Investing Strategies

CONTENTS

turning the madness of crowds to your advantage

Shares chosen at random may over time do as well or better than those chosen by rational or 'scientific' methods.

On 19 October, 1987, we saw sharemarkets plunge worldwide, apparently without warning, shattering even the records of the Great Crash of 1929. It was a classic example of "market risk" which, as you learned is the movement in the sharemarket as a whole and the fluctuation of all share prices according to the waves of optimism and pessimism which periodically sweep markets.

This, and the subsequent mini-crash of October 1989, has ushered in what many market analysts now regard as a new era of volatility. You may face wider swings in markets than resulting in both higher risk and reward.

But don't be alarmed. Markets still provide plenty of safe havens for the more conservative investor. Moreover, there are a wide range of hedging techniques available to "lock in" profits and insure against market risk.

In this lesson you will see how knowledge of market cycles will enable you to stand aside from what has often been called "the madness of crowds".

Even more importantly, you'll see how an understanding of your own needs and current position is the continuing key to winning in what often appears to be an irrational world.

You will learn:

- How selection of individual shares must always take place within the context of the major movements of the market as a whole.
- How two classic emotions — fear and greed — drive markets, and how assessing your own capacity to deal with these emotions is an underlying skill vital to successful investing.
- How markets always move in cycles, a fact that many investors fail to remember during protracted "bull" markets.
- Successful investing strategies that have paid off in the past and whether any are right for you.

A bull market is where share prices are rising, a bear market is where share prices are falling.

the madness of crowds - and how to learn to stand aside from it

Astute observers of human nature have long chronicled the follies of mass behaviour in relation to investing. Throughout history, from the South Sea Bubble in 1719-20 to the crash of October 1987, markets have been caught up in periodic waves of alternating fear and greed.

One writer to document this was Charles Mackay, author of Extraordinary Popular Delusions and the Madness of Crowds, published in 1841 and often referred to as "the greatest book on investing ever written".

Mackay chronicles the waves of irrational behaviour that seem to affect mankind at regular intervals, such as the 17th Century Dutch mania for tulip bulbs. Otherwise hard-headed businessmen paid fortunes for rare tulip bulbs at the height of this craze, bartering them on exchanges that sprang up especially to trade them. In time, of course, the market crashed and tulip bulbs reverted to their rightful place in the scheme of things.

Another writer much admired by students of investing is Gustave Le Bon, a French physician who in 1895 wrote a book called *"La Psychologie des Foules"*, translated as *"The Crowd"*. His insights, later elaborated upon by Sigmund Freud, do much to explain how madness infects markets from time to time.

Le Bon said a crowd does not all have to be in one place. It can consist of many scattered individuals bound together by a "collective mind". This leads to individuals succumbing to a heightened form of suggestibility, which in turn breeds a feeling of invincibility and "irresistible impetuosity".

John Maynard Keynes, the great economist, accepted this fully and said, in effect, that an important part of investing is the game of guessing which way the crowd will swing rather than assessing the objective merits of individual shares.

> ***"When the public is in the market in a big way the market suffers distortions ... because the public does not know very much and is very emotional."***

Simply knowing when to **stand aside** and **do nothing** may be one of the most important of all investing skills.

the sharemarket: home of the lemmings

Let's say a major stockbroking firm with the best reputation for fundamental analysis of bank shares tells its clients to sell bank shares. Soon everyone else follows. Equally, if the three biggest superannuation funds start buying mining shares, then everyone else follows suit.

Always remember: as an individual investor you are ideally placed to stand outside the crowd. No one can sack you from your job as your own investment manager for failing to follow a fad.

This is one of your key strengths over the market professionals. You will be returning to it again in a later lesson as you learn more "contrarian" approaches that enable you to exploit this advantage.

Before you move on, let's look quickly at a further manifestation of the copycat tendency that permeates much professional sharemarket action. It is yet another result of the new high-tech world of investing, and how today's investing world would be unrecognisable to an investor of even a decade ago.

Why going with the crowd can be dangerous

Taking a minute to think about how you will react to this "madness of crowds" is an important prerequisite to successful investing.

Experienced investors always watch for signs of market "tops". The rushing in of the public is invariably an indication that such a top has been reached, shortly to be followed by a crash.

Joe Kennedy, the multi-millionaire father of President Kennedy, is reputed to have got out of the market before the Great Crash of 1929 when a shoeshine boy offered him sharemarket tips. His rationale was that if a lowly shoeshine boy had become an expert, it was time for the real experts to get.

Does this remind you of the lemming-like rush to buy TV stations in the late 1980s? Or the stories of school children making thousands of dollars during a sharemarket boom? Or the frenzy of the Australian property market in 1987-88?

Mining, property and media companies may still be good investments over time. But a stampede of the public to buy is always a danger signal. Invariably it is a time when shrewd investors will be found selling rather than buying.

the sharemarket: home of the lemmings

How computer program trading automates the herd instinct.

You probably read about how what's now called "program" trading was blamed for exacerbating the Wall Street crash of October 1987 and in turn sparking the sensational fall in share prices in Australia and worldwide.

Here is how program trading works:

1. Indexes measure the market as a whole by taking a "basket" of representative shares.

2. In recent years futures markets have developed where you can trade the All Ordinaries Index itself. This means you bet on the broader market movements rather than on a specific share as with traditional futures.

3. In theory, index futures should move exactly in step with the underlying shares. But in practice, small gaps and time-lags develop between the two markets.

4. Arbitrageurs (traders who seek to exploit price differences between markets) program computers to quickly exploit these gaps and time-lags. These are called "program trades".

5. Many computers with similar programs may be triggered in unison, placing millions of buy or sell orders simultaneously. The market becomes swamped and prices move violently up or down.

6. These sharp price changes then widen the gaps between underlying shares and the indexes, setting off further computer orders designed to exploit the differences. A chain reaction develops with each cycle of this process further triggering steep price changes.

Successful investors always say: "Buy on the rumour, sell on the news". By the time the public has heard the rumour it has become the news.

