strategies will be made clear later in the book.)

First, the past performance. You've no doubt already seen "Stocks, Bonds, Bills, and Inflation." It's something of a celebrity as financial charts go. Ibbotson Associates, the chart's publisher, will sell you a

laminated copy, but there's no need to buy one. Tell a stockbroker you're wavering on whether to renew a big Treasury bond or certificate of deposit that just matured. He'll whip out a copy like he's showing off a picture of his kids.

The chart shows what a single dollar placed in various investments has turned into since 1925. Small-company stocks and large-company stocks are represented by two squiggly lines that soar above the others, turning their dollar bills into numbers so large they look like misprints: $13,706 and $2,658, respectively, by the end of 2006. Two smoother lines representing government bonds and their shorter-term siblings, bills, creep to just $71 and $18. That's barely enough to outpace inflation, the chart's fifth line, which rises to $11. Inflation is the gradual increase in the prices of ordinary goods, everything from a can of beer to a pottery class to an ear exam. If your wealth isn't growing faster than inflation, you're getting poorer.

Look closely at such a chart and you can see what surely must have been scary times for investors: a huge dip in 1929, a long lull in the late 1960s and early 1970s, and a stumble in 2000. Stand further back, though, and you'll see that through war, peace, breakthroughs, and setbacks, stocks have climbed. Buy a large basket of stocks, hold them for a long time, and you'll grow rich. In fact, over long time periods stock returns are remarkably consistent. After inflation, they return about seven percent a year. One study by Wharton professor Jeremy Siegel, for example, found that after-inflation returns averaged 7.0 percent over nearly seven decades ending 1870, then 6.6 percent through 1925 and then 6.9 percent through 2004.

Of course, most people don't have 70 or 80 years to watch their money grow. Those who are approaching retirement might have far fewer. Your stockbroker no doubt has a chart for that, too. It likely consists of three simple pie charts. The first illustrates how if you had held stocks for a single year picked at random between 1925 and 2005, there's a 71 percent chance you would have made money. The second shows that if it was a random five-year period instead of a single year, your chances improve to 87 percent. The final pie chart is one solid color; the market has gone up during every 15-year period since 1925.

Like bonds, real estate is unlikely to outperform stocks over the next 20 years. Yes, I know that your neighbor bought a Long Island bait shack

as an investment property a few years back and just sold it for $600,000 as a summer bungalow. But that's a historical exception. The average long-term return of real estate, after subtracting for inflation, might surprise you. It is about zero. According to Yale economist Robert Shiller, houses have returned an average of 0.4 percent a year after inflation since 1890. Nearly all of the positive returns come from two periods: one following World War II and another after 2000. Both periods benefited from artificial boosts to demand. During the first, the government began in earnest to provide subsidized mortgages. During the second, the Federal Reserve slashed interest rates.

The ratio of median house prices to median rents has now more than doubled since World War II, whereas the ratio of share prices to yearly company earnings is pretty close to its World War II level and historical average. That suggests real estate has become far pricier than stocks. Of course, over long time periods, professional real estate investors know how to use enormous leverage to turn skimpy returns into bigger ones. But stock investors can achieve big returns without borrowing money. And stocks are less costly to own: As they say, they never call you in the middle of the night with a leaky toilet. If you get a call like that from your stocks, it's probably a prank.

Perhaps you've seen a late-night infomercial or magazine ad touting the blazing returns of gold. A dollar invested in gold in 1925 grew to just under $31 by the end of 2006. That's more than short-term government bonds returned but less than long-term ones did, and it's a pittance next to stock returns.

"The numbers don't lie," people sometimes say. On Wall Street, as we'll see later in this book, the numbers *do* lie—and they lie often. Past returns are never reason enough to follow an investment strategy, because sometimes they're a fluke and sometimes people manipulate them. Always look for a logical explanation for past returns. The stock strategies contained in this book are based on both strong past returns and reasonable explanations. We'll call those *correlation* and *cause* later. Let's get into the habit of pairing the two now. Without knowing what caused Ibbotson's charts to look the way they do, there's no way to predict whether updated versions 20 years from now will tell the same story.

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Companies prosper only to the extent that they can earn positive returns on their resources. A deli that fills $5 sandwiches with $6 worth of pastrami won't stay in business for long. Among the materials most companies use are money, real estate, and raw materials.

Companies that need money often borrow it by issuing bonds to investors. They pay interest on those bonds. That interest represents the cost of their money. Companies pay this cost only because they're confident they can produce profits that exceed it. Stocks outperform bonds over long time periods because companies generate profits that exceed bond interest.

