Investing Successfully

Before discussing investing, it is useful to outline speculation. Speculation is different to investing as I will show in this article. Speculation is what most private investors do in the stock market. To identify whether we are speculating or investing, look for these signs of speculation:

1. Do we know and use the name of the company, or only its ticker code? This may be fine for short term speculators, but is a sure sign we are not investing.
2. Does the company make profits and pay dividends? If it does not, we are most definitely speculating because an investor is looking for an income stream in the form of dividends and franking credits, which are only possible if the business makes a profit.
3. Is the company searching for minerals, oil or gas? If it has yet to find what it is looking for and developed the resource, it cannot be making a profit and paying dividends, so we are most definitely speculating.
4. Is the company trying to develop a new cure for a medical condition or developing a new technology? If it has not yet found the cure or developed the technology to the point where it makes profits and pays dividends we are most definitely speculating.
5. Is the company starting up a new and as yet unproven business? If it is not yet making profits and paying dividends we are most definitely speculating.

Now, there is nothing wrong with speculating, but it is higher risk than investing and requires different skills. If we think we are investing and are really speculating then we cannot be thinking clearly about what we are about. That is very dangerous to our wealth.

The ASX has over 2,000 listed securities. If we do a scan for those securities that make a profit and pay a dividend, around 400 companies will come up. This is the pool that an investor should be fishing in.

Now imagine that we have a lot of money available to invest. We might buy an entire business. Then we run that business successfully and make profits. Out of those profits we pay our self dividends. We will also be ploughing back some of our profits into the business which means that its value will rise over time. That is investing.

Of course most of us do not have that much money or the skills to run a business, so instead we invest on the stock market by buying part ownership (so many shares) in one or more of the 400 odd investment grade companies. They will pay us dividends and probably franking credits. Reinvestment of retained earnings will also cause its value to rise over time. Think of it this way: instead of one owner, listed ASX investments have many fractional owners.

I hope from the discussion so far that the difference between speculating and investing has become clear. Now we can look at what a good investment should look like:

1. As I have already discussed, the company makes a profit and pays a, preferably franked, dividend. However that is not enough to keep us safe…

2. The company should be conservatively financed. If it is not it may be too risky. Conservatively financed means it has low debt. Low debt means it can survive if business conditions turn ugly for a while, as will inevitably happen from time to time.
3. The company should have a competitive advantage. Essentially this means it is a price maker, not a price taker. Having pricing power is the secret to longevity and profitability of the business.
4. The company should have a rate of return that is above our cost of capital. Our cost of capital is the percentage return we need to compensate us for the risk involved in investing.
5. The shares in the company can be purchased at a price that is low relative to value. Always remember that price is what we pay and value is what we get. If we pay too high a price relative to value the risks are higher and we may not get the return we hope for.

I hope this exploration of what makes up investing has clarified the difference between investing and speculating.

The next problem with investing is that to do it successfully means we have to learn a new profession. How do we learn a profession?

1. We undertake formal investment education to a post-graduate level. Yes, we may be able to do it on our own by extensive reading and study, but this is both difficult and uncertain. I know because I have been there. After investing and trying to educate myself reading several hundred books over 20 years I enrolled in the Graduate Diploma in Applied Finance and Investing with the Securities Institute of Australia*. I was staggered by how much I had not learned on my own. Having graduated, I also had the opportunity to teach in the course, reinforcing my experience that if we want to understand something in depth, teach it! Write a book about it perhaps, as I have done. (* this material is now taught by Kaplan in its Masters program.)
2. From there we still need ongoing wide reading and study by reading a book a month on investing, biographies of investors, history of markets and so on. People tell me they do not have time to do this. Rubbish! If we read a chapter each night before we turn out the light to sleep we will get through a book each month easily. If we lack the discipline to do this, I question whether we should be investing.

All of this should lead us to develop our own investment plan. Because each one of us has taken a different journey through life we are all different and our investment plans will be different to suit our resources, who we are and what we know. My own investment plan is written in my book *Building Wealth in the Stock Market*. It is there as a model for what a plan might look like and what should be in it, not to be copied blindly. If we have not done the thinking that makes up the plan, I guarantee that just trying to copy my plan will not work; we will abandon it when the market puts us under pressure, as it will do inevitably.

Developing an investment plan requires years of experience, thinking through the issues and testing approaches, not just knowledge.

It is vital that our investment plan be in writing. I can attest from my own experience in developing my plan that writing it down is invaluable for two reasons: it exposes gaps in our plan we did not know were there and it also exposes logical inconsistencies in our plan.

We will know that our plan is complete when in any situation we experience while investing we can look up the plan and find the relevant rule or guideline to deal with it.

All this sounds like an awful lot of work. It is and it is not easy. However, the rewards will make it all worth the effort.

Finally, having a plan is one thing. Learning from experience is another. Learning from our investments – good ones and bad ones – requires that we keep an investment journal for every investment we make. It needs to be in writing and written up as we go, not afterwards. My journals are all published on my members website as I go along. I have found that keeping an investment journal for each stock I buy is extremely valuable as a learning tool by going back over them and drawing out lessons that may mean a tweak to our plan, but more likely expose where we broke one of our own rules or guidelines.

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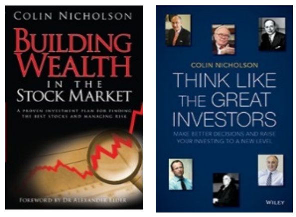

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