# 1984

# A Not So Orwellian Year

*"I specialize in out-of-favor small cap growth companies, which means, by definition, ones with problems. They can be good buys if those problems can be solved."*

"Cherchez the Sales Rep," July 16, 1984

*"The uncanny degree to which successful intermediate- to long-term performers come from the ranks of low PSR [price-to-sales ratio] stocks bothers some investors because it seems to have nothing to do with earnings, which everyone has been trained to accept as the driving force behind a stock's price."*

"Why Glamour Doesn't Pay," August 13, 1984



Nineteen-eighty-four was quite a year. Fortunately, it didn't involve nearly as much government oppression or book burning as George Orwell's *1984* foretold, but it was eventful nonetheless. Ronald Reagan trounced Walter Mondale to secure his second term as president, the Cold War was in full swing, the Olympics were in Los Angeles sans the Russians and many of their comrades, and Larry Bird's Boston Celtics defeated Magic Johnson's Los Angeles Lakers to win the NBA finals. Heck, Michael Jackson's hair even burst into flames in a Pepsi ad (he also won a record eight Grammys that year, so it wasn't a total loss for the King of Pop). And a relative newcomer, managing just $60 million, started writing for *Forbes* magazine.

From an investing standpoint, 1984 was a bit of a bore. In the US, the S&P 500 was up a paltry 6.3 percent.[1] Foreign stocks rose only slightly more, just 7.9 percent—both well below their long-term averages.[2] 1984 oil prices were still elevated relatively, but were trending down from their 1980 peak. And you could still buy a US government bond with a double-digit yield—though those too were falling. In some ways, Ken Fisher's first "Growth Stocks" column published in *Forbes'* July 16 edition came at a rather inauspicious time.

Longtime readers of Ken's *Forbes* columns might sense a typo. Ken's popular "Portfolio Strategy" column was originally titled "Growth Stocks." The new title didn't come about until years later. The eventual name change reflected several interesting evolutions in Ken's writing and investing philosophies over the past two-and-a-half decades. You see, in 1984 and for years thereafter, Ken's focus was on a much narrower universe of stocks than his global view today. His specialty at the time was beaten-up, small domestic companies. Very soon, Ken would be instrumental in defining what is now known as the "small cap value" universe—a major investing category today, but not yet well-defined in 1984. So "Growth Stocks" was a bit of a misnomer since Ken wasn't looking for growth companies—what he sought was value.

To identify out-of-favor companies, Ken did something fairly radical. While most investors then (and even now) focused on the price-to-earnings (P/E) ratio, he saw that P/E ratios could be misleading. Temporary conditions like management slipups or a spike in input costs can weigh on earnings. That causes the P/E ratio to jump, raising red flags to investors fixated on P/Es. These firms' stock prices often suffer as a result.

But as long as sales remain stable, those temporary problems can be fixed, potentially leading to outsized returns in the future. So Ken focused instead on a stock's price relative to its sales—calling it the price-to-sales ratio (PSR). Low PSRs often identify companies with solid sales, but brutalized earnings. Ken saw that sometimes a firm with very low or even *no* earnings (therefore a high P/E stock) could be hugely profitable. Once the problems were fixed, an explosion in earnings could drive stock prices sky-high. The key was finding them before that happened. As he puts it, "They [PSRs] are an almost perfect measure of unpopularity, whereas low P/E multiples aren't always so (an unpopular stock with a temporary low earnings usually sells at a high price/earnings ratio)." ("Why Glamour Doesn't Pay," August 13, 1984.)

Today, PSRs are a widely used analytical tool, but back then, they were unheard of. The PSR is an early example of what Ken refers to as "capital markets technology," or tools he and his employees at Fisher Investments develop to analyze stocks and the stock market differently from other investors and analysts. Ken and his firm have come up with many such tools throughout the years, several of which Ken has written about in *Forbes* and will be highlighted in this tome.

