Successful Investment Principals for the Modern Market, Determined Through the Analysis of Expert Investors and the Expectations of the Common Investor

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Abstract

An extensive literature review was conducted reviewing the investment principles of three stock market experts and two current advisors, as well as adverse market conditions impacting today's investment world. Informal informational surveys were completed with five individuals of differing economic and investment backgrounds. The information from the literature review and the insights of the surveys were synthesized to determine nine common successful investment principles to provide market beating returns in today's market.

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Chapter I

Introduction

One of the most fascinating endeavors in the history of the United States has been investing in the stock market. Since it's inception in the early 1800's people have looked to the market as an opportunity to profit from investing in public companies. Not only has investing in the stock market been profitable, returning an average of just under 10% per year, it has also been challenging. While the market itself returned 10%, the actual return for its investors appears to vary infinitely. Many people have amassed vast fortunes through their investments, others have lost everything. Throughout this time there have been countless theories tossed about on how to improve one's chances of a positive return. In addition millions of dollars have been spent on professional advice and money management. Unfortunately, not even the professionals can provide guaranteed returns. As investing has become more accessible to the common man, many people commenced managing their own portfolios with the belief that no one cares about their money more than they do.

While this sentiment of responsibility may give an investor confidence that they are looking out for their own best interests, it also means they have no one to blame but themselves when things go wrong. Unfortunately, most investors who manage their own funds do not prepare or equip themselves with the right knowledge to undertake the task. As a result many people lose money, get frustrated, or end up turning their portfolio back over to a professional broker. While investing in the market may be fun and exciting, it is by no means easy.

Another factor that has complicated the efforts of the individual investor is that the market is growing increasingly complex. Although Warren Buffett once attested that he thought greater than 50% gains per year were presently possible in the market due to the increase in the availability of information, that added information has also made it more appealing and given profitable investing the appearance of being easy. As more and more people start trading and the market becomes more complex, the simplicity of valuing a company and profiting from it becomes much harder. Greater fluctuations exist than ever before, with every news item impacting value significantly. One must now attempt to manage the market reactions to analyst downgrades, forecast updates, economic indicators, and natural disasters, among many other news items that have immediate impact on a stock price. During these events psychology tends to have more of an impact than valuation, and prices reflect this. In addition the presence of day traders and hedge funds making massive purchases, causing extreme demand, and enhancing price swings has resulted in either a market that causes significant stress or one that alienates the common investor.

When one considers the price of a company's stock, its inherent use is to reflect the health and well being of the company. Except in the case of the dot com era (when stock value seemed extremely inflated with respect to company value) for the most part as a company does well the share price will go up, and vice-versa. Early stock investment required a fair evaluation of a company's ability to make money, and those that performed well received the attention of investors. Although financial statements were not as cheap and readily available as they are now, assessment of the company seemed much easier. Investing required a fair amount of education in order to understand a company's financial statement, but the result was usually a fair assessment and positive return.

Unfortunately, today there are so many other factors that impact price. Often the market moves in what appears to be irrational ways, making it even harder for the average investor to understand and make rational decisions. Without a plan and a thorough understanding of how a company's stock is valued, the common investor is at a disadvantage. Such a situation has been likened to playing tennis against a professional: once in a while you might get the ball over the net, but in the long run you're going to lose if you don't know what you're doing.

Whether an investor decides to manage their own portfolio or entrust it to a professional broker or fund manager, it is becoming increasingly necessary that they understand how to value stocks and what their investment goals should be. The problem then becomes how does one accomplish this with the way the market is today? Do stock prices really reflect the health and ability of a company or are there other factors that influence price? In the myriad of investment advisors, newsletters and e-mail tips, is there a way for investors to make sense of it all and achieve their goals? These are the problems this paper will address.

Research for this paper will focus on the success of previous investors, and how their approach can be integrated with the ever-changing present market to achieve similar success. Of all stock market investors, there are perhaps three that have achieved notoriety above all others: Benjamin Graham, Warren Buffett, and Peter Lynch. Graham is considered the father of modern security analysis. His methods of valuing a company and subsequently its stock are considered the foremost authority, and his book, Security Analysis, has been considered the Bible of Wall Street since it was first published in 1934. Buffett, currently the second wealthiest man in the world, has achieved greater returns than any other in the history of stock market investing. Finally, Peter Lynch managed Fidelity's top mutual fund for over 20 years and provided average returns of 20%, nearly doubling the market average over the same period of time. A profile of these men will provide an understanding of their skills and techniques, as well as give insight into their success.