Most companies own or lease real estate. Even Internet companies usually have a headquarters or warehouse. They pay for real estate only to the extent they can use that real estate profitably. Stocks outperform real estate over long time periods because companies produce profits that surpass real estate costs.

Some companies use raw materials to manufacture goods. These materials are called *commodities*. A commodity is a good that's interchangeable with other goods of the same type. Gold is an example. Provided the chemical compositions are the same, one nugget of gold is no better or worse than another of the same size, just as one barrel of oil is the same as the next. Companies wouldn't pay more for raw materials than they can earn by using those materials. Stocks beat gold over long time periods because companies produce profits that are bigger than commodity costs.

Stocks entitle you to a share of a company's money, real estate, and commodities, but that's not what makes them so valuable. Shareholder wealth is created by the people who turn those resources into profits. When you buy stocks, you effectively hire smart people who spend their days figuring out how to make you money. Bonds, houses, and gold can't do that.

So you should own stocks. Chances are, you should put a portion of your money in bonds, real estate, and commodities, too, even though the long-term returns on those investments won't be as good. That's because if stocks have a lousy year, your other investments might have a good one. It keeps returns smoother over time. Mixing different assets together is called *diversification* or *asset allocation* and is outside the scope

of this book. Financial planners often tell old investors to favor bonds and young ones to load up on stocks, but what matters isn't so much your age as how much of your savings you'll have to spend over the next decade or two. If you are 35 and adding to rather than spending down your savings, you should load up on stocks. If you are 90 and spend only 1 percent of your saving a year, you should load up on stocks, too. If you are 65 and supplementing a pension by spending 20 percent of your savings each year, you'd better sacrifice some of the higher returns stocks provide for the short-term principal protection you can get in Treasury bills and money market accounts. One type of person shouldn't own stocks at all. Ironically, this type of person seems most likely to ask me which stocks to buy. The person will say, "I've got some money that just freed up and I won't need it for six months. Which stocks should I buy?" To make stock returns work for you, you have to buy good ones and hold them for long time periods. Think short-term, by all means. There's little reason to buy a stock that you don't think can produce enormous returns over the next six months. But don't buy it with the intention of selling it in six months. Give yourself more time to be right.

Oh, and don't worry about the frantic guy reporting from the stock exchange floor. He always sounds like that. He was hired, in part, because be does a great frantic voice, even on ho-hum trading days. That keeps people who own stocks watching television.

Before we continue, I want to make sure your bank hasn't succeeded in confusing you about the difference between investment classes (stocks, bonds, CDs), investment accounts (individual retirement accounts, or IRAs), investment brokers (Charles Schwab), and investment products (mutual funds). If you've ever asked, "Should I buy a stock or an IRA?" your bank has succeeded. The banker probably did that by telling you that the bank has a 5 percent IRA. What the banker means is that the bank offers IRA accounts, and if you put money in one you can buy a CD with that money if you like, and the bank's CDs yield 5 percent. IRAs themselves don't pay anything. They're accounts, not investments.

You can buy stocks in many different accounts: regular brokerage accounts, retirement accounts, college savings accounts, and so on. Some of these accounts carry tax advantages, usually because they're designed to fund something the government wants you to be able to pay for, such as education or retirement. Choosing among account types is important

and plenty of books can help you with that choice, but this one is about finding great stocks, not deciding where to put them.

You can buy stocks from many different brokers, ranging from expensive ones that recommend particular investments to cheap ones that just execute your buy and sell orders. To make matters more confusing, the term *broker* can refer to the firm or to a person who works for that firm and either makes recommendations or assists you with placing trades. I recommend you use cheap brokers, sometimes called *discount brokers*. In Chapter 4, I'll explain why the expensive brokers often recommend lousy investments. Cheap brokers generally charge $5 to $15 per stock trade. Choose one based on the annual quality rankings that run in financial publications such as *Barron's* and *SmartMoney* magazine.

You can buy individual stocks or shares of an investment product, such as a mutual fund, that holds them for you. (Some mutual funds hold other investments such as bonds or a mix of investments.) *Actively managed* funds have a fund manager who picks stocks. *Index funds* mimic stock indexes, or baskets of stocks designed to reflect the broad performance of a class of stocks or of the entire market. In other words, actively managed funds try to beat the market, while index funds try to merely match it. I don't recommend letting fund managers pick stocks for you. You'll see why shortly.

That leaves index funds. Many of these are good, cheap investments. You should pick individual stocks instead of or in addition to index funds, though, if you can consistently beat the broad market's returns. You'll find a hint as to whether that's possible in the title of the next chapter.