It was Ken's long and heavy earlier research into PSRs that was the backbone of his first book, 1984's bestselling stock market book, *Super Stocks.* And it was very much *Super Stocks* that caused long-term *Forbes* editor James Walker Michaels (who edited *Forbes* from 1957 to 1999)—the then-dean of American business journalism—to give Ken a shot at doing a column. Michaels loved the PSR and gave *Super Stocks* the following endorsement: "Ken Fisher has produced the first worthwhile new investment ideas in years."

But PSRs alone can't identify great stocks. Ken references a number of other factors that make firms and their stocks successful. Two attributes Ken highlights in his 1984 columns: Strong marketing and high relative market share. Ken emphasizes the importance on marketing in his first-ever column, "Cherchez the Sales Rep." (July 16, 1984.) Neat new products aren't worth a lick if customers don't need or want them. As he puts it, "The prizes usually go to the company that finds a need and fills it." High relative market share is important because it allows a company to spread costs out over more products, so "a company with a high relative market share will usually be the low-cost producer." ("High-Tech Checklist," September 10, 1984.) That can mean better profit margins and the ability to weather difficult times. As you'll read, these are just a few attributes distinguishing good investments from bad Ken points out in his inaugural year—1984.

Incidentally, Ken's initial July 1984 column was thought of (by him, at least) as a one-time-only event. His first five columns too—Ken had no inkling he'd be a regular columnist. It wasn't until the December issue that Jim Michaels gave Ken an ongoing monthly production schedule—which has continued ever since.

Ken and Jim became increasingly close over the years—particularly after 2000 when Jim stepped down as editor. Ken introduced Jim to one of his major hobbies—California coastal redwoods—taking Jim on a few tours. With their spouses they visited the Scottish highlands and enjoyed martinis late into the night. But it all started in 1984.

# *Cherchez the Sales Rep*

**July 16, 1984**

Most investors make a big mistake when investing in small growth companies. They get intrigued with technology. What a hot little gadget those guys have! It's not the hot gadget that puts small companies over the top but hot marketing. The prizes usually go to the company that finds a need and fills it.

> **The Vital Importance of Marketing and Sales**
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> In this column, Ken emphasizes the importance of having a great sales and marketing operation for any firm. It's a theme that appears throughout his writings—including some of his later books, like 2008's *The Ten Roads to Riches.*

The odds are much against an outfit that goes the other way, inventing a product and then trying to find a market for it. Take Lynch Communications, which dropped a bundle and whose stock plunged, when it had to write off its Atlas answering service product. Atlas was state of the art—a terrific gadget. But the customers couldn't finance it, which Lynch didn't find out until it was too late. Lynch put too little emphasis on market research; it lacked and lacks dedicated top-notch marketing savvy.

I specialize in out-of-favor small growth companies, which means, by definition, ones with problems. They can be good buys if those problems can be solved. If a troubled company is strong on marketing, it is a good bet to solve its problems, and its stock will almost certainly come back. So I like companies run by a top-notch marketing person, or companies with one close to the boss' elbow and ear.

Recent research done at Stanford University by Modesto Maidique and Billie Jo Zirger shows the importance of marketing. Among electronics executives they surveyed, marketing was cited over technology and research by a margin of 10-to-1 as the prime factor in success.

Okay, but how do you research marketing prowess? It's not something the standard stock services cover. One way is by getting out and talking with sales representatives. Sales reps are out on the firing line and in the trenches. At trade conferences you can meet reps from most companies (check out upcoming events in trade journals). They are very friendly and like to talk.

You can ask about things like how their competitors' reps (perhaps the company you are interested in) are compensated. Do they use their own sales force or independent reps? Sophisticated big-ticket products usually do best with a dedicated, in-house sales force. Ask how long their typical rep has been with them, ask about his prior job, his next job, how he gets his leads, how he qualifies prospects, how long it takes to close a sale and on and on.

Indirectly, you can learn his attitude toward his superiors. Few firms thrive without an upbeat attitude about management. Does management listen to the reps? After all, reps have customer contact and thereby the market's pulse. ■

# *Why Glamour Doesn't Pay*

## August 13, 1984

When most folks think about buying West Coast stocks they think of Silicon Valley. I have news for them. Most of California's recent big winners bear such non-high-tech names as Marathon Office Supply, Chesapeake Industries and RV Weatherford.