If you think all this sounds scary you're not alone. In October 1987, shortly after the market crashed, US sharemarkets and commodity exchanges suspended all computer program trading. Numerous studies are still underway to determine if such sophisticated techniques do in fact contribute to market volatility. A heated debate is likely to continue for some time.

Another sharemarket term you may have heard used in connection with downward share movements is "selling short".

This is how "bears" make money.

Let's just take a moment to see how it works.

selling short: how "bears" make money while everyone else is losing it

Selling short (or selling uncovered) is where you sell shares you don't own in the hope of buying them later after their price has fallen. For example, suppose you sell short when a company's share price is $1 and you buy later at 75c — you've made a 25c profit.

In 1980, short-selling became illegal in Australia, but the Stock Exchange re-introduced it under strict guidelines in the mid 1980s. The shares of about 110 companies are currently listed as "approved companies for short-selling". These companies have a market capitalisation of at least $100 million, and 50 million ordinary shares on issue. A maximum of 10 per cent of tradeable shares in any of these companies can be sold short at any one time.

Short-sellers must notify their brokers, purchasers of their shares and the Stock Exchange of their action. You can also sell short companies which have exchange-traded options on their ordinary shares. The actual mechanics of short-selling through the option market will be explained in a later lesson.

There are two drawbacks to selling short. Firstly, most brokers won't do it for small investors. They regard it as too dangerous. The second drawback is that they're right When you buy a share — referred to as going "long" — the most you can lose is what you paid for the share. But when you sell short your potential losses are unlimited. Suppose the $1 share you "borrowed" in order to sell when it went down, instead rose to $10. You would have lost $9 on a $1 investment!

Selling short is often tainted with an air of unethical behaviour. In fact it serves a valuable role in the mechanism of the market. The presence of "shorts" in a market will provide buying power to prop up falling shares, which leads to more stability. It is not, however, a practice suited to the small investor — for the time being, at least, leave it to the professionals.

understanding more about how markets always move in cycles: The Elliott Wave Theory

There is no one theory that adequately explains and predicts the sharemarket. If there was, everyone would follow it and the theory would self-destruct.

Even so some theories, in the hands of skilled interpreters, have proved useful in explaining market movements and occasionally in predicting future events.

One theory that many investors believe may have some validity over time is the Elliott Wave Theory, named after the Californian accountant, R.N. Elliott, who developed his ideas in the 1930s. Elliott still has many followers today.

Remembering that no theory should be taken as gospel — let's look at the Elliott Wave Theory and what it claims to represent. Understanding its simple principles will bring home to you the importance of an awareness of market cycles.
You will be able to stand aside from the naive investor who believes that bull markets go on for ever. Equally, you will realise that bad times always end. In fact, they provide the best opportunity to prepare for successful investing in the bull market that is sure to follow.

Mark Twain observed that October was a particularly dangerous month to speculate in stocks. "The others", he said, "are July, January, September, April, November, May, March, June, December, August and February.

The main Elliott waves. In previous lessons you learnt about the three basic trends identified by Dow Theorists: primary, secondary and tertiary trends. Dow noted further that bull markets appear to have three major upward moves. The first is a rebound from the pessimism of the previous bear market, the second relates to the improving economic picture and the third is created by excessive optimism.

Elliott extended Dow's analysis with a complicated set of principles based on his belief that market action follows a natural rhythm based on human psychology

Elliott described eight waves in a typical business cycle. One of the three upward waves is longer than the other two, and the two shorter waves are approximately equal in size. The second corrective wave will end at or above of Wave. Further, he stated that no two consecutive waves in the same direction will show the same characteristics.

As with all such theories, real –life interpretation is somewhat subjective. When the theory fails, analysts say their interpretation was incorrect. So Elliott's theory is not much use as a trading tool, although it does provide a guide to the longer-term fluctuations of the business cycle.

You might also like to compare charts of individual shares with Elliott's theory. It may be of little use to you in predicting short-term movements, though it will serve to remind you of the inevitability of the wave movements.

Understanding more about how markets always move in cycles: The Elliott Wave Theory

understanding more about how markets always move in cycles: The Elliott Wave Theory

Being aware of the Dow Theory, Elliott Wave Theory and other cyclical indicators is useful only in that it gives you a continuing consciousness of how all markets always move in cycles. All bull markets are laying the foundations of a bear market to follow and vice versa. Remembering this is a key investing skill – one that will enable you to put in perspective the extremes of sentiment that frequently carry markets to excesses.

Elliott believed that social psychology mattered – the prevailing mood of the times – rather than specific news.

Could an old Russian be right – or are super-cycles super-nonsense?

The Kondratieff Long Wave is named after a Russian, Nikolai Kondratieff. He was a professor at the Business Research Institute in Moscow after the Russian Revolution.

Between 1922 and 1928 he developed his now-famous "Long Wave" theory. In essence, it claims that a series of 50-year cycles govern all economic activity. The cycles are related to the bunching of major innovations.

Kondratieff still has many followers today. He postulated that each 50-year cycle consists of three phases:

- Twenty years of growth and prosperity ending in severe inflation.
- Ten years of stand-off between inflation and deflation with share values rising strongly.
- Twenty years of general deflation accompanied by economic downturns and growing political and social tension.

According to Kondratieff's followers, we are now heading into the deflationary stage of the cycle. To his followers this predicts rough times ahead.

Could Kondratieff be right? Interesting as his long wave appears, in all probability it indicates nothing in particular. Much has changed in the fifty years since Kondratieff's time, and the very length of the cycles makes the theory of little use in day-to-day investing.

Modern mathematical research also shows that numbers taken at random will often result in similarly apparently convincing patterns. They may, in fact, simply be an optical illusion.

