

42TM Rules

*of Sensible
Investing*

LEON SHIRMAN

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P r e f a c e

Just as I have completed the first draft of this book, the markets experienced their worst week ever (October 6–10, 2008), with the S&P 500 falling by 18%. The indices are down over 40% from their latest peak reached almost exactly one year ago. We are in the midst of the greatest financial crisis since the Great Depression. What a time to be writing a book on investing!

These are certainly very scary times. Banks, suffering from massive write-offs related to the collapse of mortgage-based securities, are hoarding their cash and are reluctant to lend. If banks don't lend, businesses can't finance their daily operations and could be forced to shut down. And this being a worldwide crisis, the economy of the whole world is in serious jeopardy. That is why governments across the world are taking action to inject trillions of dollars into the banking system to prevent an economic meltdown. It is not clear at this point how successful these actions will be.

Today's events are clearly unprecedented and terrifying. But let's take a look at the previous three major bear markets. From 2000 through 2002, the market fell 45%. This was the time when hundreds of high tech companies were going out of business, erasing trillions of market value. The events of 9/11 that happened during this period were also unprecedented and terrifying. No one was sure whether we would ever feel safe at home again.

On October 19, 1987, the market fell 23% in a single day. That was the worst day loss ever, both in point and percentage terms at the time, worse than the crash that marked the beginning of the Great Depression. That was unprecedented and terrifying, and there were many doomsday predictions of markets falling

much further. It didn't happen. In 1973–1974, the market fell 48%. We had double-digit inflation and unemployment rates, and our oil supply was choked off by the Arab embargo. That, also, was unprecedented and terrifying.

Each major bear market is unique and frightening in its own way, and it seems that the world is about to end...again. But the economy and the markets recovered from each of these setbacks, and proceeded their march to new highs. I have reason to believe that this will be the case this time, too.

When I was writing this book, I, like everybody else, did not imagine that we were about to witness these calamitous days. Other than adding examples, however, I am not planning to make modifications to the book. The investing principles presented here still apply in the current situation, perhaps even more so. The events of the last several weeks, as historic as they may have been, will not change my long-term investing philosophy and the Rules for Sensible Investing.

Leon Shirman

October 13, 2008

Intro

For obvious reasons, the topic of investing is a very popular one. Countless volumes are available on many investing aspects, such as thorough analysis of past market performance, psychology of investing, stock selection, etc. Why write another book?

In *42 Rules for Sensible Investing*, I compiled practical approaches and techniques that I used over the years into a number of concise and easy-to-follow rules. The rules themselves are not new, and I am sure many people have been and are using them, either consciously or subconsciously. Some of them I arrived at by personal trial and error, some I consider to be common sense, and some were inspired by strategies used by successful investors.

I like to think of this book as a condensation of valuable investment ideas—Cliffs Notes on investing, if you will. It is not a substitution for a textbook. You will not find detailed discussions and descriptions of various methodologies here. Instead, think of it as a checklist you can refer to when you make an investment decision.

Different people can have completely different investment approaches, and still be successful. I realize and understand that. The rules presented in this book work well for me, but I don't expect you to concur with every one of them. In fact, you will probably disagree with a few. Keep this in mind when you read through the book.

I am hopeful that flipping through these rules (which you don't need to do in order) will prompt you to think about your own rules and even to write them down. Please feel free to pass these rules to others and to start a discussion. After all, these are my rules. What are yours?

3

Invest for the Long Term

Over the long term, stocks have outperformed bonds and treasury bills with less risk.

Over the long term, staying out of the stock market is more risky than being fully invested.

This statement is certainly going to cause some controversy. How can I say that? At the time of this writing, in September 2008, the Nasdaq is still below 50% of the level it reached eight years ago, in 2000. We are also in the midst of a credit crisis of historic proportions with a number of venerable financial firms failing practically overnight. It is accompanied by a bear market with all major averages down over 30% from their highs several months ago. If that's not risky, what is?