Table 1.1 lists the ten top-performing California stocks of 1983 (with sales over $10 million). Only three are high tech, and even they aren't exactly household names. With price increases ranging from 213% to 1,100%, these stellar performers defied most conventional means of identification.

What did these star performers have in common? Not low price/earnings ratios. As a matter of fact, most of them had no earnings at all. The list doesn't show it, but only one paid a dividend. Likewise, you couldn't identify this group based on a percentage of book value—it just wouldn't work. In short, you couldn't have picked them on any of the more popular measures of value.

What they did have in common is what I call low price/sales ratios (PSR). That is, they were stocks where the total market capitalization was a small proportion of annual revenues. (To figure the PSR simply multiply the stock price by the number of shares outstanding and then express the resulting sum as a percentage of revenues. Thus a company whose market capitalization was $100 million and revenues were $200 million would have a PSR of 0.5.) It's just like a P/E ratio but uses total sales instead of earnings. Note in the table that of last year's big California winners all but one started the year with a PSR of 1.0 or less—usually much less.

The uncanny degree to which successful intermediate- to long-term performers come from the ranks of low PSR stocks bothers some investors because it seems to have nothing to do with earnings, which everyone has been trained to accept as the driving force behind a stock's price.

**TABLE 1.1** The Top Ten

| Rank | Company | Price (1/1/83) | 1983 Gain | Sales* ($ millions) | PSR (1/1/83) | P/E Ratio (1/1/83) |
|---|---|---|---|---|---|---|
| 1 | Marathon Office | $0.50 | 1,100% | $21.5 | 0.04 | d |
| 2 | Chesapeake Industries | $0.38 | 833% | $15.4 | 0.06 | d |
| 3 | RV Weatherford | $1.29 | 636% | $43.6 | 0.05 | d |
| 4 | Marshall Industries | $5.94 | 435% | $118.0 | 0.18 | d |
| 5 | First Lincoln Financial | $4.12 | 367% | $94.8 | 0.10 | d |
| 6 | Wherehouse Entertainment | $3.63 | 348% | $83.4 | 0.17 | 16 |
| 7 | Anthem Electronics | $8.59 | 255% | $38.7 | 0.79 | 23 |
| 8 | International Rectifier | $5.19 | 247% | $119.2 | 0.25 | d |
| 9 | SYM-TEK Systems | $5.00 | 215% | $12.4 | 0.48 | 9 |
| 10 | Servamatic Systems | $1.06 | 218% | $18.5 | 1.48 | d |

* Fiscal 1982 d: deficit

Ken Fisher. "Why Glamour Doesn't Pay." Forbes. August, 13, 1984

> **PSR**
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> This wasn't the first introduction a *Forbes* reader had to Ken's new stock valuation—the price-to-sales ratio (PSR). *Forbes* had previously featured both Ken and the PSR—this was just Ken's first mention of it in his own column. This ratio was also the premise behind Ken's first book, *Super Stocks*. You'll read much more about PSRs in later columns.

As David Dreman has repeatedly pointed out, the fact that a company is poorly regarded now doesn't mean it will be later. That's why unpopular stocks frequently outperform popular stocks, and that's why low PSRs work so well: They are an almost perfect measure of unpopularity, whereas low P/E multiples aren't always so (an unpopular stock with temporarily low earnings usually sells at a high price/earnings ratio). Simply put, unpopular stocks of good companies perform well.

Whether in California or in Michigan, whether among big companies or small, whether among high tech, low tech or no tech, big winners tend to come from among the ranks of low-price/sales-ratio stocks. My research, contradicting what most people would expect, shows that this has been true for generations—all the way back to the 1920s and 1930s.

What is a high PSR and what is not? Looking at California's 1983 winners, six out of the ten sold at prices valuing whole companies for less than 20% of their annual revenues. Only two sold for more than 75% of sales.