Looking at charts is fun – and the patterns and cycles that appear are often extremely convincing. However there may well be other purely mathematical forces at work that have nothing to do with economic or sharemarket reality. Don't get hooked on any one theory – remember, successful investing is a pragmatic, real world business. The real world is always more predictable and full of surprises than the gurus would have you believe.

why you should never be persuaded to buy a share purely on the basis of technical analysis

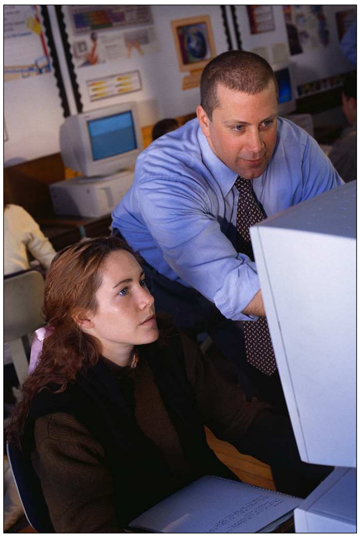
Many wealthy investors have built their fortunes by using fundamental analysis to spot enticing value opportunities. Few, if any, have made a pile by simply chart watching. Many of the best-known chartists make a living by selling their services — either through newsletters or to brokers — and not by investing on their own account.

Many newsletters and "gurus" hawk their technically-based wares on the basis of often-convincing claims of past successes. Often these brilliant predictions based on the past don't pay off because of the random element in share price fluctuations.

Despite this, brokers frequently urge you to buy because "the chart looks good". Remember — this alone is never a reason to buy. Charts may offer confirmation of decisions reached by other means, and that's how astute investors use technical analysis.

As you'll soon see, one of the best, consistently successful ways to build wealth is by "value" investing — the search for shares whose value has not yet been recognised by the market. You will not be interested in the complicated "buy" and "sell" signals generated by technical analysis. Rather, you'll stick to the simple aim of waiting for the share to approach its true value.

Don't make the same mistake as many new investors who become hooked on a favourite theory complete with expensive looking charts and other nostrums. Rely instead on a sound basic knowledge of all aspects of today's financial marketplaces — and act on reality and not some "theory that explains everything".



Learning lessons from successful investors

Investment gurus write paperback books that tell you sure-fire ways to make a million — usually by cashing in on some cataclysmic event that's going to change the world.

Invariably, it turns out they make most of their money writing books — not practising what they preach. Anyone unwise enough to stake their own fortune on such advice ends up disappointed. Investment geniuses, on the other hand, by and large don't spend much time writing books or speaking publicly. They are too busy making money for themselves and their shareholders — year after year

Careful study of the methods of these truly great investors — and finding the one which best fits your own needs — may give you profitable ideas to help you reach your own goals.

why you should never be persuaded to buy a share purely on the basis of technical analysis

How "reversion to the mean" suggests poorly-performing shares do better than excellent ones

"Reversion to the mean" simply means that over time all things have a tendency to revert to the average. If tall people married other tall people, logically we'd have people as tall as houses by now. In fact, what happens is that, overall, tall people tend to produce children who are a bit taller. So, in actual fact, we all end up within a certain range of height.

Research shows that the same may be true of shares. Studies by Vern Atrill and Ross Healy demonstrate that the key financial ratios of companies tend, over time, to revert – like tall or small people's children – to the average level. Similarly, for a variety of reasons, many good companies often tend to become better ones. Poorly-performing companies tend to be taken over. High-flying "excellent" companies often may have nowhere to go but down.

So it often may make sense to avoid a superior company whose shares will be fully-priced, and which may have reached the limit of its market or technical potential. Instead, it may be better to buy into a solvent but depressed share that investors are shunning because it appears to have hit rock bottom.

Over time, you may do better buying shares in companies that appear to be in the doldrums, compared to those being touted as models of excellence. Of course there will be exceptions. Studies show that reversion to the mean is a real phenomenon in share performance as in other facets of life.

So now you're going to look at a number of approaches to investing as practised by great investors of the past and present day. Finding the one which may work for you will, as always, be a highly personal matter. None are "get rich quick" approaches. All require discipline and single-minded application. Each approach contains valuable and timeless lessons on how to make money which are just as applicable today and tomorrow as they were in the past.

definition of strategies

Defining a successful investment strategy is not just a question of choosing your words carefully. Success is measured by how closely your strategy meets your chosen objectives.

For you, success may mean the accumulation of large and unspecified capital gains on shares — or you may be only concerned with generating an income that keeps up with inflation.

Or you might choose to mix investment with pleasure by buying holiday homes or antiques and works of art. This is a perfectly valid objective, but it's important to analyse the alternatives clearly. For instance, if you're planning to put $200,000 into a holiday home, consider the alternative option of investing the same sum in a diversified portfolio of shares.

The regular income you'll get may be used to purchase a much wider range of holiday options. Also you won't have the burden of actual property ownership. The ultimate decision is of course a personal one — but the point to stress is that careful definition of investment objectives and strategies is a vital first step.

personal factors influencing your investment aims and methods

Personal factors may be divided into two categories:

- Those which determine your overall objectives
- Those which influence the means or route by which you will carry out your strategy

Your overall objectives will depend on:

- The income and capital needs of your family.
- Your age — how close you are to retirement
- Your likely need for access to cash in the future to meet specified requirements such as school fees or wedding expenses
- The overall size of your portfolio
- Your level of borrowing
- Other financial priorities

The approach you choose to adopt will vary according to your own preferences and the trade-off between risk and reward.

Here are some specific examples:

- You may be a gambler and decide to invest all your funds in BHP shares if you're convinced they would make more money for you than any-thing else.
- You may be a risk-averse investor unlikely to invest more than 10 per cent of your assets in BHP even if you are confident of the potential gain to be realised.
- You may be a prudent investor with definite ethical beliefs who probably wouldn't invest in a company selling tobacco whatever the potential profit.

This is investment strategy at the personal level — it's inextricably bound up with personal preferences and views, and you have to consider these to set the initial bounds to your overall policy.

the basic alternative routes

Financial planning makes use of any one, or indeed any combination, of the following basic investment routes:

- Capital gains from trading
- Capital gains from longer-term investment
- Income growth to meet identified needs while keeping pace with inflation
- A combination of capital and income growth
- Mixed investment – pleasure with profit.

Start the development of your o successful personal investment plan by analysing your own needs and abilities carefully. Then select whichever route seems to be the most appropriate.

This lesson concentrates mainly on the successful strategies of investors active in making sharemarket investments and seeking capital gain. One approach to capital gain is trading. This uses technical analysis and is really a short-term activity.