Two of the more recent investment advisors, The Motley Fool and James Cramer, will be profiled as well to provide insight into modern thought in today's market. The Motley Fool's top investment newsletter, the Motley Fool Stock Advisor, has provided an average return of 57.9% since it's inception in April of 2002, versus the S & P 500's 16.4%. James Cramer is an American television journalist and former hedge fund manager. He is currently the host of Mad Money which airs nightly on CNBC, co-founder and director of TheStreet.com and host of the radio show Real Money with Jim Cramer. His popularity continues to grow with 384,000 nightly viewers of his Mad Money TV show as noted in the October 21st issue of Newsweek. Cramer will be profiled not for his performance or his ability, but as an example of the impact he has on the market and the changing sentiment of today's investor. Finally, we will look at the impact day trading has had on market performance and what attention, if any, must be given to it.

At the conclusion of the research analysis we will discuss the responses of some local, high net worth investors, with regard to their investing goals and their thoughts on investing in the market. Each investor was given a short questionnaire to determine their goals and expectations from investing as well as their previous investment experience. The paper will then discuss the implications of the research data on the goals and expectations of the local investors. From all the data that is collected, we expect to be able to provide sound investment principles that will meet the needs of today's investors in today's market.

Chapter II

Review of Literature

Benjamin Graham

Benjamin Graham, often called the father of value investing, was an influential economist and is perhaps best known today from frequent references made to him by Warren Buffett, who studied Finance under Graham at Columbia University from 1950-51. Warren Buffett credits Graham as grounding him with a sound intellectual investment framework, and described him as the second most influential person in his life after his own father. Graham's book, Security Analysis, was published in 1934 and has been considered a bible for serious investors since it was written. It and The Intelligent Investor published in 1949 (4th edition, 1976), are his two most widely acclaimed books. Warren Buffett describes The Intelligent Investor as the best investment book ever written.

One of Graham's fundamental principals was that investors first draw a distinction between investment and speculation. He defined a sound investment as one which, after a thorough analysis of the facts, promises safety of principal and a satisfactory return. Anything else he considered speculation.

Graham wrote that an investment is most intelligent when it is most business-like, a statement which Warren Buffett regarded as the most important words about investment ever written. Graham said that the stock investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right. Graham's favorite allegory was that of Mr. Market, a very obliging fellow who turns up every day at the stock holder's door offering to buy or sell his shares at a different price. Often, the price quoted by Mr. Market seems plausible, but often it is ridiculous. The investor is free to either agree with his quoted price and trade with him, or to ignore him completely. Mr. Market doesn't mind this, and will be back the following day to quote another price. The point is that the investor should not regard the whims of Mr. Market as determining the value of the shares that the investor owns. He should profit from market folly rather than participate in it. If Mr. Market's price is unreasonably high, then wise investors have the opportunity to sell. On the other hand, if it is unreasonably low, then they have the opportunity to buy. The investor is best off concentrating on the real life performance of his companies and receiving dividends, rather than be too concerned with Mr. Market's often irrational behavior. This represents Graham's principal of buying low and selling high, and determining valuation based on intelligent security analysis, rather than succumbing to the whims of Mr. Market.

In terms of retained earnings, Graham was an advocate of dividend payments to shareholders rather than businesses keeping all of their profits (Security Analysis, Graham and Dodd, 1962). He also criticized those who advised that some types of stocks were a good buy at any price, because of the prospect of sustained stock price growth, without a good analysis of the business's actual financial condition. These observations remain extremely relevant today.

Finally, when considering an investment, Graham outlined four basic principals in Security Analysis (Graham and Dodd, 1962):

1. Know the business

The investor needs to become knowledgeable about the business or businesses carried on by the company in which they plan on investing. This means a thorough understanding of what it sells, how it operates, what is the competitive environment, what are the threats and opportunities, and what are the strengths and weaknesses. An investor who buys a fruit shop, or a shoe factory, without investigating these things and knowing them, would be foolish. The same applies to buying stocks. An investor who does not understand the business should not be investing in it.

2. *Know who runs the business*

An investor who cannot operate a business for himself or herself needs a manager. This is the position of the average stockholder, who owns a share of an enterprise that is run by others. The owner of a business in this position would want a manager who will manage the business competently, efficiently and honestly. Thus, the stockholder should not be satisfied with any less. Unless the investor believes, through sound research, that the company is managed efficiently, competently and honestly, in the best interests of the shareholders, they should not invest in the company.

3. *Invest for profits*

An investor would not normally buy a business that did not, after proper research, appear to have reasonable expectations of producing strong profits over time. Stockholders should take the same approach and buy, as Graham says, "not on optimism, but on arithmetic".