By the same token, the top five performing stocks of the Dow in 1983 all had PSRs below 0.20. In 1983 the low PSR quartile of the DJI increased 56.1%, vs. 28.7% for the low-P/E quartile, and 20.3% for the DJI as a whole.

Of course, low PSRs alone won't guarantee success. You still need to sort quality from garbage. ■

# *High-Tech Checklist*

**September 10, 1984**

From my mail and telephone calls I gather my recent columns confused some readers. I stressed the relative unimportance of technology when it comes to investing in small companies and then proceeded to recommend some small technology companies. Later I crisscrossed again, showing that many of the best buys aren't high tech.

I wasn't arguing against high-tech stocks; indeed, they are my specialty. My point was simply this: Leading-edge technology is not critical to successful investing. Certainly *appropriate* technology is needed; you can't sell buggy whips. But the really critical factors are not technological. The critical factors are a low stock price and good marketing.

One risk-reducing marketing-oriented sign to look for is high relative market share. It helps, too, if there are no heavyweights trying to muscle in to the market. The champ is a lot safer when up against lightweight competition, and so are you. It's about as close to monopoly power as society allows.

Investors often get this backward, buying low-market share and figuring the company has nowhere to go but up. It's possible, but it's a risky strategy. A company with high relative market share will usually be the low-cost producer, because it spreads its costs over many more units, and being the low-cost producer is a big advantage. In tough times it can drop its prices lower than the competition and still make money.

High relative market share also provides selling economies in advertising and public relations, since you have more units to spread your cost over. In strategic planning the big guy can afford more gray matter—like market and feasibility studies by outside consultants. You can maintain your own sales force instead of relying on independent sales representatives, who may cover many other different lines or be hard to control.

Of course, high relative share doesn't guarantee success. General Motors and US Steel are classic examples where management squandered the advantages of its market dominance. But in General Motors' case, at least, that huge market share enabled the company to remain strong, in spite of decades of management mistakes. ■

# *The Lion and the Mouse*

**October 8, 1984**

"You make the most money with the least risk in small, well-managed companies aimed at big, fast-growing markets." Right? Wrong. Long-term risk/reward is maximized by investing in companies aimed at markets appropriate to their size. Small companies should address small markets. Big companies should address big markets. Rarely should the two meet.

I began to get a feel for size segmentation, an important and often misunderstood marketing issue, some time ago. I was probably the only kid on the block eager for bed. My old man told great bedtime stories. My favorite was the lion and the mouse. Remember? The lion gets caught in a trapper's snare. At first he wants to eat the bait that had lured him, the mouse. But slowly, persistently, the mouse chews through the trap to set the big guy free. They become fast friends. Everybody has his place in life.

Thus, it's no surprise that when the huge microcomputer market developed, the likes of Texas Instruments, Hewlett-Packard and Digital Equipment jumped in. As $4 billion giants, they need $400 million of growth to increase their size by 10%. But it was IBM, the giant of them all, that made the biggest splash—and in the process covered lots of little guys with mud. Companies that were considered healthy microcomputer prospects only last year—Fortune Systems, Osborne, Vector Graphic, Victor Technologies and a host of other look-alikes—now look sick or crippled.

There are more casualties to come. Why? Small outfits like Apollo Computer and Compaq have a long fight ahead against IBM. And the giant also-rans like DEC, H-P, and Texas Instruments show no signs of fatigue. As the market matures, rest assured that those champion nonpioneers, the Japanese, will show up.

Huge companies rarely address small markets, and do poorly when they do, because they can't afford to waste their best brains on them. Will a big outfit send its stars into a small market where, at best, they might get a 30% market share? No way!

Can they justify price-warring their way into markets dominated by entrepreneurs who are close to the customer? Can a lion hunt for mice the way a cat can? Why should it bother with mice at all?

Enter the smaller company, which can put its top people on the smaller market and get meaningful results—partly because it runs into few large competitors, and partly because the few giants it encounters usually do poorly and lose interest.

