

# Combining Share Selection Strategies

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*Presentation given at an Australian Shareholders Association Conference*

## Introduction

In this presentation I will be addressing issues to do with investing in the Australian stock market. I will not specifically discuss these issues for speculators (traders) although many of the ideas may be applied to speculation, especially the material concerning money management. Trusts, REITs and Listed Investment Companies (LICs) are special cases and are outside today's discussion.

## Why Invest in Stocks?

Investors buy part ownership of profitable companies in order to secure an income stream in the form of dividends and imputed credits. If the company does well, the market value of the shareholding will increase over time. Wealth is created when the total return from investing in the company is in excess of the rate of inflation.

In general terms, the main things that an investor should be focussed on are:

- **Companies that make profits and pay dividends.** All other companies are speculations, with the possible exception of a profitable company that is expected to pay dividends in the near future.
- **Companies that may be purchased at a price that affords a margin of safety.** In general terms, a margin of safety is present when the company purchased is relatively cheap, spins off a relatively high dividend yield and has low or no debt.
- **Achieving an average return in excess of the ASX All Ordinaries (or ASX200) Accumulation index.** If not, the investor is clearly better to be a buy-and-hold investor in a broad market index fund, which will generate a market return, by definition.

The objective in investing is to build wealth slowly and steadily, rather than take a high-risk path that rarely succeeds and can fail disastrously, especially when a high level of debt has been taken on to try to magnify returns, but that just as frequently magnifies losses.

## The Great Divide

There are two main disciplines that may be employed in the selection of stocks for investment and in the management of those investments. They are:

- **Fundamental analysis** – it is used by most of the investment industry as their only or prime method.
- **Technical analysis** – it is used mainly by private investors and almost all speculators.

One of the great tragedies in investing is that adherents of both disciplines tend to denigrate the other discipline, while maintaining that their own discipline is the only true way. In particular, both tend to accuse the other of investing in the rear-view mirror while their own discipline looks forward. This is not true:

- Fundamental and technical analysis both rely on past and present information, albeit different information much of the time.
- Fundamental and technical analysis each affords an insight into the future and makes valuable contributions to the management of risk.

So, there is no need for us to choose the method we should adopt. They are not alternatives from which we must select only one. The two disciplines complement each other and the combined strength of the two disciplines is more powerful than confining ourselves to only one of them.

One reason for this great divide between fundamental and technical analysis is that there is a widespread ignorance or misunderstanding of the other discipline. The key to resolving the great divide is to see that the two disciplines have quite different roles, although there is some overlap:

#### **Fundamental analysis**

- Great for estimating the relative value of a stock.
- Not much use for timing purchase and especially sale of a stock.

#### **Technical analysis**

- Great for timing purchase and sale of a stock.
- Not much use for estimating the relative value of a stock.

In order to conquer the great divide and give us a good chance of securing excellent returns over those who confine themselves to their one true way, we need to recognise the role of each discipline and employ it appropriately.

## **The Roadblocks**

Both disciplines have roadblocks that cause investors to prefer one method over the other.

The major **roadblock in fundamental analysis** is that most private investors quickly find that it is all together much too difficult. This derives from a faulty expectation that investing and particularly analysis is easy. We have to understand that security analysis, to give it its proper name, is practised by highly trained professionals, who work long hours and have better access to information than will ever be there for private investors.

Therefore, if we want to do our own investment analysis, we are going to have to devote a great deal of time and effort to it. I don't know of any profession that can be successfully carried out without first gaining the necessary knowledge in a formal or informal manner and then without gaining the experience necessary by carrying out real investments, preferably under the guidance of

a mentor. This is how it is done in most professions. Ask what makes us think that the investment profession is any different.

However, that said, the most difficult step is the first one. When confronted by financial statements, we must resist our automatic reaction of our eyes glazing over and we are frozen in an unthinking state. There is much of the fine technical detail in security analysis that can best be left to the professionals. What we need to do instead is to start to focus on the few key concepts that drive investment value and which enable us to quickly identify high risk situations.

The major **roadblock in technical analysis** is that it has a bad name. This is richly deserved. Very little of it is based on sound research using the accepted disciplines of scientific method. Technical analysis has what is best described as a *lunatic fringe* who use it based on beliefs that have no basis in fact and are held tenaciously even in the face of contrary research that is scientifically based. Much of their argument is an excellent example of confirmation bias – they quote examples where it works, but do not look at the more numerous times when it failed to work.