4. *Have confidence*

Graham encourages investors to properly research their investments and, if they believe their investment judgment to be sound, to act on it. He cautions investors in this position against listening to others. The important thing is that a successful and careful investor makes her or his own decision, based on their own ideas of the worth of the investment.

At this point, after these four principles, Benjamin Graham says that investment policy can be reduced to three simple words: "Margin of Safety". Margin of safety is the price at which a share investment can be bought with minimal downside risk. Graham would not make an investment unless he could do so with some margin of safety, usually between 10 and 25%.

An investor may calculate the intrinsic value of a share by differing methods and will eventually come up with a price that he or she believes represents good buying value. Graham acknowledges, however, that calculations may be wrong, or that external events may take place to affect the value of the share. These cannot be predicted. For these reasons, the investor must have a margin of safety, an inbuilt factor that allows for these possibilities.

It is clear why Benjamin Graham is considered the father of value investing. His principles simplify security analysis in a way that would make investors comfortable with their decisions. Traces of Benjamin Graham's ideas are found in nearly every successful investor, and one would be remiss to overlook his philosophy.

Warren Buffett

Warren Buffett was born in Omaha, Nebraska on August 30, 1930. His father, Howard Buffett, was a stockbroker and member of US Congress. He attended the University of Nebraska (transferring there from the Wharton School at the University of Pennsylvania) and took a Master's degree in economics at Columbia University Business School from 1950-51, studying under Benjamin Graham.

He went on to work for Graham at Graham-Newman where he followed Graham's value investing rules. He returned to Omaha in 1956 with no plan in mind, until someone asked Buffett to manage investments for him. This was Buffett's first investment partnership, putting in his own money together with money from friends and family.

By 1969, he had returned an average of almost 30% a year, in a market where 7% to 11% is the norm and anything more is outstanding. Later, he dissolved all partnerships and went on to acquire a textile firm, Berkshire Hathaway (Wikipedia.com, n.d.).

By 1970 Buffett owned 29% of the stock outstanding in Berkshire Hathaway, worth approximately $25 million dollars. At that time he named himself chairman and began writing the annual letter to shareholders. Berkshire Hathaway at that time made $45,000 from textile operations, and $4.7 million in insurance, banking, and investments.

Buffett's investment principles have been researched and scrutinized in over a dozen books, such as The Warren Buffett Way, Buffettology, How to Think Like Benjamin Graham and Invest Like Warren Buffett, Trade Like Warren Buffett, and How to Pick Stocks Like Warren Buffett. Buffett has never written his own book on investing, stating everything there is to know has already been written. Although he is not openly revealing about his strategies, his letters to shareholders and conversations with associates, as well as other sources, have provided valuable information for those willing to analyze and synthesize it. This paper will attempt to focus on the most relevant thoughts presented by those authors without delving too much into fundamentals. One will notice Graham's thoughts threaded throughout Buffett's principles, further validating both Graham and Buffett as experts in the field.

Like Graham, Buffett believes stock investments should be looked at in the same way as buying a business. The stock investor is really buying a tiny share or partnership and should apply the same principles that they would in buying a business. As such, the company should be soundly managed. Some evidence of good management, according to Buffett, includes buying back shares when it has surplus funds and when the stock is trading at a discount.

How a company uses its retained earnings is also evidence of good management for Buffett. In evaluating how a company uses its retained earnings, positive signs include either giving them to the owners as a dividend, buying back shares, or reinvesting them into the company. To Warren Buffett, the ability to use retained earnings wisely is a sign of a well managed company. If the company management cannot do any better with earnings than he can, then he is better off if the company pays him the full amount in dividends.

Another principle that Buffett and Graham share is that of understanding the business in which one invests. This is not only true for the investor, but also for the company. Buffett feels companies should focus on activities that are within their expertise, and not spend shareholder's money on projects or areas that they know little about. If the principle applies to direct investment, it also applies to indirect investment and an investor is better off investing in a company that uses its capital in areas of its own expertise.

Like all investors, Buffett looks for companies with growth, both present and future. After all, an investor likes to see a company grow because, if profits grow, so do returns to the investor. The important thing for the investor, however, is that the company increases the returns to shareholders. A company that grows, at the expense of shareholder returns, is not generally a good investment. In addition, it is logical to conclude that a company that has had regular and consistent increases in earnings per share over a protracted period is soundly managed.