The same is true of the dreaded Japanese, who do great in big markets like steel, autos, TVs and the like, but poorly in small markets—particularly where there is a lot of sophistication to the selling process or where service support is required. Consider the small laser market, which is made up of a number of niches based on different technologies. The Japanese have coveted lasers for years without success. The US is a major and growing net exporter of lasers to Japan.

I ran a company supplying these markets. I loved the very names of the products—Argon, CO2, diode, eximer, HeNe and, my favorite, yttrium aluminum garnet (YAG) lasers. The only things missing were Buck Rogers and large markets. At first the markets were so puny that people said lasers were "solutions looking for problems to solve."

Slowly the growing markets became dominated by a few independents like Spectra-Physics, Coherent and Control Laser. The few big firms in the business, such as Raytheon, have not done well. Recently, giant Allied Corp. made a big push into lasers, but Edward Hennessey's troops have precious little to show for the effort.

So remember the lion and the mouse. Stick to companies that address growing markets, but markets appropriate to their size. ■

# *Blind Pessimism*

**November 5, 1984**

There is a good chance that Ronald Reagan will be reelected and that the Republicans will retain Senate control. If so, Reagan will be the first second-term President since Truman to have a house of Congress controlled by his own party. Most second-term presidents have faced hostile legislatures.

Why is this important? A second-term president doesn't suffer the short-term political pressures faced by one seeking reelection. Thus he can afford to prescribe sound but unpopular "medicine." But he can do so only if Congress will go along. A second-term president with at least one house held by his party can do more than a president confronted by two hostile houses. We have had 2½ two-term presidents in the postwar era—Truman, Eisenhower and Nixon (the half). Only Truman was in a strong position to counter second-term opposition stonewalling from Congress. Reagan, reelected and supported by at least a Republican Senate, could make enough local interest deals with Democratic House members to pass lots of controversial legislation. Reagan could afford to trade short-term popularity for a long-term viewpoint—to ensure his good treatment by historians.

There are several simple and logical actions that together could balance the budget and reduce governmental spending as a percentage of GNP. Putting public and private employee retirement systems on comparable terms would be one. Simplifying regulation would be another: Why should state and federal watchdogs cover the same territory in so many areas, ranging from income taxation to securities regulation? Recent presidents haven't been free from reelection worries to take on this kind of thing. But that's the kind of fight Reagan loves.

Interest on the federal debt is two-thirds the federal deficit and is greater than the combination of the deficit and the municipal surpluses. Reagan could slash interest expense by offering lower-coupon, gold-backed Treasury bonds, or inflation-adjusted bonds tied to the CPI.

In short, a Reagan second term with a malleable Congress could change the economic and social picture—and very much for the better. It could take us from an atmosphere that has been hostile to capital and to equities into one that could be extremely bullish. But the market remains gloomy.

We have a whole generation of investment pros who are too skeptical. They can't see potential progress. Most institutional investors are more like bureaucrats than investors. It isn't their money. They mostly want to preserve their jobs. To them, safety is success.

They are conditioned by 30 years of one-termers and Democratic domination. They can't believe anything else is possible. Talking with these guys can be a nightmare. Mention any topic and they can show you a potential disaster in the making. Their predisposition to safety lets them rationalize pessimism into anything.

The Republicans will probably keep the Senate. They lead by six now. There are only eight vulnerable Republican senators—in Illinois, Iowa, Minnesota, Mississippi, New Hampshire, North Carolina, Tennessee and Texas. But the Democrats have a few up for grabs, too. Yet, a front-page *Wall Street Journal* feature (August 22) echoed what's commonly heard on The Street by headlining: "If Reelected, Reagan Might Find Problems Tougher Than in 1981—Political Climate, Moreover Could Be Even Harsher." Among the investment pros I know, 90% agree.