The key to this claim lies in definition of what exactly constitutes "long term" and how you define "risk." Let's take these concepts one by one.

Since 1900, the stock market returned an average of nearly 10% annually. The traditional competition to stocks, bonds and treasury bills, only returned about 4% during the same period. One dollar, invested in the stock market in 1900, would have grown to over \$20,000 today. That same \$1 invested into bonds would be worth only \$60. Rule 2 states that compound interest is good. Indeed.

The domination of the stock market has been rather consistent over shorter periods as well. As explained in *Stocks for the Long Run* by Jeremy Siegel, over any 5-year period, stocks outperformed other investment types over 70% of the time. For 10-year periods, this number rises to

80%. Over 20 years, it goes to 95%. Finally, over 30-year intervals, stocks have always outperformed other investment types. I would say that this defines the first element in my claim, namely that long-term should mean over 20 years or more.

You may wonder whether a holding period of 20, or even 30, years applies to your situation. After all, chances are that you are not planning to hold a particular stock or a mutual fund that long. However, I am talking about the holding period of the entire portfolio, regardless of the number of changes you may make in it. And this holding period, in most cases, will run for several decades.

Now, let's take a look at risk. Traditionally, many people think of risk as the possibility of losing a substantial part of their investment. Looking again at performance of stocks vs. bonds and treasury bills, over any period of 10 years or longer, the maximum loss suffered by stocks was less than that suffered by bonds and treasury bills. Even in the worst 5-year period, the maximum loss from stocks was only one percentage point higher than that from bonds.

In mathematical terms, risk is often defined as the standard deviation of average annual returns. Standard deviation measures how widely spread the values are from the average. Using this formal definition, again, over any period longer than 20 years, stocks carried less risk than competing investment types.

The superior performance of stocks does come with a price of short-term volatility. Back in the 1800's, Mark Twain said: "October is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February." Over a few months or even years, no one can argue that this danger is all too real. However, history shows that over longer terms, stocks are in fact less risky, if one sees risk as lost opportunity. In the long term, the risk of investing in "safe" securities and realizing subpar returns is far greater than the risk of short-term fluctuations in the stock market.

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Market Declines Happen

Stock markets declines happened before and will happen in the future. They are a natural part of the market cycle.

Over the long term, stocks outperform other liquid investments such as bonds and treasury bills. That performance does come with a price of volatility and periodic market declines. A decline of 10% to 20% from a peak is called a correction. Corrections are very common in the market and occur, on average, every 18 months or so. A bear market is one that is in a decline of 20% or more. An average bear market results in a loss of about 30% of market value from the peak and lasts 9 to 18 months (sometimes longer).

During the last 100 years, we witnessed 18 bear markets, which included nine protracted bear markets with declines of 30% or more and the greatest of all bear markets, the 1929 Crash, when the stocks dropped almost 90% over 3 years. From the high of 1973, the market dropped 45%. In the crash of 1987, the Dow dropped 23%—in one day! This volatility plays an important part of a traditional definition of what risk is—namely, a possibility of losing a substantial part of your investment in a relatively short period of time.

The causes for market declines vary. Often, stock market drops are associated with economic difficulties. The memories of the Crash of 1929, which was followed by the Great Depression, still linger. However, behaviors of the markets and the economy can also be decoupled from each other. For example, the 1987 crash did not have any effect on expanding the economy and was simply a correction, as some contend,

of overextended equity valuations. Another common reason for market declines is some kind of uncertainty—for example, before an armed conflict. Markets would drop on worries about an impending clash, and would rally once the fighting began. That was the case in 1990, before and during the beginning of the first Iraqi war. At present (September 2008), we are experiencing the deepest financial crisis since the Great Depression, caused by a number of factors, including a severe correction in housing market.