Buffett always liked to invest in companies with a competitive advantage. In 1993, Warren Buffett had this to say about companies with a continuing competitive advantage (Buffett, Berkshire Hathaway annual letter, 1993):

'Is it really so difficult to conclude that Coca Cola and Gillette possess far less business risk over the long term than, say, any computer company or retailer? Worldwide, Coke sells about 44 % of all soft drinks, and Gillette has more than a 60% share (in value) of the blade market.' Leaving aside chewing gum, in which Wrigley is dominant, I know of no other significant businesses in which the leading company has long enjoyed such global power.'

The competitive advantage of a brand name company is also enhanced if the product needs continual replacement, such as food and beverages, razor blades, and newspapers. It is no coincidence that Berkshire Hathaway has major stakes in Gillette, Coca-Cola, and The Washington Post, further reiterating Buffett's stance on companies with competitive advantage.

Warren Buffett believes that the return that a company gets on its equity is one of the most important factors in making successful stock investments. Just as a 10% return on a business is, all other things being equal, better than a 5% return, so too with corporate rates of returns on equity. Also, a higher return on equity means that surplus funds can be invested to improve business operations without the owners of the business (stockholders) having to invest more capital. It also means that there is less need to borrow.

Another factor that Buffett looks at is debt. Warren Buffett does not like to invest in companies that have too much debt, particularly long-term debt. With long-term debt, increases in interest rates can drastically affect company profits and make future cash flows less predictable.

Warren Buffett acknowledges that debt can effectively increase the return on equity in a company but warns against it. In his 1987 letter to shareholders, he said this:

'Good business or investment decisions will eventually produce quite satisfactory economic results, with no aid from leverage. It seems to us both foolish and improper to risk what is important (including, necessarily, the welfare of innocent bystanders such as policyholders and employees) for some extra returns that are relatively unimportant.'

Assuming that all these thresholds are satisfied, the investment should only be made at a reasonable price. Nobody really knows the specific principles that Warren Buffett applies when deciding the price he will pay for a share investment. However he has said on several occasions that it is better to buy a 'great company at a fair price than a fair company at a great price'. Buffett encourages investors to exercise patience once they've determined the right price to buy a stock. Buffett himself has said that he is prepared to wait forever to buy a stock at the right price.

When it comes to diversification, there is a seeming disparity of views between Graham and Buffett. Benjamin Graham was a firm believer, even in relation to stock purchases at bargain prices, in spreading the risk over a number of share investments. Warren Buffett, on the other hand, appears to take a different view, which is to concentrate on just a few stocks. He believes that if one has done their research, they are better off holding a few companies that they are confident in than many that may dilute the profit potential. In addition concentrating one's investment in a few stocks forces the investor to thoroughly perform their due diligence since more of their portfolio may be riding on it.

The remarks of Warren Buffet and analysis by Buffett authors (James Altucher, Robert Hagstrom, Mary Buffett, David Clark, Lawrence Cunningham, Timothy Vick) suggest that, at the very least, Warren Buffett looks at a number of aspects of a corporation and its operations. They can be put in the form of questions that any sensible investor should ask before considering a stock investment. A summary of these questions are as follows:

1. Is the business of the company easily understood?
2. Does the company invest in and operate businesses within its area of expertise?
3. Does the company have the ability to maintain or increase profitability by raising prices?

4. Is the company, looking at both long-term debt, and the current position, conservatively financed?
5. Does the company show consistently high returns on equity and capital?
6. Have the earnings per share and sales per share of the company shown consistent growth above market averages over a period of at least five years?
7. Has the company been buying back its shares, and if so, has it bought them responsibly?
8. Has management wisely used retained earnings to increase the rate of return to shareholders?

Once these questions are answered, the next and most important question is determining the price that an investor such as Warren Buffet would pay for the stock, allowing for a margin of safety. Clearly Buffett's performance as an investor brings value to his principles, and in determining one's own investing style, one would be wise to examine Buffett intensely.

Peter Lynch

Peter Lynch is a successful Wall Street investor whose record ranks him as one of the best stock-pickers in the world. He is a retired president of Fidelity Investments. Before being hired as a stock analyst for Fidelity, Lynch served for two years in the United States Army and studied at Boston College, then studied finance at the Wharton School of the University of Pennsylvania.

Lynch started his career as a textile analyst in one of Fidelity's mutual funds. Lynch was given the $20 million Fidelity Magellan Fund to manage in 1977, and under his direction it grew to eventually be worth over $14 billion by 1990, when he retired. The fund averaged a staggering 29.2% return a year, and only underperformed the S&P 500 twice. His biggest investing successes included discovering undervalued companies such as Taco Bell and Pier 1 Imports before periods of strong growth.

After he retired he wrote two popular books on stock picking, One Up on Wall Street in 1989 and Beating the Street in 1994. These books provide significant insight into Lynch's value investing philosophy and allow the reader to a personal look at one of the best mutual fund managers of the twentieth century.