With institutionalized skepticism so thick, any good news on the federal spending front from a president freed of short-term constraints is apt to catch the investment pros by surprise, pushing up stocks in a longer and more violent buying spree than the August 1982 or 1984 rallies. I wouldn't be surprised to see the DJI at 2200 by 1989. That would still leave it at levels consistent with the long-term past, about 12 times earnings and 1.5 times book value. Moderately priced growth issues could rise more. ■

# *How to Cash In on Whizzers*

**December 3, 1984**

You are on vacation in California and notice that strawberry-coated whizzers are all thev rage—kids are lining up for them everywhere. But back home in Peoria, they are unknown. Returning from vacation, you quit the factory and start up the state's first whizzer stand. If you are aggressive, you might dot the whole Midwest market with whizzer stands before any big competitor gets a whiff of what you are up to. By the time competition shows up, you have lots of hard-to-overcome advantages. For instance, on the basis of market share in your region, you can amortize the cost of regional advertising over your various stands. The latest whizz to come along can't. You are on local radio and in the regional newspapers and magazines. Smaller competition isn't. By capitalizing on your early start you have made yourself the whizzer king of the Midwest and are well on your way to joining the *Forbes* 400.

Since you are buying for all your stores, you can get freight-rate breaks, based on volume and central warehousing, that a Johnny-come-lately can't afford. So your costs per unit are lower. Operating in this mode, you get many of the advantages of a national firm without losing the human touch of being local. By the time you have lost that local touch, you are big enough to cash in your chips and head for Hawaii.

This principle is inherent in any new idea—you don't need to be first, only first in your region. After Colonel Sanders proved that folks would buy fast-food chicken in Kentucky, S. Truett Cathy exploded out of Atlanta with Chick-Fil-A restaurants and his boneless fried chicken sandwich. Cathy has built 280 outlets in 31 states—and a fortune to boot. But he still concentrates heavily in the Southeast. Even with the big three fast-fooders (Burger King, McDonald's and Wendy's) now in the chicken business, Cathy holds his own with his strong regional base. The big national chains don't have that many advantages over a regional giant. Wendy's decided to go into the chicken business, but its national status hasn't helped much. Its Sisters Chicken & Biscuit chain has struggled up to 49 outlets and is still losing money.

**Ward No More**

Of course, Ward's is long gone now, replaced by myriad superfast online directories and search tools. But the idea is the same: You can use publicly available information to spot advantages others haven't thought of yet—if you know how.

Sometimes the big guys simply overlook fertile markets. For example, Seattle-based Nordstrom pyramided an unexciting shoe business into a major regional retailing chain with a national reputation because it was good, but also because the national chains hadn't exploited the Pacific Northwest the way they could or should have. By the time the nationals caught on, Nordstrom was king of the mountain. Along the way, its stock increased fivefold in value.

While retailing is one prevalent place for regional segmentation, there are lots of others. Regional focus is fundamental to cost-conscious commodity producers, particularly those with heavy, freight-intensive products. Cement producers, burdened by the need to truck wet cement to remote building sites, have always marketed locally. Inland steel producers, far from water, have been relatively protected from the full brunt of cheap foreign steel. And even low-cost steel producers such as Nucor and Chaparral (50% owned by regional cement producer Texas Industries) carefully operate along regional lines to maximize profits.

Hotel, restaurant and supermarket chains, along with distributors, insurance companies and airlines, are just a few of the areas in which regional segmentation has paid off as a means for little guys to build up good-size businesses without suffering at the hands of bigger, more powerful national competition.

Investing in regional segmentation offers additional advantages for individual investors. You can check them out at home. What are the kids lining up for in your area? What burgeoning local products have you been buying that didn't exist five years ago? No New York-based security analyst is likely to beat you to such bargains.

A nifty tool for checking out regional up-and-comers is Ward's Directory. It's great, available in many libraries, and yet, like most good things, it's largely unknown on Wall Street. Ward's spotlights the 55,000 largest US corporations—public and private—by ZIP code. It shows the location, phone number, corporate sales and number of employees, as well as whether the stock is publicly traded. By looking at several years' editions, you can spot unknown emerging companies in your own backyard—or anyone else's. ■

# *Big Bloopers of 1984*

**December 31, 1984**

Nineteen-eighty-four was not a banner year in the stock market but it was an exceptional year for me—exceptionally bad, my worst yet. But one learns from mistakes. So, here goes a dearly learned lesson:

My biggest bloopers were: Charter Co., a $12-to-$2 nosediver; Storage Technology plunged 50% before I sold out; System Industries dropped sharply from $9 to $3.