Why "bottom-up" value investing consistently outperforms the conventional brokers' "top-down" approach

You've now reviewed the various approaches to investing and the basics of the market. And you've used simple basic accounting skills to reappraise your own financial position.

Later you will be trying two branches of investing knowledge together – and adding a third ingredient. That "ingredient" is the concept of value investing. Broadly speaking, investment analysis comes in two types.

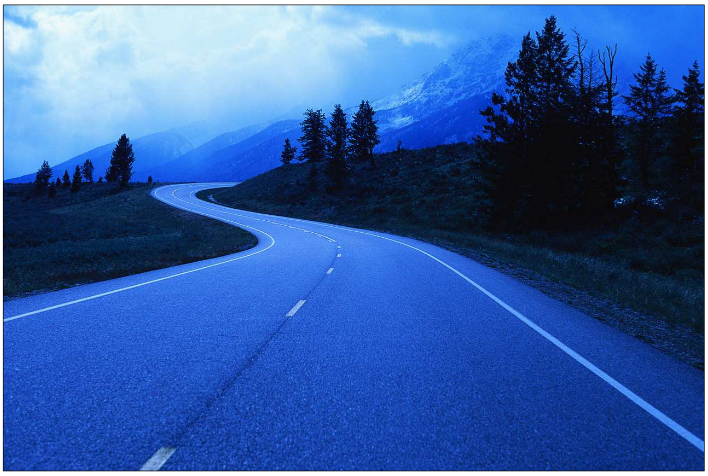
- **The so called "top-down" approach**. You'll find a good example of this in the lavishly-produced reports churned out by big stockbrokers. The analyst starts at the top by looking at the economy in general. He determines which sectors should benefit from current trends, then moves down to a specific industry and company. All of this is accompanied by impressive-looking charts and a mass of statistical data. Top-down looks logical and impressive and – needless to say – costs a lot of money to produce. In fact it works much less well than:
- **The "bottom-up" approach.** You start and end with the search for individual securities that the market has failed to put a true valuation on. You then simply lean back and patiently wait. This is the essence of the powerful money-making concept behind value investing. Find shares that are "cheap" and sooner or later the market will recognise its error and you will be rewarded by a rise in price.

You need only learn how to compare a few simple ratios to make your own assessment of which shares are likeliest to provide good "value" – and hence the best chances of appreciation over time.

Thus, armed with only the most basic knowledge of accounting, you'll be able to make your own decisions free of the emotion and herd instinct that drives much of the market.

This standing aloof from the crowd is probably the single most important non-technical investing skill. Combined with a sound knowledge of the pitfalls of conventional investing and the basic principals of the value approach, it is the true route to successful investing.

the basic alternative routes



Another approach is "value" or growth investing, which emphasises the importance of fundamental analysis. Another strategy you might adopt is vesting for income growth. Finally, there is the mixed strategy of combining the business of making money with pleasure.

Gains for shorter-term trading. You may be a financial trader in a number of different markets — shares, commodities, currencies, for example. To be successful, you need to be emotionally in tune with your activities. Trading requires a quick mind able to take rapid decisions, as well as the tenacity to continue trading in difficult periods.

"Real-time" information technology gives traders instant access to every market move, it favours the professionals who are on the job night and day.

There's been a dramatic expansion in the financial markets suited to traders. Active options and futures markets now operate in North America, Europe and the Far East. This expansion in equity options markets has had an immediate impact on conventional sharemarkets. Many institutional investors now use options to hedge their positions in the larger shares. So movements in option prices feed back to the underlying share prices.

Objectives for longer-term investment growth. If you want long-term growth, you'll aim to generate capital gains which outpace inflation. The timescale depends on your own personal needs and experience, but it's always measured in years rather than weeks or months. Short-term gains and losses may well occur over weeks or even days, but don't let short-term movements affect your overall long-term aim.

Property investment. Property has been a popular form of long-term investment in Australia.

Population and real income changes underlie trends in property prices. You may be able to take advantage of opportunities created by the legal or tax system, but on the whole this is a long-term investment, often requiring practical knowledge or specialist assistance.

Gearing, or borrowing to buy property, may dramatically boost your returns in both nominal and real terms during favourable periods. The inverse of this — when high interest rates and falling property values coincide — was vividly illustrated in Australia in the early 1990s. Many unfortunate homeowners became caught in a negative equity trap when they found themselves unable to service their loans. They could not even free themselves of their debts by selling, since the market value of their homes was worth less than their outstanding mortgage.

Income growth. If your objective is to generate income from your investment portfolio, you'll need to be sure above all that the production of income will at least maintain its purchasing power against the rate of inflation and relevant cost of living indexes, if you're retired, this is one of the most important yardsticks by which to judge the success of your investment strategy.

How to find information on specific companies and their share performance

As you learned in Lesson 2, daily newspaper financial pages provide basic information on daily price movements, highs and lows for the year, yield and P/E ratios. Once you've narrowed your choices down to a handful of shares, you may want to explore ways to investigate them in more depth. The major source of historical information is the Stock Exchange Research Service. This gives a condensed version of the annual report and accounts of a company over the past five years, including historical share prices, plus a brief rundown of the company's history. The Stock Exchange also has a library which is open to the public and has a file on each listed company.

The company review service is available at major public and university libraries which may also have a range of other independent reference materials on specific companies. You can obtain a company's latest annual report by phoning the company and asking them to send you one.

To get further information on these services contact the Stock Exchange in your State.

Computer Investor Services Pty Ltd publishes monthly a 200-page chartbook giving charts on Australia's major companies, indices, commodities and currency relationships. The charts cover either a five-year period, using weekly high, low and last price data, or a one-year period using daily high, low and last price data. Charts are rescaled for share splits, rights issues and bonus issues. This chart book is available through the Stock Exchange Bookshop.

Income and capital growth. If you need to generate a regular income that maintains its real value, possibly to cover living expenses in retirement, while also protecting capital values, you will need to use strategies that combine elements of capital growth and income generation.

Mixed strategies. In general, mixed strategies will tend to be peripheral and secondary to the main aims of personal investment planning. In other words, you'll only invest in holiday homes and valuable antiques once your basic financial independence has been secured, and your risk profile adjusted accordingly.