Lynch coined some of the best known mantras of modern individual investing strategies. His most famous investment principle is simply, "Invest in what you know" (One Up on Wall Street, Lynch, 1989). This simple principle resonates well with average non-professional investors who don't have time to learn complicated quantitative stock measures or read lengthy financial reports. Since most people tend to become an expert in certain fields, applying this basic "invest in what you know" principle helps individual investors find good undervalued stocks.

Lynch uses this principle as a starting point for investors. He has also often said that the individual investor is more capable of making money from stocks than a fund manager, because they are able to spot good investments in their day-to-day lives before Wall Street becomes aware of them. Lynch understands this concept well. Throughout his two classic investment primers (One Up on Wall Street and Beating the Street), he has outlined many of the great investments he found when not in his office. Often he found them when he was out with his family, driving around or making a purchase at the mall. For example Lynch's experience at Taco Bell, recognizing their low margins and "under the radar" status, caused him to buy heavily into the stock prior to the company's popularity. Recent examples would include the success of the Build-A-Bear workshop, Apple I-Pod, or Whole Foods market, all stores and products that have increased in popularity and can be observed by the individual investor.

Peter Lynch's approach is strictly bottom-up, meaning he starts with a company he is familiar with and works his way up the numbers, as opposed to constructing a stock screen with which to filter out companies based on their quantifiable numbers and work one's way down. Lynch selects from among companies with which he is familiar, and then through fundamental analysis that emphasizes a thorough understanding of the company, its prospects, its competitive environment, and whether the stock can be purchased at a reasonable price.

Lynch would call himself a "story" investor. For him, each stock selection is based on a well-grounded expectation concerning the firm's growth prospects. The expectations are derived from the company's "story"--what it is that the company is going to do, or what it is that is going to happen, to bring about the desired results.

The more familiar one is with a company and the better one understands its business and competitive environment, the better your chances of finding a good "story" that will actually come true. For this reason, Lynch is a strong advocate of investing in companies with which one is familiar, or whose products or services are relatively easy to understand. Thus, Lynch says he would rather invest in "pantyhose rather than communications satellites," and "motel chains rather than fiber optics."

Lynch does not believe in restricting investments to any one type of stock. His "story" approach, in fact, suggests the opposite, with investments in firms with various reasons for favorable expectations. In general, however, he tends to favor small, moderately fast-growing companies that can be bought at a reasonable price.

Lynch's bottom-up approach means that prospective stocks must be picked one-by-one and then thoroughly investigated. As such there is no formula or screen that will produce a list of prospective good stories. Instead, Lynch suggests that investors keep alert for possibilities based on their own experiences, for instance, within their own business or trade, or as consumers of products.

The next step is to familiarize oneself thoroughly with the company so that one can form reasonable expectations concerning the future. However, Lynch does not believe that investors can predict actual growth rates, and he is skeptical of analysts' earnings estimates.

Instead, he suggests that you examine the company's plans. Questions one might ask are how does it intend to increase its earnings, and how are those intentions actually being fulfilled? Lynch points out five ways in which a company can increase earnings: It can reduce costs; raise prices; expand into new markets; sell more in old markets; or revitalize, close, or sell a losing operation. The company's plan to increase earnings and its ability to fulfill that plan are its "story," and the more familiar you are with the firm or industry, the better edge you have in evaluating the company's plan, abilities, and any potential pitfalls.

Analysis is central to Lynch's approach. In examining a company, he is seeking to understand the firm's business and prospects, including any competitive advantages, and evaluate any potential pitfalls that may prevent the favorable "story" from occurring. In addition, an investor cannot make a profit if the story has a happy ending but the stock was purchased at a too-high price. For that reason, he also seeks to determine reasonable value (Beating the Street, Lynch, 1994).

When evaluating companies, there are certain characteristics that Lynch finds particularly favorable, which he outlined in Beating the Street (1994). These include:

- The name is boring, the product or service is in a boring area, the company does something disagreeable or depressing, or there are rumors of something bad about the company. Lynch likes these kinds of firms because their ugly duckling nature tends to be reflected in the share price, so good bargains often turn up. Examples he mentions include: Service Corporation International (a funeral home operator--depressing); and Waste Management (a toxic waste clean-up firm--disagreeable).
- The company is a spin-off. Lynch says these often receive little attention from Wall Street, and he suggests that investors check them out several months later to see if insiders are buying.
- The fast-growing company is in a no-growth industry. Growth industries attract too much interest from investors (leading to high prices) and competitors.
- The company is a niche firm controlling a market segment or that would be difficult for a competitor to enter.
- The company produces a product that people tend to keep buying during good times and bad--such as drugs, soft drinks, and razor blades--More stable than companies whose product sales are less certain.
- The company is a user of technology. These companies can take advantage of technological advances, but don't tend to have the high valuations of firms directly producing technology, such as computer firms.
- There are a low percentage of shares held by institutions, and there is low analyst coverage. Bargains can often be found among firms neglected by Wall Street.
- Insiders are buying shares. This is a positive sign that insiders feel particularly confident about the firm's prospects.

