

CHAPTER 1

THE PSYCHOLOGY OF INVESTING

Human psychology is a key factor in investment strategy. As you know from the Introduction, I am not a psychologist, and I don't pretend to be one here. But what I have to say in this chapter is based on my experience as both an investor and a professional in the financial industry.

I believe that to become a successful long-term investor in the stock market, the best practice is to take smaller, continual rewards rather than the occasional big gain amidst a sea of disappointing misses. Regular success builds confidence, which is fundamental to becoming a good investor. Increased confidence allows you to think independently of the herd, and this mindset is essential to success.

Singles and Doubles Are Better

It's human nature to try to hit a home run, to want to experience the glory and praise that come from knocking the ball out of the park. We yearn to be singled out as the person who has achieved something

exceptional. The problem with this strategy is that, in the world of investing, more often than not you'll miss. While you may have the occasional success, over time you are likely to lose your bravado, and fall into an inevitable slump as you wait for your next home run.

Most people don't react well to failure, whether it is the occasional big one or frequent little ones. If you're looking for home runs, you will fail most of the time. The following example illustrates how the human psyche deals with success and failure.

Imagine a game show that presents you with two choices: Door Number 1 and Door Number 2.

The show's host calls you down from the audience and explains the game. "Okay, John, here's how we play this game. I give you \$1,000 and you choose either Door Number 1 or Door Number 2. Then I will ask you to decide if you want to continue with your prize or stop playing. You'll have a choice to make, you can walk away at any time."

"All right," you say, "let's go with Door Number 1."

Door Number 1 opens wide to reveal four suitcases, one of which you must pick. You make your choice, the host opens it and you've just lost \$300. You have \$700 left.

"Pick another one, John. We're not done yet." You choose again, and again you lose some money, this time \$200. You're left with \$500, which is half of what you started with, and two remaining suitcases.

The host says to you, "So, John, my friend, would you like to continue or do you want to play it safe and keep what you have?" You reflect on the fact that you began with \$1,000, dropped first to \$700 and then to \$500. Most people, in my experience, would be inclined to call it quits at this point—which in my industry means either changing investment advisors or dropping out of investing in the stock market altogether.

This is human nature and nothing to be ashamed of, as far as I'm concerned. We're all drawn to quick returns and always hope to hit that glorious home run, and if neither comes quickly, we look elsewhere to find that positive experience.

Imagine now that, just for fun, the host opens the last two suitcases. It turns out that one of them held yet another loss of \$200, but the final suitcase held a gain of \$1,700, our elusive home run. Had you followed through and opened all of the suitcases, you would have gained \$1,000, and wound up with \$2,000 in the end.

Now let's imagine a different course of events. After the host gives you his spiel and the \$1,000, you pick Door Number 2, which, as it turns out, presents you with a different scenario. With your first choice of suitcase, you've won \$200. The host asks if you want to continue and, of course, you do. "I've just won \$200. I've still got my original \$1,000. Let's go."

Much to your delight, although it would be nice if the amount were larger, the next suitcase gives you a gain of another \$100. "You're on a roll," the host says. "What do you say?"

And with the next suitcase you win another \$400, and you're sitting on \$1,700 in total. There is one suitcase left and you go for it, and, wonder of wonders, you win another \$300 and finish the game with \$2,000. Most people would agree that the scenario behind Door Number 2 is a far more attractive one. It's certainly less dramatic, but far easier on the nerves, and one that most people would be far more likely to see through to its conclusion.

The second scenario in this game-show analogy illustrates the psychology of my method of investing in the stock market. I recognize that positive reinforcement helps an investor build confidence, and the approach that I propose in this book is based on incremental success, on strings of singles and doubles, rather than the odd home run. I will show you how to invest in order to realize a high frequency of small- and medium-sized gains. The key is to find companies with long-term upward trends in their stocks' earnings per share (EPS). EPS is a key concept in my method and I will explain it in further detail in the next chapter.

This approach is not as glamorous as a home run, but a steady succession of small to medium gains will give you a better chance of sticking to a plan than will several losses followed by a large gain.