One reason for this is that a great many technical analysis aficionados use it as an easy way out of the fundamental analysis roadblock. This is understandable, but makes no sense if what they are doing does not actually work.

The way out of this is to approach technical analysis with a more critical mindset. There are many sound ideas in technical analysis that make sense once we can demonstrate their validity based on investor behaviour. We should focus on those technical analysis tools that have been based on the long-term observation of market behaviours. They can be difficult to prove scientifically, but pending research, make good sense to us and we are able to show many more examples of them working than we can find examples of them not working in the way that the theory suggests.

## My tools for selecting stocks

One of the most enduring truisms about investing is that there are many methods that are effective, such that any claim to being the only true way is not justified. I have chosen a combination of tools that have served me well over many market cycles. I do not claim that the way I use to select stocks is special in any way, but it has been effective for me. Moreover, I am not suggesting that other methods are any less effective. It is very important in investing to choose a set of tools that makes sense to us as individuals and that we feel comfortable with using. I am the first person who will encourage wide reading and experimentation with a range of methods to try to distil a combination of them that will be effective. My one warning is to beware of anyone who is deriding the methods of others and trying to persuade us that he or she has the perfect method.

## Company Profile (fundamental analysis)

First, I visit the company website, where there is often a great deal of information about the company and its business. When there is not much on the company website, I use other sources like the ASX website to study company reports and also the Morningstar research on my broker's website. With larger companies, I will already have a good knowledge in this area. However, my investment plan is focused on smaller industrial stocks and with many of these I will be starting with little if any background knowledge.

## Trend of Earnings and Dividends (fundamental analysis)

Next, I assemble a graph of earnings per share and dividends per share for around ten years, depending on how long the company has been listed. I am looking for consistency and growth in both earnings and dividends, especially in recent years.

## Chart Model (technical analysis)

I have two models for the way the vast majority of charts of stocks unfold over time. These are the value model and the growth model. Anything else is a rubbish chart and quickly consigned to the too hard basket. On both models, my ideal buying point is an upward breakout from a substantial sideways pattern (a year or more is ideal). The models suggest that these stocks should be about to start trending upward. To find these stocks, and also any that have already begun an upward trend, I scan the market regularly for stocks making 52-week new highs in the last week.

In this respect, I always look at the chart of any stock I read about. If the chart is heading to the bottom right corner, I may not even bother reading about it. However, I am intensely interested in those that are forming accumulation or consolidation patterns on my models.

## Value

However, every stock making an upward breakout or already trending is only attractive to me if it has a margin of safety. I am looking for undervalued stocks. For this purpose I use two tried and tested measures: relatively low price earnings ratios and relatively high dividend yields.

In this regard, I also regularly scan the market for stocks that have a low price earnings ratio. Most of them will in fact be trending down because the market expects that past earnings will not be repeated. However, among the dross will often be a few gems that I can watch closely for a breakout.

## Risk

The major risk is financial risk, or a high level of borrowing. For most industrials my heuristic is to have no more than 60% debt to equity. However, some companies in the financial services area will have higher normal gearing than this and must be investigated in more depth. Banking and insurance are two sectors where the analysis can be very specialised and it is best to rely on professional research.

The other risk is liquidity risk. I am looking for stocks that are sufficiently liquid to enable me to easily buy and, more importantly, to sell should things go wrong. I tend to use market capitalisation and also the average number of shares traded over the last 22 days from Stock Doctor.

***Note:** In this section I have only discussed my methods for selecting stocks. It is outside today's agenda to deal with the even more important process of managing investments through to liquidation, which for me is heavily based on technical analysis.*

## Risk Management

Risk can be a tricky thing to define. The academic world has taken an easy way out and defined it as the variation in return over time. However, this is not what the private investor views as risk. Risk to a private investor is the chances of losing much or all of their investment capital. So, private investors did not see the gains they made in the 2003-2007 bull market as anything to do with risk.

However, what happened to many of them in the 2007-2009 bear market was a stark definition of risk as they saw it.

This definition plays back into the prime objective in investing (and speculation, for that matter), which is preservation of capital. It is our investment capital that generates an income stream for us to live off in retirement. In addition, our investments should keep us ahead of inflation over time so that our real wealth is increasing.