- The company is buying back shares. Buybacks become an issue once companies start to mature and have cash flow that exceeds their capital needs. Lynch prefers companies that buy their shares back over firms that choose to expand into unrelated businesses. The buyback will help to support the stock price and is usually performed when management feels share price is favorable.

Characteristics Lynch finds unfavorable are:

- Hot stocks in hot industries.
- Companies (particularly small firms) with big plans that have not yet been proven.
- Profitable companies engaged in diversifying acquisitions. Lynch terms these "diworseifications."
- Companies in which one customer accounts for 25% to 50% of their sales.

As portfolio manager of Magellan, Lynch held as many as 1,400 stocks at one time. Although he was successful in juggling this many stocks, he points to significant problems of managing such a large number of stocks (<u>One Up on Wall Street</u>, Lynch, 1994). Individual investors, of course, will get nowhere near that number, but he is wary of over-diversification just the same. There is no point in diversifying just for the sake of diversifying, he argues, particularly if it means less familiarity with the firms. Lynch says investors should own however many exciting prospects that they are able to uncover that pass all the tests of research. Lynch also suggests investing in several categories of stocks as a way of spreading the downside risk. On the other hand, Lynch warns against investment in a single stock.

Lynch is an advocate of maintaining a long-term commitment to the stock market. He does not favor market timing, and indeed feels that it is impossible to do so. However that doesn't necessarily mean investors should hold onto a single stock forever. Instead, Lynch says investors should review their holdings every few months, rechecking the company story to see if anything has changed either with the unfolding of the story or with the share price. The key to knowing when to sell, he says, is knowing why you bought it in the first place. Lynch says investors should sell if:

- The story has played out as expected and this is reflected in the price; for instance, the price of a stalwart has gone up as much as could be expected.
- Something in the story fails to unfold as expected or the story changes, or fundamentals deteriorate; for instance, a cyclical's inventories start to build, or a smaller firm enters a new growth stage.

For Lynch, a price drop is an opportunity to buy more of a good prospect at cheaper prices. It is much harder, he says, to stick with a winning stock once the price goes up, particularly with fast-growers where the tendency is to sell too soon rather than too late. With these firms, he suggests holding on until it is clear the firm is entering a different growth stage.

Rather than simply selling a stock, Lynch suggests "rotation"--selling the company and replacing it with another company with a similar story, but better prospects. The rotation approach maintains the investor's long-term commitment to the stock market, and keeps the focus on fundamental value.

Lynch offers a practical approach that can be adapted by many different types of investors, from those emphasizing fast growth to those who prefer more stable, dividend-producing investments. Lynch sums up stock investing and his outlook best (One Up on Wall Street, Lynch, 1994):

"Frequent follies notwithstanding, I continue to be optimistic about America, Americans, and investing in general. When you invest in stocks, you have to have a basic faith in human nature, in capitalism, in the country at large, and in future prosperity in general. So far, nothing's been strong enough to shake me out of it."

The Motley Fool

The Motley Fool was started by two brothers, David and Tom Gardner, who say that they learned about stocks and the business world from their father at the supermarket. Their father, a lawyer and economist, would tell them, *"See that pudding? We own the company that makes it! Every time someone buys that pudding, it's good for our company. So go get some more!"*

These early lessons had tremendous influence on the Gardner's, and as a result the brothers founded the world's premier multimedia financial education company, The Motley Fool. David and Tom Gardner are a testament to the ability of every person to take control of his or her finances and become a successful investor. As students of English, Literature and Creative Writing, neither Tom nor David was formally trained in finance and investing. However, their passion for knowledge and motivation to achieve financial success led them to study and fine-tune the skills that have made them successful investors today. The company's mission has remained the same since its inception: to educate, enrich, and amuse individual investors around the world.

The Motley Fool name originated from Shakespeare's As You Like It, where Fools, who entertained and amused the royal court, were the only members of the society permitted to speak the truth to the king and queen without consequence. The Motley Fool takes the same approach, stating it's their job to tell people the truth about investing and show them how they can manage their own money better than a financial advisor. They believe that the power to succeed in the financial world lies in each investor's ability to use common sense, research and hard work to understand the facts about the companies he or she invests in.