This is partly because the income from such investments is often low or sometimes negative — as with antiques and works of art, which have to be insured — and partly because they are less liquid than sharemarket investments

strategy limits and objectives

Limiting your risks. Risk limitation is a basic key to successful investment. Generally, the fewer financial assets you have, the lower your absolute and relative exposure to risk can afford to be. Similarly, as you near retirement, you'll tend to favour the more secure investment options

Most successful investment systems and strategies have been based on limiting capital losses. This ma have been achieved by spreading risk or by placing individual limits on each trading position, or by combining both methods,

Risk limitation tactics. You can minimise risk by spreading the range of your investments among a number of different types of asset. The ideal overall portfolio, for instance, may contain a mix of property, cash, fixed interest, shares and a variety of other investments such as works of art and antiques.

Another way to spread your risks is by investing carefully in a range of geographical areas. This will limit political or economic risk. You may also tailor your portfolio to limit currency risk, which you run if all your investments are held in one currency alone.

When selecting individual shares, aim to spread your investment in any given sector among a number of holdings. Also, spread your investments across different sectors, e.g. hold some bank, building and mining shares. Extensive research indicates you'll need a portfolio of at least ten good-quality shares to reduce risk significantly.

Another way of reducing risk, particularly for smaller portfolios, is by using collective investment funds such as unit trusts and listed investment companies.

It is essential to develop a strategy which suits your own investment aims and objectives.

Using stop-losses and hedging. An often-used way you may reduce risk is by using a "stop-loss". This is simply an order to your broker to sell if the share falls below a certain point. Stop-losses may be dangerous. Remember, share prices fluctuate. Your shares could dip momentarily below your stop-loss, you could be sold out — and then see the share price soar.

You may feel that in practice this close monitoring of each investment would simply take up too much time. In fact, the application of the stop-loss principle is a valuable tool in controlling the size of your potential losses — so at least consider it if you are an active trader. Another alternative to consider is risk reduction through insurance or by the "purchase of safety". You achieve this by using traded options and by investing in index futures for more general market movements. Such insurance is not cheap, but may be worthwhile if you want to be sure of maintaining the value of your assets.

strategy limits and objectives

Asset allocation and timing. The main reason for allocating investment funds between a number of different types of asset is to maximise returns. It is in a way the mirror image of the risk-reducing strategy.

You may allocate your assets in two main ways:

- Between different sectors and geographical areas

- Over different time periods.

In each case, your objective is to reduce risk by adjusting your exposure in any given market according to circumstances. Timing is the essence of successful investment. In farming, it is said that the difference between a successful farmer and a failure is two weeks. In share trading, the difference is more usually measured in hours, and sometimes in minutes, with regard to the timing of individual share purchases and sales.

successful strategies for long-term capital growth

Successful property investment. Real property is different from most other investments — particularly the sharemarket in that each property site is by definition unique.

In the case of real estate, this uniqueness relates above all to geographical location. This in turn is often influenced by a number of political, social and personal factors as well. For example, government controls on rural development may ensure the continued value of fine country houses. Road schemes and other public works activities may, conversely, drastically reduce the value of properties in these areas.

Even if you think property investment is too long-term or too specialised for you, you may still learn some worthwhile lessons from property investors who have succeeded in earning personal fortunes.

Top down investing

A successful international investment strategist is the American Jim Rogers. His distinguishing feature is that he bets on whole countries. He seeks to pin-point countries which are more promising financially than is generally believed. Then he moves in before other investors recognise the opportunities that are available. And when eventually they do, that is the time to get out with a handsome profit.

In the mid 1980s Rogers made his name with a number of inspired gambles. In Portugal, the far Left had taken over in 1974, capital had fled abroad and businesses collapsed. Hardly a promising market, but Rogers watched the situation closely. A decade later, an anti-Communist regime took over and he sensed that a recovery was at hand. In 1985, he bought all 24 available shares on the Lisbon exchange and all new issues thereafter. His timing was perfect, and he came away with a magnificent reward for his intuition.

At the same time, he perceived that a recovery was at hand for the stagnant Austrian economy. Like so many successful investors, Rogers is insistent on doing his own homework – he often finds that the available information is inadequate. This is a key element in his success.

The main elements of a successful property investment strategy:

Before making an investment decision, gather the maximum amount of information possible through careful research of the chosen market — either directly through personal investigation or with the aid of professional advisers.

Use gearing to boost investment returns — but remember, it also dramatically increases losses if results turn sour.

Only become involved in direct property investment if you feel you are temperamentally suited to long-term decision making.

Don’t agonise over past mistakes. Instead, be prepared to learn from them.

value investing strategies for long-term capital growth

"Value" investing through fundamental analysis was pioneered by the American Benjamin Graham. His brainchild, the Benjamin Graham Joint Account, was virtually wiped out by the Wall Street Crash. Then he re-entered the market too soon afterwards. This experience made him ultra-cautious.

Caution underpins all his publications, including Security Analysis — an academic textbook, co-written with Professor David Dodd in 1934. His other major work is The Intelligent Investor, a more popular book, which has been described as "the best book ever written for the stockholder".

Cutting your losses is just as important as taking your profits.

Graham worked out a quantitative method by which investors could select shares based on their "intrinsic" or underlying value. This involved familiarity with company accounts and reports, as well as any more personal experience that could be gleaned. The success of Graham's disciplined approach was copied to some degree by so many investors that by the early 1970s value investing had become commonplace.

Graham's buying and selling rules

Graham rules may be simplified to focus on two points.

- The purchase of shares trading below the value of their net current assets after deduction of plant and all fixed assets and liabilities.
- Buying groups of shares at less than their intrinsic value as determined by earnings, dividends or book values.

Fundamental to Graham's investment strategy was his distinction between investors and speculators.

- Investment must be based on "thorough analysis" and the promise of a safe return.
- The sharemarket speculator who takes risks without proper analysis provides opportunities for the investor.
- Not all shares can be analysed. Anyone buying into a company which can't be analysed is a speculator rather than an investor.

Graham favoured large investments in companies where a close personal interest was possible — either in management or as part of a holding group. This sort of approach means that you must have an intimate knowledge of the business.