Only an investor with an iron stomach, or a gambler's unflinching faith in his luck, would see the first game-show scenario to its conclusion. This point is so important that it bears repeating: *The second scenario builds confidence, which helps investors see a plan through to its conclusion, which in turn makes for a better and more successful investor.*

Tune Out the Noise

We've just seen the value of going for singles and doubles rather than home runs. Another significant part of this approach involves tuning out the noise. "Noise" is my term for all the news and events that occur in the stock market after you invest. These bits of information, which may be inaccurate and speculative, are distractions that will keep you from reaching your goal. They eat away at your confidence, leading you to doubt your original plan.

As investors, one of the hardest things to overcome is our emotions. It takes enormous discipline to develop a plan, avoid distractions and follow the plan to completion. When you think of placing your capital in an investment, you usually have buy and sell targets in mind, as well as a time frame. Then you are distracted by the noise and you're led astray.

For example, imagine that you bought shares of Johnson & Johnson at a low valuation (i.e., underpriced in light of their potential to increase in value), but then a short time later you read that several analysts are expecting a correction, a general downward trend, in the stock market. Hearing this news from "the experts" could lead you to sell your Johnson & Johnson shares for fear of a decline in stock price. If you are susceptible to noise, your exposure to the analysts' predictions may cause you to change your plan.

What separates truly gifted investors from average ones is their level of discipline. A superior investor follows a plan and has the confidence to ignore the noise and distractions that could otherwise disrupt the plan.

Consider the following. Most investors who own a house are disciplined investors. There are at least two reasons for this:

1. They need a place to live and they have no intention of selling their home.
2. They are not aware of the changing value of their investment in their home.

Imagine if all houses had electronic billboards attached to their fronts so that homeowners could see the changing value of their houses every day. If a house price moved like a typical stock, then it would not be uncommon for a \$300,000 house to go up or down by 1%, or \$3,000, in a day. For many people, this would probably be equivalent to the cost of a week-long vacation in a nice place. Most people would be unnerved knowing that on any given day they had just made or lost the equivalent of a nice holiday. Because homeowners don't see the changing daily values of their houses, they are much less affected by these changes, and so follow their plan to stay where they are, unaffected by fluctuations in value.

If homeowners knew that their houses were going up or down by large amounts, there would be more trading, and less long-term investing, in houses than there currently is. A disciplined investor, like most homeowners, has a plan and sticks to it, knowing full well that there will be ups and downs on the way to reaching the long-term goal of seeing an investment strategy through to completion.

Discipline in investing means being able to follow a plan and avoiding all the obstacles and distractions that the market will place in your way.

EPS Explained

Let's now take a more concrete look at singles and doubles using the Purple Chips approach.

In the following exhibits, I refer to C.R. Bard, which trades under the stock symbol "BCR" on the New York Stock Exchange (NYSE).

Exhibit 1.1 Calculating EPS

Date	Quarter	Earnings per share (EPS)	Trailing 12-month EPS
Dec. 2010	Q4	\$1.54	\$5.61
Sept. 2010	Q3	\$1.43	\$5.46
June 2010	Q2	\$1.39	n/a
Mar. 2010	Q1	\$1.25	n/a
Dec. 2009	Q4	\$1.39	n/a