Charter and Storage Technology both went into Chapter 11. While System Industries didn't, it came close. What happened? How can future repeats be avoided?

Charter came first. I was bewildered at its sudden crash to bankruptcy. Sure, it was leveraged and troubled, but management seemingly understood the problems. The company had sufficient finances (just barely) to buy enough time to sell or close the unprofitable oil refineries and insurance businesses (beclouded by the Baldwin-United debacle) and to push its large, profitable oil marketing operations.

The bankruptcy was announced on Friday, April 20. I was stunned. Shorting sharpshooter Alan Gaines, of Gaines & Berland, had been screaming for months that Charter was a goner. I laughed, but he laughed last. Yet the suddenness surprised even him. Only 58 days earlier, accounting giant Peat Marwick signed audited financials showing stockholders' equity making up 34% of total assets, and a current assets-to-liability ratio of 1.1—not great, but hardly immediate bankruptcy material.

I spent the next weekend reviewing the prior decade's bankruptcies. With the exception of the freakish Johns-Manville case, I couldn't find a single bankruptcy coming on the heels of such strong financials. By past standards Charter should not have gone bankrupt. Often companies were allowed to have current liabilities exceeding current assets—and still the banks kept them alive. But not Charter. Why?

### Picks Gone Bad

Ken's fourth and most important rule of portfolio management (you can read about all four in his 2006 bestseller, *The Only Three Questions That Count*) is: Always know you can be wrong. Ken frequently uses his columns to reflect back on his worst stock picks. Introspection is vital to good portfolio management, but far too many investors—professionals and do-it-yourselfers—fail to honestly assess how they've done.

Media attention, for one thing. The *Wall Street Journal* vigorously pursued negative news on Charter. This negative press seemingly created a flood of Charter insurance policy redemptions, generating deteriorating financials, creating still more bad news, which the *Journal* printed. Finally, citing these articles, Charter's oil trade creditors suddenly became unwilling to continue extending credit. Chapter 11 was the only choice.

There is a pattern to a stock's action prior to bankruptcy. For months the stock moves slowly lower. Then one day a not too significant announcement will drop the stock about 30% to 50% within the day. At that point, caution is preferable to courage. A few days or weeks later comes the bankruptcy announcement, which tumbles the stock one more 30%-to-50% notch. From there it goes nowhere for months or maybe years. Charter, for instance, has traded between 1½ and 2½ since April, having been at 11 only weeks before bankruptcy.

Storage Technology also got negative press every time it sneezed. It, too, had financials superior to historic bankruptcies. Again, bankruptcy descended from out of the blue. When larger than expected third-quarter losses toppled Storage Tech from 9 to 6 in one day, I recognized the pattern and sold out. A few weeks later the bankruptcy came, and Storage was at 2½.

System Industries just escaped bankruptcy. Being smaller and more obscure, it never much attracted the media's gaze. When this computer-memory manufacturer's financials slowly deteriorated, its bankers, Chase Manhattan and BankAmerica, became increasingly nervous. But this time the board of directors moved in advance of Chapter 11, replaced the chief executive and, to calm the bankers, raised capital at distressed prices.

Bankers, disturbed over mounting loan losses, increasingly are nervous and won't renew credit for troubled companies the way they once did. When that happens, companies must seek Chapter 11 protection. There has not been such a sustained gush of bankruptcies since the 1930s. What is interesting is that this is happening during prosperity. Why? As I mentioned, media attention has something to do with it, speeding up the process.

What I learned from my mistakes was that in this new world of nervous bankers and eager journalists, the threshold of bankruptcy is much narrower than it formerly was. Balance sheet tolerances must be tighter than before. Companies don't go bankrupt unless they have a lot of debt. I also learned to steer away from troubled companies where the troubles make good press. ■