Investing Guidelines

From fifty years' experience investing in businesses through the stockmarket I have developed some guidelines than seem to improve the chances of success. These are not some idiosyncratic guidelines that I have developed; they are echoed through the literature on investing. They seem to be in the nature of universal truths honed from long and varied experience.

Invest Counter-Cyclically

I will start with the most difficult guideline to implement, yet arguably the most important in terms of improving investment results. Economies and markets fluctuate all the time. There is an enormous industry that runs a constant and highly confusing commentary on the endless fluctuations, most of it ill-informed. Most of these fluctuations are quite minor in the overall scheme of things, but the media commentators are paid to stress them as being of importance.

Avoiding this constant babble and focussing on the larger swings in economies and markets is best achieved by focus on longer-term charts of stock markets in Australia and around the world. Looking at world markets is important because even if we only invest in Australia, our country is constantly affected in significant ways by what is happening in the wider world. I am now posting charts of all significant stock markets around the world each week on the members website. To view a sample, scroll down to the lower right side of the home page on www.bwts.com.au and click on the hyperlink *Samples of some members material* this will open a list of samples of members material. Look for the item *(date) Weekly Market Charts and Analysis*. This is a PDF file.

The way I look at markets for this purpose is through the twenty-year charts. I am looking for the larger up and down swings, known in the industry jargon as bull and bear markets. Now, what most people do is to invest in the late stages of bull markets when everything is looking great. The problem with this is that this is when shares in good businesses are most highly priced. It is an easy time to buy because everyone around us is buying and doing well. This is absolutely the easiest time to buy because we will feel most comfortable doing what everyone else is doing, but it is unfortunately the wrong time to be buying.

The right time to be buying is conversely the most difficult time to buy. This is when markets have fallen substantially. Four to six times in our lifetime there will be a big bear market when share prices have fallen 40 to 50% from their peak. There will be fear all around us, but these are the times of truly outstanding opportunities to buy part ownership of great businesses are very attractive prices. This is what is called counter-cyclical investing.

As I mentioned above, there will only be a few of these great opportunities, but in between there are many more minor bear markets that also present counter-cyclical opportunities. Most people love rising markets. Smart investors who understand that it is best to buy counter to the cycle see falls in the markets as opportunities, not risks. As I write this, markets have fallen sharply on speculation about the US presidential election. Most investors feel fear. This is natural. Smart investors feel the fear and also sense that temporary market setbacks are a buying opportunity.

They have done their research and wait for these opportunities to buy. Smart countercyclical investors buy shares when they are cheap, not when they are expensive.

Avoid Debt

Most people who go bankrupt are in the situation where they have become unable to pay their debts when they fall due. The same applies to businesses. This simple observation is a very powerful key to successful investing in two ways.

The first way to apply the observation that high debt leads to insolvency is in the temptation to boost returns by borrowing money to buy stocks, especially borrowing through a margin account. It is probably fairly safe to do this if we have developed the art of counter-cyclical buying and limit investment on margin to sound companies. However, even then it can be dangerous if too much is borrowed. My own policy is never to buy shares on margin, so I never have to worry about margin calls, while still managing a rate of return better than the market index. If you must buy on margin, the idea is to keep the margin loan small until you have a demonstrated ability to manage it through at least one complete bull-bear cycle.

The second way to apply the observation that high debt leads to insolvency is in the temptation to chase the high-flying companies that are boosting their profits by the heavy use of debt. In the corporate sphere, just like the personal investing sphere, debt boosts returns but also dials up the risk of failure. Everyone reading this will still, I hope, remember the big bear market of 2008-2009, triggered by the global financial crisis. Let me remind you of some highly indebted businesses that went belly-up: ABC Learning Centres, Babcock and Brown, Allco, Centro and several more. High debt boosted returns in the good times, but when the tide turned their high debt could not be sustained and they failed completely. Relatively high debt may be sustainable in businesses like food retailers that do not swing down so much in a bear market. However, for most businesses, high debt should be a red flag: it is dangerous to swim there.

Safety in Diversity

Diversification means that we spread our risk across a number of shares in our portfolio. Like a sword, diversification cuts both ways. If we diversify too much, that is we spread our capital across too many different stocks, then our investment return is likely at best to track the broad market index. On the other hand, if we hold too few stocks in our portfolio then the level of risk is dialled up in the sense that if one of the businesses we have invested in goes bad, it could significantly hurt the investment return of our portfolio.