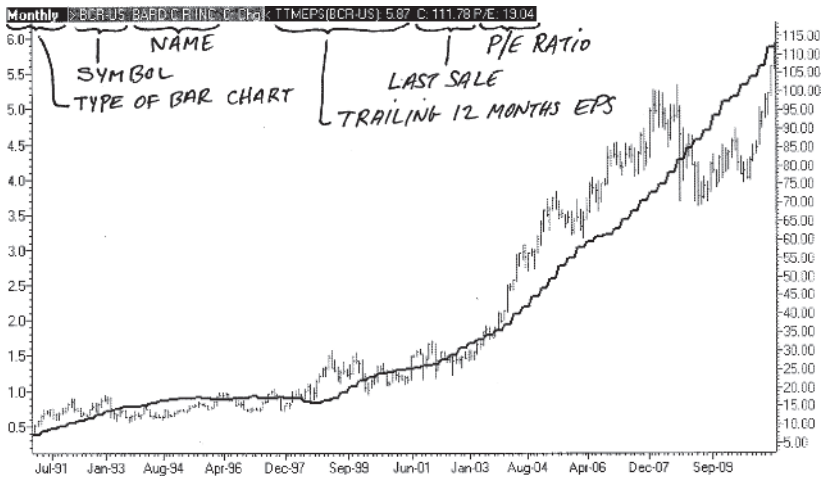
C.R. Bard is a large American maker of medical devices that are used in hospitals around the world. Before I go into details, we need to understand the concept of “earnings per share,” because it is the foundation of the Purple Chips method. EPS is simply a measure of how much money a company has earned in its most recent four quarters, or one-year period, for every share that is owned by shareholders.

Exhibit 1.1 shows the EPS for C.R. Bard from December (Q4) 2009 to December (Q4) 2010. If we add up the four quarters of EPS in 2010, we get what is referred to as the trailing twelve-month EPS of \$5.61 per share for the one-year period ending December 2010 ($\$5.61 = \$1.54 + \$1.43 + \$1.39 + \$1.25$). Note that the trailing twelve-month EPS is sometimes also referred to as the rolling twelve-month EPS. For the purposes of this book we will use only the former term, which is abbreviated as TTM. So, in September 2010 (Q3), the trailing EPS was \$5.46, which is the sum of Q3 2010, Q2 2010, Q1 2010 and Q4 2009 (the last four quarters).

If we were to record a trailing twelve-month EPS for each quarter on a time chart, we end up with the EPS line that you will see in most of the exhibits in this book.

Exhibit 1.2 shows the layout of the chart used throughout this book. The top line of the chart shows us information such as the chart type, trading symbol, name of share issuer, last sale price, change from the previous close, TTM earnings per share and the price/earnings multiple (note that the term “price/earnings multiple”

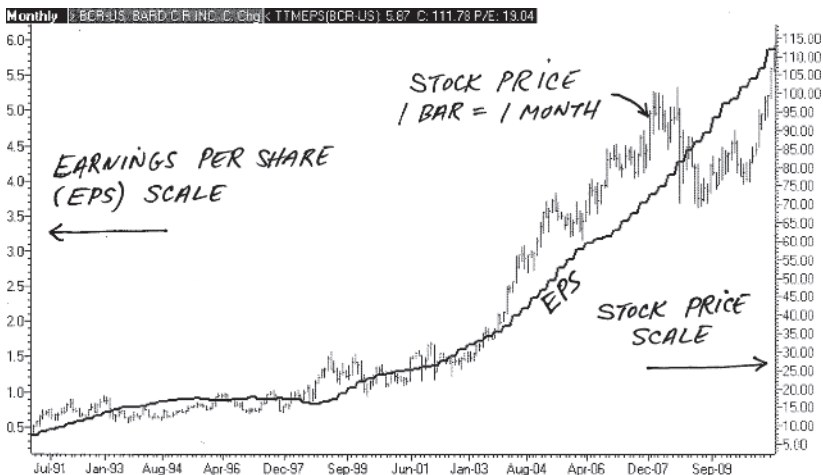
Exhibit 1.2 C.R. Bard (BCR, May 2011)



and “price/earnings ratio” are interchangeable, but for clarity, we will use “multiple”).

Exhibit 1.3 gives definitions of the remaining information on the chart. On the bottom of the graph you’ll see time marked out in intervals where each tick represents one month, and on the left side,

Exhibit 1.3 Understanding the Scales—C.R. Bard (BCR, May 2011)



the EPS scale, which shows the EPS in dollars. On the right side, the scale shows the stock price in dollars. The stock price is presented as a series of vertical bars, with each bar representing the trading range for one month. The heavy black line shows the EPS at a certain date. Note that the EPS line in every chart in this book ends at that last trade price of the stock. As you will see later, the position of the EPS line on the stock chart allows you to see changes in valuation that will highlight investment opportunities.