Whatever the reason, declines in stocks happen. They are, in fact, recurring and expected events. It may be difficult for you not to be emotionally worried about market swoons—after all, it is not fun watching the value of your savings dwindle in front of your eyes. In rational terms, however, worrying about that is just about as productive as worrying about rainy weather. You don't assume that several days of rain signify the beginning of the next Great Flood. But if you believe financial media during market setbacks, not only will you be convinced that the Great Flood is upon us, but also that the Ark has already sailed and all hope is lost!

I find it very helpful to think of this analogy when the next regularly (or irregularly, as the case may be) scheduled market decline arrives. Granted, it will take time (sometimes several years) for the market to fully recover, but I have full confidence—and historical data to back me up—that it will.

At the time of this writing, we are in the midst of the 19th bear market of the past century. It is also the 10th severe bear market with a drop from the top of over 30%. And without a doubt there will be the 20th bear market and the 11th 30% decline. These pullbacks are all but certain; they are a natural part of the market life cycle, just as winters and summers are natural parts of the life cycle of our planet. A savvy investor should not fear or get upset with such corrections, but be prepared to take advantage of the low prices and a coming upswing in the market.

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Control Your Emotions

Don't do anything related to investing due to an emotional response. Be rational.

For many people, investing can be very emotional. After all, you are placing your hard-earned money at the whim of the market, over which you have no control. When the market declines, or experiences severe corrections (and it does that regularly, see Rule 8), and you see your holdings drop in value, there is always an urge to do something about it. In declining markets, fear takes over and the natural instinct is to sell to prevent further losses.

The opposite of fear is greed. In an advancing market, greed takes over and produces a desire to buy more in order to reap greater profit. That is a very natural and typical reaction. After a 1000-point drop in the Dow, people are pessimistic and want to sell, not buy. After a 1000-point advance, sellers are few and far between and optimism abounds. As a fund manager, I am certainly aware of this phenomenon. I typically receive new contributions during the times of market advances, which, short-term at least, often are precisely the wrong times to invest.

These decisions are based on the desires of your heart, not your brain. They are driven by emotion and not by reason, and the resulting choice is often incorrect. Does this mean that when market goes down, we should buy more, and when it advances, sell? Of course not. In all cases, we should use all tools available to us to evaluate the current situation and make a rational decision

based on available data, and not because a market pundit on TV declares that the sky is falling.

The emotional response can be evoked not only because of overall trends, but also because of specific news about a company that you invest in. We all know that share prices can sometimes move violently in response to certain news about the company. An emotional reaction to this situation would be a desire to do something, anything, to “fix this problem.” This is a very dangerous state of mind that often produces the worst investment decisions. Our job as investors is to calmly analyze the situation and make a rational choice based on the available information. This analysis could lead to a decision to sell, buy more shares, or, more often than not, do nothing at all (see Rule 32). Impulse buys and sells are the worst things you could do, that will inevitably lead to regrets later.

Let me tell you a story about the Magellan Fund. From 1977 to 1990, the Magellan Fund was managed by Peter Lynch, and during this time achieved extraordinary average annual returns of nearly 30% per year. Many consider Peter Lynch to be the best mutual fund manager ever. Nevertheless, the majority of people who invested in the Magellan Fund during Lynch’s tenure actually lost money. How is that possible? While achieving excellent returns, Magellan Fund was certainly subject to overall market fluctuations and had its share of ups and downs. Apparently, many investors made emotional decisions to put the cash in during the good times and take it out during the bad.

In popular TV science fiction series “Star Trek,” Mr. Spock is the science officer on the starship “Enterprise.” Mr. Spock is from planet Vulcan, whose inhabitants live by relying on reason and logic, without any interference from emotion. I don’t recall that subject of investing comes up in “Star Trek,” but Vulcans should be very good at it. Try to think like Mr. Spock when it comes to your portfolio. And, as the Vulcans say, live long and prosper!

Rule

17

Buy What You Know

Invest in the companies that you understand.