The Motley Fool started small, but in 1994, a partnership with America Online allowed The Motley Fool to come to life online. Fool.com was launched on the World Wide Web soon thereafter. The brothers quickly established the "Fool Portfolio" of stocks, funded with their own money, and investors around the world were invited to learn from the Gardners' investing successes and mistakes. The Fool Portfolio (renamed the "Rule Breaker Portfolio") was celebrated for its dramatic gains until its closure in March 2003.

Currently, The Motley Fool offers seven monthly investment newsletters to their members, covering a variety of investing styles - Motley Fool Hidden Gems (focused on small cap stocks), Motley Fool Rule Breakers (focused on highly speculative stocks), Motley Fool Rule Your Retirement (focused on preparing for retirement), Motley Fool Inside Value (focused on undervalued companies), Motley Fool Champion Funds (focused on mutual funds), Motley Fool Income Investor (focused on dividend paying stocks), and Motley Fool Stock Advisor (David and Tom Gardner's original investment newsletter).

Since the Motley Fool exhibits such a diversity of thought with regard to investing, this paper's research will focus on the Fool's most successful newsletter, The Motley Fool Stock Advisor. From April of 2002 to the present, this newsletter has returned better than 60% on its portfolio recommendations.

The Gardner's believe Stocks are a wonderful place to put one's money, assuming they have at least five years to invest. If one doesn't have at least five years, they believe people shouldn't be investing in stocks, especially if it's with money that will be needed in the near term. They believe diversification across asset classes, and that includes "safety cash", is important.

The Gardner's would classify themselves as long-term (buy-to-hold) investors (www.motleyfool.com, n.d). Although this distinction may not have been necessary in the days of Graham and Buffett, in today's trading world it is a rarity. The Gardner's make no attempt to time the market and prefer to invest for the long-term because they have faith in the long-term growth prospects of the U.S. and global economies. Their approach to investing is called dollar-cost averaging, in which one makes periodic like-sized investments over time.

The Gardner's believe in developing a diversified portfolio that helps maximize profits and minimize risks. They feel one should own enough stocks so that a few bad surprises won't ruin returns, but not so many that great selections are minimized in a sea of mediocre stocks. As a rule, they recommend holding anywhere from eight to 15 stocks, depending on the amount of money involved.

As mentioned before, the Gardner's strategy is to buy and hold, which results in minimal turnover in their Stock Advisor portfolio. They recommend selling only when they think a stock will no longer outperform the market over the next three to five years. When they do sell, it's usually because one of two things has happened: either all of the good news is already factored into the stock's price, or something material has changed at the company or in the business. This approach is similar to Peter Lynch's "story" concept, in which one only sells if the story has changed.

The brothers' individual investment strategies are slightly different. Tom Gardner looks for stable companies with predictable growth. He examines the financials carefully and his picks are based on detailed assumptions. He is patient, but if a company fails to deliver according to his metrics (i.e. Cash flow growth) he will think hard about selling. David Gardner is much more speculative, preferring stocks that will show drastic upside, and as such he is more forgiving and more focused on the franchise than the relationship between the financials and the stock price.

Most of the analysis tools are based on Benjamin Graham and Peter Lynch's principles. In fact, much of the Motley Fool's investment advice references Graham, Buffett, and Lynch and considers them the experts. As such the analysis of their principles is not so much to differentiate them from Graham, Buffett, and Lynch, but to profile a current, successful investment strategy using the same principles. Although the market is continually changing and constantly affected by the growth in technology, the advancement of day trading and hedge funds, and the movement of mutual fund money, the Gardner's prove that the wisdom of past successful investors is still applicable today. Although today's market may be more complex and volatile, it is clear that accurate security analysis can still provide market beating returns on a consistent basis.

Adverse Market Influences

Day Trading

Day trading most commonly refers to the practice of buying and selling stocks during the day so that at the end of the day there has been no net change in position, or for every share of stock bought an equivalent share is sold. A gain or loss is made on the difference between the purchase and sales prices.

Day trading is not necessarily more risky than any other trading activity. However, the common use of buying on margin (i.e. using borrowed funds) amplifies gains and losses such that substantial losses or gains can occur in a very short period of time. It is commonly stated that 80% or 90% of Day traders lose money. Day trading used to be the practice of financial firms and professionals and some savvy private investors and speculators but in recent years has become notoriously common among casual traders taking advantage of the ease of trading via the Internet.