The EPS line differs from the stock bars because it appears as a series of steps. When you display these factors together in this visual form, you can see that the EPS line is much less volatile than the stock price. That is to say that the EPS line is steady and moves in a predictable fashion, whereas the stock price seems to move in a wild and unpredictable manner. As you read this book it will become obvious to you that unlike a stock price, the earnings or EPS of a company are not influenced by emotions.

Exhibit 1.4 charts the stock price of C.R. Bard with its EPS. The point at which the two dashed lines intersect shows that the EPS was \$5.61 per share in December 2010.

Exhibit 1.4 Reading the EPS—C.R. Bard (BCR, May 2011)

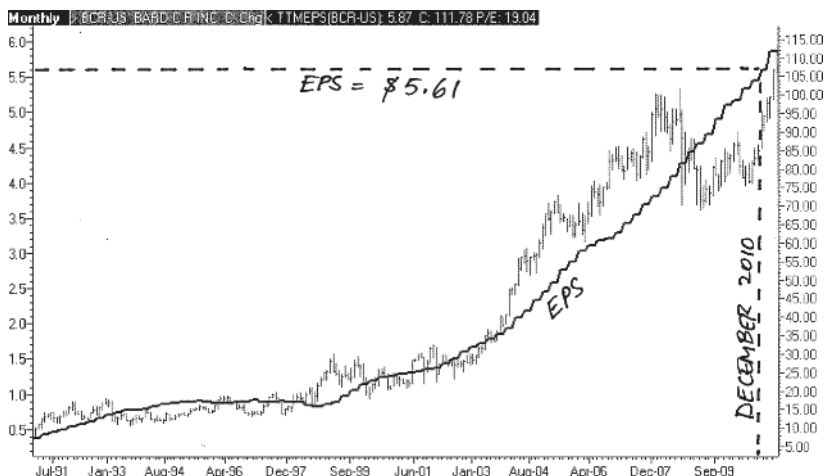


Exhibit 1.5 Abbott Labs (ABT, August 2011)



Exhibit 1.5 demonstrates how the Purple Chips model would have¹ bought and sold the stock of Abbott Labs (ABT) between the years 1999 and 2011. “B” and “S” mark the buy and sell points over the years. Using this approach, the result is a gross profit of \$24.40 per share. This is not bad considering that while an investor was not invested in Abbott Labs, he could have been putting his capital to work in other opportunities that were highlighted by the Purple Chips approach. Therefore he could maximize the use of his capital. Chapter 6 details Abbott Labs in a case study.

Exhibit 1.6 shows the results of the buying and selling of Abbott Labs in tabular form.

Exhibit 1.6 Gain/Loss Summary for Abbott Labs

Date	Buy	Date	Sell	Gain/Loss
Dec. 1999	\$33.10	May 2000	\$38.90	\$ 5.80
June 2002	\$37.10	July 2002	\$37.10	\$ 0.00
Feb. 2003	\$34.10	May 2003	\$40.90	\$ 6.80
Nov. 2005	\$40.10	Jan. 2007	\$51.90	\$11.80
Oct. 2008	\$51.10	Oct. 2009	\$51.10	\$ 0.00
June 2010	\$46.10	-	-	-
Total gain/loss				\$24.40

The preceding example with Abbott Labs demonstrates that this methodology *is based on finding good-quality companies, buying them when they are inexpensive and selling them when they are expensive*. In more technical terms, we buy the stocks of top-quality companies when their valuation is low and the odds favor a return to a more reasonable valuation. We hold on to these stocks until their valuation has risen to the point at which we have determined it is advantageous to sell, and then repeat the process, buying and selling the same good company whenever we identify investment opportunities.

Of course, we don't rely on just one or even a very small number of companies. The success of this model is based on identifying a select, but reasonably sized, group of companies and waiting for each of these candidates to become a bargain.