Generally Graham favoured diversification among different issues to spread the risk. Graham himself recognised theories are not perpetually successful — they need to be revised in the light of ongoing events and, not least, because of their widespread duplication.

In 1976, shortly before his death, Graham recognised that his elaborate analytical techniques could not compete in a technological financial world. His answer was to simplify his methods.

The groundwork for value investing laid by Benjamin Graham has since been amended and elaborated by such well-known contemporary investors as Warren Buffet and Sir John Templeton. Take a look at their strategies in more detail.

Warren Buffet's business valuation methods

Warren Buffet, a Graham disciple, is regarded by many as one of the most consistently successful professional American investors since the Second World War. In essence, his approach to share investing is that he regards himself as buying part of a carefully chosen business. Buffet divides businesses conveniently into a few wonderful ones and a large number of poor operators. His view is that government bonds are often a much better investment than mediocre shares. Occasionally a good business may be bought cheaply, providing total returns well worth waiting for. Buffet equates a share with a fractional interest in business. His interest in it begins with the fundamental question, "How much would I pay for all of this company? And on that basis, what will I pay for one per cent of it?".

Buffet's successful investment strategy includes both sensible advice regarding investor method, and technical tips for profitable share selection.

The key features of Buffet's method are:

- It's always worth waiting patiently for the right investment at the right price — however long that may be.
- Action is no guarantee of good results — it's better to pick a few good shares and stick with them.
- By exercising a degree of "controlled greed" and taking time to look at the whole investment process, you may absorb yourself adequately in the investment scene.
- Independent thought is vital, as is the capacity to justify decisions logically to yourself.
- Detailed knowledge, carefully gathered, will enable you to develop the self-confidence and security necessary to overcome commonly held opinions and prejudices. Only with the necessary homework completed will you be able to develop this certainty and decisiveness.
- Get to know and like chosen investments in the same way that you would get to know your house before purchase — an investment is a share in a business.

Warren Buffet's business valuation methods

Buffet's guidelines for buying a good business include the following:

- High return on invested capital.
- Profits created in cash.
- High stock turnover and a high return on plant and inventories.
- Predictable earnings.
- The management must think like the owners.
- The company must have a strong business franchise enabling them to pass costs on to the customers.
- Ideally, the business should be in an industry where there are only a few large companies. In Australia, such industries include the media, banking, retailing and brewing.
- Good businesses have clearly definable characteristics – for this reason rapidly changing industries such as high technology and conglomerates are not chosen by Buffet.
- The business must not be subject to such difficult management problems that choosing managers is likely to be difficult.

Among the more important criteria used by Buffet to select individual shares are the following:

- High basic return on capital employed excluding any benefit from accounting gimmicks as well as a high return on stock and plant.
- The underlying business operation must be comprehensive.
- Profits earned must be in cash.
- The business must possess a strong "franchise" – that is, an ability to price their products freely. They should not be subject to undue government regulation or intense competition.
- The growth of the company must not rely on the abilities of a single "genius" – but rather a complementary team.
- The future earnings stream must be relatively easy to predict.
- Relatively high stock turnover ratios are preferred.
- Management must be owner (ie shareholder) oriented rather than concerned with their own welfare.
- Buffet particularly favours companies benefiting from a "royalty" form of income, or commission earnings based on the growth of others.

How to spot a failing business

Buffet believes bad businesses are far more plentiful than good ones Generally the characteristics to look out for are the opposite of those found in a good business:

- The organisation makes its money in accounting profits rather than cash, or else it needs a diet of more and more funding as sales grow – a "chain letter" business. Choking off the cash flow will lead to failure.
- The management is dishonest or seeks to use their positions for personal advantage. Buffet chastises managers who expand through overpriced acquisitions, ignoring the interests of long-standing shareholders.
- The company relies too heavily on one large contract.
- It is heavily burdened with debt.
- It exposes itself to the vagaries of inflation – especially if its success depends on providing a service or commodity some distance in the future.
- Buffet has an aversion to farm businesses. They are totally reliant on crops which might fail and are vulnerable to price rises in vital products, such as oil and fertiliser.
- Buffet generally regards retailing companies, life assurance and reinsurance as too risky.
- Gas and electricity companies are normally a bad bet for long term investment because of stringent government regulations.

growth investing strategies for capital appreciation

Yet another successful American professional investor was T. Rowe Price. Indeed, he even lent his name to a complete theory of investment – the term "T. Rowe Price approach" is one instantly understood in financial markets.

He founded the firm T. Rowe Price Associates Inc. of Baltimore and achieved remarkably consistent results from his growth funds by selecting companies with exceptionally good growth potential and holding on to them, often for many years.

The T. Rowe Price approach demands that you seek fertile fields of growth and then hold the shares for a long period. This method requires less active participation than that of a trader.

The growth investment strategy of T Rowe Price. Rowe Price believed in a firm set of rules for buying and selling shares. This plan of action involved fixing the initial valuation (pricing) and then setting a scale for his buying and selling program. He based his valuations on price-earnings multiples. They were determined by the following:

> Record of earnings growth – Rowe Price was cautious about projecting rapid growth too far into the future.
>
> He preferred buying when growth shares were out of fashion.
>
> Blue-chip shares with good dividend payment records were reckoned worth a higher multiple than second-line shares.
>
> Stable shares were thought to be worth higher multiples than cyclical shares, except when the latter were in a recession.

The P/E multiple had to be lower when bond yields were high – the total return from growth shares has to compete with that from the general market in bonds and shares. It seems that Rowe Price set a target buying level about one- third above the lowest P/E reached by chosen shares during any given market cycle.

Buying and selling was carried out to strict rules:

- Buying started as soon as a share reached its target price and generally averaged the target level.
- Selling was initiated when a company's growth rate started to decline, triggered by a reduction in the return on invested capital or other signal of major change in growth trend.

The actual sale of shares started with a 10 per cent reduction when the price rose at least 30 per cent over its upper buying limit and continued with further 10 per cent sales for every 10 per cent rise in price.

These days' professional investors seek undervalued companies in all parts of the world.