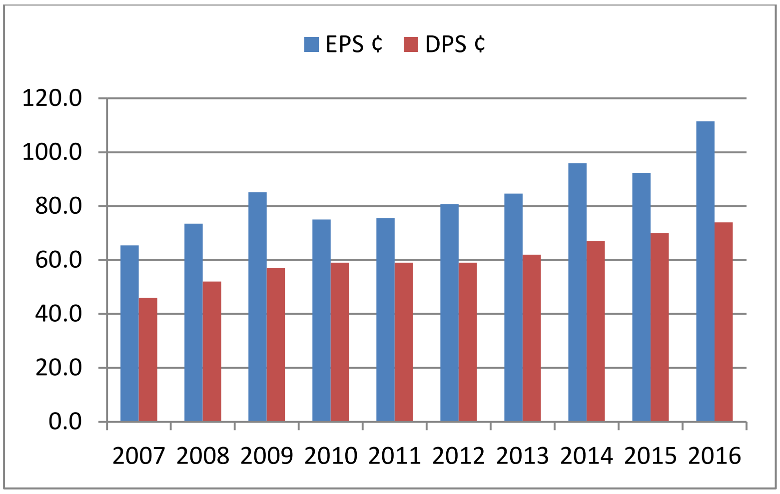
The aim with diversification is to spread our risk without reducing returns too much. Benjamin Graham advocated holding more than ten shares and less than thirty shares. My own aim is right in the middle of Graham's preferred range at sixteen to twenty shares.

I also think it is important to see diversification another way. For example, if we hold twenty stocks in a portfolio and most of them are banks, then we are not really diversified because if the banking sector falls on hard times our portfolio will be badly affected. So, diversification has another dimension in addition to the number of stocks in our portfolio. We should aim not to be overly exposed to any one industry or sector. I try to hold no more than two stocks, or to invest more than twelve percent of my portfolio, in any one industry sector.

Smoothly Growing Earnings

The objective in investing in the stock market is to buy part ownership of businesses that will provide an ongoing and steady stream of earnings. The best way to be sure of this is to look at the past earnings performance of the business. I like to look back at least ten years, which will usually include at least one small bear market. Look for businesses whose earnings held up well through a downturn. This will usually involve finding businesses that are not overly affected by the cyclical swings of the business cycle.

I like to graph earnings per share and dividends per share for the last ten years, showing a fairly steady rise as is shown below for Sonic Healthcare:



This is not a perfect picture, but the trend is quite clear and the occasional dips are not severe. There is a reasonable basis for assuming that this pattern will continue.

Inherent in such a picture is that the business is likely to have demonstrated that it has a capable management in place that has shown an ability to continue to grow the business. This means that it has some level of competitive advantage, without which competitors would have competed the profits away through aggressive pricing.

Buy at a Low Price

It goes almost without saying that if we buy shares in a business at too high a price, we will likely suffer a less than favourable return. Instead, what we should be hunting for are businesses as described under the previous heading than are available for purchase at a low price relative to their intrinsic value. Now, price is easy to get a fix on – shares are traded almost every day on the stock market.

Intrinsic value is a far more slippery concept that is best summarised as the value of all future dividends or earnings over the life of the business discounted to present value. Why is this concept slippery? It is because it involves estimating earnings or dividends plus the discount rate well into the future. In my experience, it is just not possible with any degree of accuracy.

As an alternative, the industry tends to use price earnings ratios, which assume that present earnings are maintainable. This makes it easier for the everyday investor because *The Australian Financial Review* publishes the market average price earnings ratio in their weekend edition each Saturday. The market average PE ratio might be regarded as fair value. So, what we are looking for are businesses that meet all of the above requirements and are selling significantly below the market average price earnings ratio.

For example, if the market average price earnings ratio is 16 times, then a company with a price earnings ratio of 10 to 12 times might be attractive. However, that said, be careful with very low price earnings ratios: they could indicate that the market does not expect past earnings to be continued.

There is one caveat here and that is that some businesses show outstanding growth histories. They are unlikely to be available at such low price earnings ratios except after big bear markets. With these businesses I like to buy when they have a price earnings ratio that is not too far above the market average. If the market average price earnings ratio was 16 times, I would like to be buying these stocks when their price earnings ratio is less than 20 times.

The important thing to keep in mind here is to buy at an attractive price, but remember that it is better to buy a good business at a fair price than to buy a poor business at a very low price. The trick is not to be carried away and pay too much. Successful investing involves deep analysis, but it can all be undone by buying stocks at too high a price; so be patient and wait for the good prospects to present themselves.

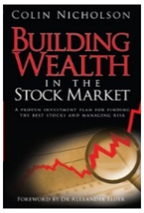
To read more of my work

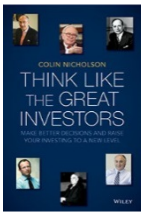
Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:





BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website