The kernel of the risk issue is in this table from my book *Building Wealth in the Stock Market*:

<b>% Loss of Capital</b>	<b>% Gain on Remaining Capital Needed to Recover</b>
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900

One of the major risks is known as market risk. When the market falls, most stocks fall with it. Market risk is dealt with by market timing, which is beyond today's agenda.

The other major risk is known as specific risk. This is the risk that one or more of the companies we invest in fails badly and we lose a lot of our investment capital. There are two main ways to deal with specific risk:

- **Diversification** or spreading our capital over a reasonable number of stocks so that, if one fails, it is not a disastrous loss of capital from which we may not easily recover.
- **Position sizing** or controlling the amount of capital that can be lost in any one stock.

I will take them in turn.

## **Diversification**

The idea behind diversification is quite simple. If we spread our capital out evenly over many stocks, the risk of any one severely damaging the total portfolio is greatly reduced. However, there is a very real dilemma in diversification.

As we increase the number of stocks, the additional risk reduction becomes steadily less. In theory, once we have eight uncorrelated investments, we have reduced specific risk substantially. The problem here is that all stocks are correlated to some extent, so the practical number of stocks is probably at least double that minimum. So, the more stocks we hold, the lower the specific risk.

Where the dilemma arises is that, in order to make superior returns, we should aim to focus our portfolio on a limited number of outstanding stocks in which we have substantial holdings. This is

explained very clearly in a book called *The Zurich Axioms* by Max Gunther where his first axiom was to *always play for meaningful stakes*.

In the final analysis, there is a balance that must be struck between reducing and assuming risk:

- A minimum level of diversification to limit risk
- A minimum investment in any one stock in order to assume risk and open our portfolio to the possibility of making outstanding returns.

Another aspect of diversification is the size of the companies we invest in. Smaller companies can grow far faster than big companies. However, they can also fail far more often and easily.

My own investment plan aims to invest a minimum of 2% and a maximum of 6% of my capital in any one stock. This is an expression of the way I have dealt with the dilemma. However, I must warn readers that my approach is quite aggressive, especially when overlaid on my focus on smaller companies. Each investor has to strike a balance with which they are comfortable.

## Position Sizing

The idea behind position sizing is also quite simple, but if readers have not encountered it before, it can take a little time to fully appreciate all of its implications.

**The first step** is to find a stock in which we wish to invest. Then we study the market depth to determine a likely buying price.

**The second step** is to determine where we are wrong about the stock we are intending to buy. This can be done in an endless variety of ways. In principle, if we buy a stock, then we must have some expectation of what will ensue. Once we can define what we are expecting, it is usually quite simple to define when that expectation is not being realised. In my case I am expecting an upward trend to unfold. From the definition of a trend, I can define when the trend has failed to unfold, or when an unfolding trend has failed. This price level is called a sell-stop; a price at which, if the stock fell to it, we would be wrong and should sell.

**The third step** is to subtract the sell-stop price from the buy price. The difference is the risk we are taking on each share.

**The fourth step** is to determine how many dollars we will put at risk in the stock. This is usually between 0.5% and 2% of our total investment capital. So if our total investment capital is \$100,000 and we are prepared to risk 1% on the stock, this will be \$1,000.

**The fifth step** is to divide the dollar amount we are prepared to risk on the stock by the risk per stock. Assuming that the risk back to our sell-stop is 25¢, the maximum number of shares we should buy is  $\$1,000 \div 25¢ = 4,000$  shares.

The important insight that should be grasped in position sizing is that the distance that our sell-stop is from our buy price is not of concern. This is because the bigger the risk per share, the smaller the number of shares we buy in a stock and vice versa. If instead of 25¢ at risk in the example in the fifth

step above, the risk per share down to our sell stop was 50¢, the maximum number of shares we should buy is only 2,000 shares.

A secondary insight into the position sizing procedure is that it all comes to nought if we lack the discipline necessary to execute our sell-stop if it was to be hit. For this reason, it is often suggested that beginners employ pre-set stops with their broker until they have gained enough experience.

*This address was necessarily quite general. Readers wishing to understand my investment plan in total will find it in my book **Building Wealth in the Stock Market**.*

## To read more of my work

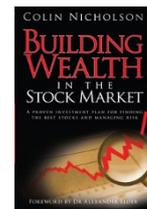
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