MAY/JUNE/JULY 2013 e-NEWSLETTER

OVERVIEW OF UPCOMING EVENTS AND CLASSES THIS FALL:

> Annual Meeting via the Internet (FREE), Thursday, September 5
> Introduction to Investing, September 14
> Stock Selection Guide (SSG), September 28
> INVESTOR FORUM, OCTOBER 12
> Beginning ToolKit and Lab, October 26
> Judgment on the SSG, November 9
> Advanced ToolKit and Lab, November 23
> Small Talk, dates TBA

18 THINGS YOU MUST KNOW (Part II)

10. You are under no obligation to read or watch financial news. If you do, you are under no obligation to take any of it seriously and you shouldn't. Do you own research and trust your own judgment.

"You must believe in yourself and your judgment if you expect to make a living at this game. That is why I don't believe in tips. If I buy stocks on Smith's tip I must sell those same stocks on Smith's tip." – **Jesse Livermore**

11. Investor Dean Williams once said, "Confidence in a forecast rises with the amount of information that goes into it. But the accuracy of the forecast stays the same."

An academic study assembled a small group of stocks based on historical data of five to ten years past. The stocks were given fake names but their actual subsequent five year performance was known. Then a group of analysts were assembled and given minimal information based on the actual data of five to ten years ago. The analysts had only the information supplied which excluded the most recent five years. They were asked to make their projections as to the portfolio performance over the recent five year period. They were then given much more information on the same stocks and asked if they'd change their prognostications. They were asked if the additional information increased their confidence in their projections. The two sets of projections were somewhat different but the level of confidence the analysts had in their second set of projections was much higher than the first set. Since the performance of the stocks was known, the two sets were checked against actual results. It was found the second set slightly underperformed the first set. All that additional information, surprisingly, didn't increase the success

of the projections but did increase their confidence. (You can do a similar test yourself using Value Line reports. Value Line supplies ten years of data. Using the oldest five years of data (e.g., 2004 – 2008), you can project the subsequent five years (e.g., 2009 – 2013) and then check to see how well you've done.)

12. When you think you have a great idea, go out of your way to talk with someone who disagrees with it. At worst, you continue to disagree with them. More often, you'll gain valuable perspective. <u>Fight confirmation bias like the plague</u>. A club whose members don't argue is a club that is dysfunctional. If you have a club of ten members and they all agree all of the time or always go along with one member who is more aggressive or is viewed as more knowledgeable than the others, you have nine members too many!

> *"In psychology and cognitive science, confirmation bias (or confirmatory bias) is a tendency to search for or interpret information in a way that confirms one's preconceptions, leading to errors."* – Science Daily

13. Daily market movements are driven by people with short investment horizons. Are you a long-term investor? Then nothing they do applies to you. Ignore it. Short term price fluctuations are random and are caused by an infinite number of uncorrelated motivations… perhaps one is selling stock as part of estate liquidation while a mutual fund has changed managers and the new one doesn't like that stock and wishes to make a change. Most short term buying and selling reasons have nothing to do with company performance. Ever notice how the financial commentators can always supply a reason for a given day's market movement at days' end and yet don't even attempt to tell you what the market will do the very next day?

14. Take the highest level the S&P 500 traded at in every decade going back to 1880. At some point during the subsequent 10 years, stocks fell at least 10% *every single time*, with an average decline of 39%. <u>Market crashes are perfectly normal</u>. If market volatility makes you uncomfortable and causes you to lose sleep, then be sure to buy stocks in solid companies paying a growing dividend. Knowing that the dividend is coming into your account each quarter like clockwork does wonders for calming anxieties.

15. Remember what Wharton professor Jeremy Siegel says: "You have never lost money in stocks over any 20-year period, but you have wiped out half your portfolio in bonds [after inflation]. So which is the riskier asset?" Yes, stocks are more volatile than bonds, but so what? Remember to invest only in solid companies with a solid management and then only buy them when the stock price is temporarily depressed. Growing companies paying growing dividends will always beat bonds over time and assuage anxiety meanwhile.

> *"The taste for gambling and speculation is not equally distributed through the population – and thank heaven for that! I strongly suspect that most investors would just as soon not live their lives entangled with Wall Street's never-ending pageant of fear and greed. Dividends, by contrast, set the investor free from fickle market*

prices and unreliable capital gains." Quoted from *The Ultimate Dividend Playbook* by **Josh Peters**, CFA and Morningstar analyst

16. People talk about market averages -- average P/E ratios, average annual returns -- but historically, markets rarely trade anywhere close to averages. Stocks are typically swinging between far undervalued or far overvalued, crashing or surging. The middle ground we think of as "normal" is a rarity. Just remember that the "average" value for the P/E ratio is a number the actual P/E will gyrate around and rarely hit exactly for more than a moment. When the P/E is gyrating very much above the average, chances are the stock is overpriced. When the P/E is swinging below the average, then that might be a good buying opportunity. Trust your judgment and your SSG.

> *"One of our most important rules is to buy stocks that trade at below-market P/E multiples. Academic studies, and our own, ranging over 65 years show that low P/Es and other contrarian strategies have consistently outperformed the market over time. A second important rule is not to rely on finely tuned earnings estimates. Although most analysts believe that if earnings come in even 3% under estimates, a stock can fall sharply, the average consensus miss since the early 1970s has been closer to 50%.".* - **David Dreman**, Chairman of Dreman Value Management and author of recently published *Contrarian Investment Strategies: The Psychological Edge*

17. The best company in the world run by the smartest management can be a terrible investment if purchased at the wrong price. Valuation does matter!

> *"The beauty of stocks is they do sell at silly prices sometimes. That's how Charlie and I got rich."* – **Warren Buffett**

18. Despite various efforts to do so, actual risk is un-measureable. Risk comes in many forms, some relatively familiar, but most are clearly surprises and totally unexpected as Nassim Taleb explains in his book, "The Black Swan". Catastrophic "black swan" events are individually rare, but there may be an infinite number of them which is why something seems to be happening all the time to threaten our investments. Modern portfolio theory uses volatility as one measure of risk. Volatility may make you anxious, but it has little to do with real risk. While risk can't be measured, it can be reduced by reducing our exposure to it. The SSG is all about reducing risk exposure. If Section 1 is "straight, up and parallel", you are off to a good beginning in reducing the risk of owning that company's stock if only a little bit. But that still isn't enough, because past performance is not a good predictor of future performance as the SEC constantly reminds us. So we go to Section 2 to see how management has performed. If Section 2 shows an upward or even trend, we reduce our risk a little more. But again, it's not enough because past performance is not a good predictor of future performance. So we finally come to SSG sections 3 and 4. We insist on a "margin of safety" when buying a stock because the risks are unknown and historical performance doesn't predict future performance error free. Buying with a U/D ratio of three or greater gives us some margin of safety when our projections turn out to be in error. But all the SSG mechanisms can't eliminate risk only reduce our exposure to it. Diversifying is the final

measure taken to reduce our exposure to loss by minimizing the effects of any one stock on our portfolio.

> *"The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability -- the reasoned probability -- of that investment causing its owner a loss of purchasing power over his contemplated holding period. Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period."* – **Warren Buffett**