How individual research will give you a winning edge

This is vital to provide the extra edge of knowledge over the "herd". It may take the form of studying certain countries or certain industries, or building on personal knowledge of specific companies.

It may involve personal observation of branches of retail chains, banks or builders' merchants or the examination of products from well-known manufacturers.

Whatever form it takes, never underplay the role of individual research. It may be the only way you can make informed judgements based on information superior to that available to larger institutional investors.

Although Rowe Price's funds performed well during the US sharemarket boom in the 1960s and early 1970s, they fell dramatically in value in the 1974 crash when "growth investments" went out of fashion.

T. Rowe Price's strategy for pursuing growth investments diverges significantly from the value investment approaches of Graham, Buffet and Templeton. Rowe Price didn't believe in valuation models which attempted to predict future company earnings and future dividends. He preferred to keep his investments in the best companies in growth industries until they began to decline.

Rowe Price's investing guidelines

Rowe Price's guidelines for selecting company stock included the follow:

- Superior research facilities and personnel, enabling companies to develop products and markets.
- HJ quality achieved by low labour costs but well paid employees, ie. high productivity
- High profit margins, a high return on capital employed and above average growth of earnings per share. Rowe Price looked for at least 10 per cent return on invested credit.

Provided that the purchase and sell indicators proved reliable, this method of investing was popular with higher rate taxpayers. Because turnover of shares and hence realised gains tended to be low, they did not have to face huge capital gains tax bills. Similarly, transaction and brokerage costs were also low.

Conventional portfolio investing – the Peter Lynch example

Peter Lynch has written two books on investment – *One Up on Wall Street* and *Beating the Street*. In these, he outlines some of the lessons he learned while managing one of the most successful and largest mutual funds in the US – the Fidelity Magellan Fund.

Lynch does not subscribe to the current widespread belief in the US that you cannot beat the sophistication and resources of the large funds managers. He cites nominal share portfolios run by high school children that have frequently beaten market indices and most professional fund managers. The key to their success – as also that of adult investment clubs – has been a determination to research and understand the basic activities of each company.

Like many other professional sharemarket investors, Lynch prefers downturns in the market as these provide buying opportunities. He maintains that successful investors have to be optimistic. There are frequent opportunities to take a contrarian view when the market is weak. On thirteen occasions this century the US sharemarket has fallen by at least one-third in value. Lynch reckons these are great opportunities for buying good stocks cheaply.

In Lynch's view, the key is to focus on the company and not the share price. He favours great companies in lousy industries and cites Crown Cork as an example of a frugal management successfully reducing costs in all areas except manufacturing systems. To the benefit of shareholders the company was able to reduce their expense ratio to less than a fifth of their competitors' ratios. Crown Cork also exemplified another Lynch maxim, namely, "All else being equal, invest in the company with the fewest colour photographs in the annual report".

the disciplined technical trading of W. D. Gann

W. D. Gann was reputed to have been one of the most successful Wall Street traders this century. He carefully amassed more than $50 million during his half century of activity in the markets. Although Gann's precise methods would not appeal to many people as they require prolonged and detailed attention to a large number of historical price records and charts, many of the rules that he developed are entirely relevant to most investors.

Do your homework

Gann's basic tenet of successful investing was the need to study the sharemarket continuously and in detail. In his view investors lose money mainly because they lack adequate knowledge of both markets and shares. Other major reasons for failure he ascribed to overtrading and the absence of stop loss orders to limit individual losses.

Gann believed firmly that active investors and traders must apply strict rules in order to deal profitably in shares. His basic analysis combined the study of movements in asset prices with the lapse of time. On this foundation he developed a complex series of procedures for analysing past price movements. He monitored prices and charts of leading bonds, shares, commodities and indexes and evolved a large number of specific trading rules as well as a smaller number of more general investment rules.

How to apply the strategic lessons of others

You've seen that successful investors have developed not only their own strategy but also their own techniques and tactics most suited to personal aptitudes and preferences. Certain fundamental guidelines may be drawn from the experience of these highly successful operators. These can be divided into two types:

- Personal factors, and
- Technical or resource aspects.

Gann's rules for trading include many well-known guidelines proven over the years. The more important are:

- Never risk more than 10 per cent of capital in any single trade.
- Always use stop-loss orders to protect profits and limit losses.
- Never trade against the overall trend.
- Never overtrade.
- If in doubt get out of the market and if uncertain initially don't get in.
- Never average a loss.

the disciplined technical trading of W. D. Gann

Most of Gann's guidelines are negative and are designed to stop you losing money. This reflects the point made by many successful investors — namely that preventing losses is the key to making money on portfolio investment. Remember the maxim "cut losses early, but let winners run". The positive side of Gann's investment system relates to the purchase and sale of shares and other investments on signals created by prices moving above or below specified points over given periods of time.

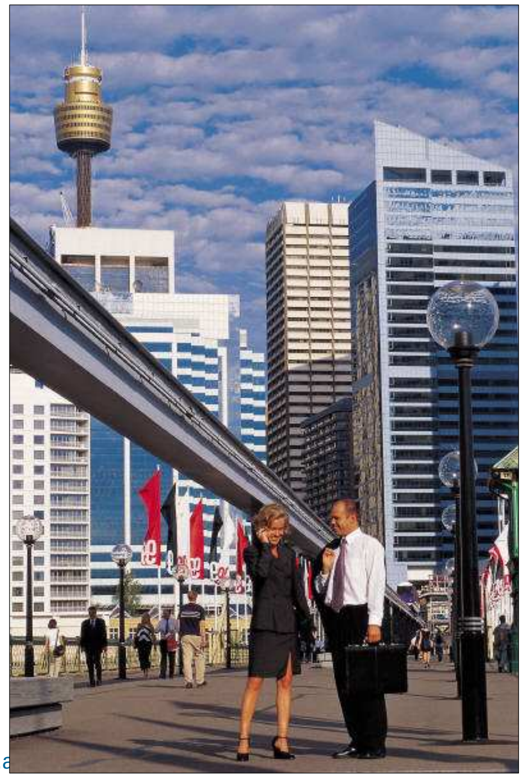
He maintained trading positions must be effected in accordance with and not against market trends. Trends for shares, sectors and whole markets were based on rigorous analysis of price movements over time and a large number of technical indicators and pointers. These indicators included three-day moving averages and nine-point swing charts for determining overall trends, as well as a number of more specific rules.