The phrase “Buy What You Know” was introduced by Peter Lynch in his classic book *One Up on Wall Street*. This rule was one of his most important, if not the most important, investing principles. It should be yours, too. Simply put, it means you should use your familiarity with a product or an industry as your advantage in choosing a stock to buy.

We have already talked about the significance of having simple reasons for investing in a company. Now, in addition to that, you should have good understanding of how this company operates. If you do, then you probably have a good handle on various risks associated with investing in this company. And your success as an investor depends on your ability to ascertain the risks.

There are several aspects to understanding a business. Here are some questions that you should be able to answer if you are considering investing in a company. First, how does it make money? For example, for most retailers, the answer to that is quite obvious. Other companies may not sell directly to end customers and could have very complex sales channels instead. You should have a very clear picture of how their revenue generation works. Who are your company’s customers?

Rule

24

Know When to Sell

Sell when you find a better place for your money.

As an investor, you probably know that a decision to buy a stock is much easier than a decision to sell. Once you own a stock, you somehow feel psychologically attached to it, and in order to sell, you need a good reason—a much better reason than prompted you to buy it in the first place! The current stock price usually doesn't help to make this decision. If it is higher than what you originally paid, then you think that the stock might go higher still. If it is lower, you'd like to get back to your purchase price so that you could at least "break even."

I am certainly guilty of thinking along both of these lines. In the late 1980's, I owned a number of high tech company stocks: Oracle, Sun Microsystems, and Intel among them. I sold all of them for what I thought was a respectable profit, only to see them rise more than ten-fold in subsequent years. On the other hand, I held on too long to Krispy Kreme Donuts, only getting out of it when it lost more than two-thirds of its value. I am sure that you have similar experiences.

According to the well-known investor and author Philip Fisher, if you did a good job in selecting a stock in the first place, "the time to sell it is—almost never." Warren Buffett agrees. Nevertheless, we all make mistakes and therefore we need a strategy as to when to pull the trigger and sell. A basic rule of thumb is to revisit your reasons for purchasing the stock in the first place. (Hopefully, you didn't buy it because your cousin Bob said it was hot. In this case, sell now!)

Are these reasons still in place? Has something changed in the company's business or its competitive situation? Will you buy this stock again, at its current price? If not, then consider selling.

Probably the most important reason for selling is that you identified another opportunity that presents a better place for your money. Your original investment thesis may still be intact, and you may expect the stock to go up, say, 15% per year. But if you think you found another that has the potential to increase by 25%—that could be a valid reason to sell.

Keeping your portfolio balanced may present yet another reason for selling or at least reducing your position. Let's say you were fortunate enough to pick a big winner so that it now represents a significant part of your portfolio. Should you sell? There is no good answer to this one—it depends on your own tolerance of risk. Experience says, "let the winners run," which inevitably leads to these equities taking dominant positions in the portfolio, and of course this increases the risk of volatility. I am not too happy about this right now, as two of my largest holdings dropped more than 50% from the top in this current bear market, but I still believe in their long-term potential. I also remind myself that Warren Buffett at some point had about a third of his total assets in Coca-Cola. But in any case, it is up to you to decide whether you can stomach this kind of volatility.

Other grounds for selling include poor financial performance, untrustworthy management, increasing competition—but all of these could really be inferred from the very first rule of revisiting your original rationale for purchasing the stock. That, together with identifying better investment opportunities, are the primary reasons to sell.

Note that current company valuation, or its stock price, usually should not figure in this determination. The price could be double what you paid for it, or it could be half. The market has no memory and doesn't know what you paid. The past doesn't matter, only the future does—and so you need to re-evaluate the company from the present forward. Don't attempt setting price-related goals ("I'll sell when I make 50%" or "I'll sell when I break even"), as they are based on the past. Other poor reasons for selling include basing your decision on overall market or economic conditions (see Rule 27), as well as on commonly-used stock valuation metrics (such as the P/E ratio). Growth stocks often appear overvalued based on these metrics.