Using charts Gann refined the application of purchases at single, double or triple bottoms and sales against single, double or triple tops. Examples of these are given in another lesson on technical analysis.

Gann also advocated sales on 50 per cent retracements from highs and purchases on 50 per cent advances from lows, provided the movements were in line with the overall trend. Operating in the North American market he identified time periods as being important in determining changes in price trends. Gann listed a number of dates and annual periods when changes of trend often occurred.

At the time that he was operating, early and late January were considered to be significant periods for determining trend change, but 3-10 September and 21-28 September were the most important weeks of all. In fact, Gann mentions no less than 23 periods, each lasting three to ten days, as being important in determining changes in trends. Gann also observed the weakness of investors when it comes to making decisions and acted to overcome it. Many people get out of shares either too soon or too late.

In the first instance the failing is usually due to their impatience — after waiting a long time for a price move, the desire to take any gain is often strong — despite the probability that considerable further gains may be possible after a long period of price inactivity. Getting out too late is often the result of greed when investors continue to hope for earlier peaks to be reached despite a falling price pattern.



Speculative trading with George Soros

George Soros is undoubtedly one of the most successful investment traders in recent years. His major quoted fund has recorded compound annual growth of over 30 per cent for more than 20 years.

This outstanding performance has been due to a combination of correct trend spotting, timing and gearing his basic funds through borrowing. Large stakes have been taken in shares, bonds and, above all, currencies. Through the extensive use of long and short trading positions, Soros has been able to lever his equity base by as much as five times. When the investment decisions were right, this was remarkably profitable. But in 1987 and 1988 results were adversely affected.

This type of high profile investment trading requires a particular combination of skills, abilities and aptitudes which most of us do not possess and would be unwise to emulate. Yet some of Soros's tenets have a more general applicability.

Soros is adamant that all speculative traders must first define clearly their level of acceptable risk. Their initial trading positions should be modest and should subsequently be built up as trends are confirmed (or reversed if markets alter). One of his strengths has been the ability to cut losses, admit failure and quickly eliminate unsuccessful positions. As a "top-down" investor, Soros aims to catch, at an early stage, the change in investors' perceptions relating to future trends in shares, bonds, commodities and currencies.

Remember that Gann was a trader in shares — his interest was in profiting from a detailed study of market prices and accumulating capital profits from active trading. He emphasised chart analysis of price movements rather than fundamental economic research and he paid little attention to the long-term yield on investments. How relevant you find his strategy today depends on your own preferences and interests as an investor. You'll need to ask yourself how far the Gann approach is valid in modern sharemarkets where massive computerised program trades may move the largest international equity markets by five to 10 per cent in a day.

It is crucial to take profits and not to "fall in love" with shares.

personal factors affecting investment strategy

It's vital to understand these before you decide to pursue any particular investment strategy.

Personal factors influencing investment strategy fall into the "three As" — namely Attitude, Aptitude and Ability.

Attitude to investment is of paramount importance and will determine the amount of time you are willing to spend on the subject. If you have other interests which take up a lot of your time, take this into account when deciding which investment strategy to follow.

Aptitude for risk taking will similarly influence the type of strategy. Fast-moving trading strategies, for example, would be totally inappropriate if you're uncomfortable with high levels of risk.

Don't overlook your basic **abilities.** Remember most of the successful investors covered in this lesson started without the advantage of any initial professional training in investment. An ability to undertake detailed financial analysis certainly helps in understanding individual investments more fully and, if you've got this far, you probably have this capability.

Your aptitude for risk taking

Decide what level of risk exposure is acceptable. Don't contemplate any strategy which would make you feel uncomfortable in terms of potential losses. This is particularly relevant to trading strategies using margin calls but is also relevant to a lesser degree for all equity investment.

Be decisive.

It is not easy to buy shares, however cheap, when all the commentators are preaching doom and gloom – but if your detailed analysis indicates that some investments are exceedingly cheap, then to be successful you will need the nerve to carry out the logical implications and buy.

You will need the faculty to make quick decisions both in terms of purchases and sales. It is equally important to have the ability to sell at a loss and admit that a mistake has been made. You can't be infallible, but to be successful you need to be able to recognise errors or unforeseen changes that require rapid decisions. And then you must follow through and put them into effect.

your action checklist

You've seen how some select individuals have outmanoeuvred the herd through the development of their own investment techniques.

Use the ideas in this lesson to develop your own investment strategy.

From your reading of financial magazines and newspapers would you say that the current mood of the crowd of investors is basically optimistic or pessimistic? Does this give you some clues about your own investment strategy?

Before deciding which investment strategy might succeed for you, first consider the "three As" — your attitude, aptitude and ability.

Then look at your investment objectives relative to your own resources in terms of time, talent and finance.

Then examine the basic alternative routes available to you:

- Capital gains from longer term investment
- Capital gains from trading, income growth to meet identified needs and/or to keep pace with inflation
- A combination of capital and income growth
- Mixed investment objectives - pleasure with profit.

Give your methods time to work - do not make frequent changes to your methodology

Whatever methods you do decide to follow, remember - careful research is the key to success.

Exercise

Explain what is meant by the madness of the crowds

When a cab driver gives advice - get out … what does this mean?

List 3 names of papers you can read each day to gather news.

Exercise

You need to start a journal of news. Every day you read the papers:

- list 5 news articles for future possible investments
- list 5 bad news articles
- cross reference the articles with the share prices to learn about the personality of the stocks.

What is the PE ratio of a company mean?

When crowds panic some stocks skyrocket in price ... why?

Exercise

List 5 indicators of investing … like keeping an eye on the charts etc

1

2

3

4

5

Some people invest for growth and others invest for cash flow … explain the difference.

Exercise

Re-read page 22 and explain Warren Buffets strategies.

Who was W.D.Gann and what did he achieve.

FINAL REFLECTIONS

What have you learnt from this module and what has your idea of investment changed from reading this module before you started.

Why?