The ability for individuals to day trade coincided with the extreme bull market in stocks from 1997 to early 2000, known as the "dot-com bubble". From 1997 to 2000, the NASDAQ rose from 1200 to 5000. Many naive investors with little market experience made huge amounts of profits by buying these stocks in the morning and selling them in the afternoon, at 400% margin rates. In March, 2000, this bubble burst, and a large number of less-experienced day traders began to lose money as fast, or faster, than they had made during the buying frenzy. The NASDAQ crashed from 5000 back to 1200; many of the less-experienced traders went broke.

For decades finance professors have talked about the "rational markets hypothesis," the notion that a stock price accurately reflects all available information about the company's prospects. Many talk differently now. A growing body of academic research, in fields ranging from psychiatry to anthropology, explains market behavior in terms of irrational urges. The Journal of Psychology and Financial Markets, the first academic journal devoted to investor psychology, warns in its March debut issue: "People do not behave as molecules," namely as independent actors making individually random movements that are collectively predictable. No, investors act more like herds of agitated animals.

The impact of day trading on today's market has continued past the dot com bubble and burst. There are a number of firms that offer day trading occupations, websites devoted to day trading (tradingmarkets.com), and an annual trade show devoted to the practice. Despite the historical lack of performance in the industry, it appears to be growing, and more importantly, influencing the market in adverse ways.

Most traders attempt to take advantage of price movements due to any number of factors, from earnings reports to economic data to news events. As a result price movements are magnified as volume is increased due to day traders attempt's to "ride the wave". Instead of the market acting rationally to available information, it acts irrationally to the detriment of the particular stock and long-term investors in the stock. Although many times the market corrects itself within the next several weeks, the short term impact is not unnoticed.

Perhaps the largest beneficiary of day trading is the brokers who facilitate it. They offer extended margin (75%) because they stand to benefit from increased commissions. The ability to trade on such high of margin further increases the price swings and volume. It is impossible for any investor to ignore the impact that day trading has, or to ignore the impact of other adverse market forces.

Investment "Gurus"

The Investment world is full of advice, from experienced investors to bubble millionaires, and from college professors to newspaper editors. Over the last twenty years the pool of advice has grown significantly, diluting its quality. It used to be that one sought advice from a time-tested successful investor with an experienced track record. These days it appears anyone and everyone has written a book on "How to make money in the stock market" whether they've done so themselves or not. With the popularity of the market increasing, these so-called "gurus" are having a more significant effect.

Perhaps the most significant these days is a man named Jim Cramer. Jim Cramer is a former hedge fund manager who co-founded TheStreet.com and went on to work at CNBC, where he was a host on Kudlow & Cramer with Lawrence Kudlow. He now has a radio show called Real Money Radio and his own television show focused on stocks, called *Mad Money with Jim Cramer*. He exhibits his encyclopedic knowledge of equity securities during the "Lightning Round" segment on Mad Money where he quickly analyzes stocks suggested by callers. Mad Money may appear more about showmanship than anything else, with Cramer throwing chairs playing sound bites, and telling people to "Back up the truck!" and "Get the paddles!". The show has become a cult hit with 384,000 nightly viewers. Cramer is a trader to the core and displays none of the buy and hold or long term strategies of this paper's previous research. His rapid-fire in-and-out moves are raising chat room buzz to levels not seen since day traders reigned supreme during the bubble.

Cramer graduated magna cum laude from Harvard College in 1977 where he was an editor of the Harvard Crimson. After college he worked as a journalist at the Los Angeles Herald

Examiner. He went back to school to get a Juris Doctor Degree from Harvard Law School and after graduating in 1984 went to work in Goldman Sachs Private Client Services unit.

In 1987 he started his own hedge fund company, Cramer & Co., which managed $450 million dollars and earned an average return of 24% per year after fees. In spite of his concentration in Tech stocks, Cramer's fund managed to under perform the Nasdaq 100 throughout the bull market of the late 1990's. After a stellar 2000, Cramer's fund finished up the year +36%, compared to -11% for the S&P 500 and -6% for the Dow Industrials.

Cramer cashed out of his hedge fund at the end of 2000, and now considers himself a journalist. He obviously has fans, as evidenced by his nightly viewership, however he also has many critics. He is able to produce mediocre short term results, with his roster of Picks of the Week from *Mad Money* since the show started in March having jumped an average of 7.1% after three months, according to *Business Week* calculations. What's perhaps more interesting are the immediate effects he has on stocks. Usually by the end of the first day's trading after Cramer unveils his picks, usually on Mondays, they're up an average of 2.2%, vs. drops of 0.1% each on the S&P and Dow. For example consider Conexant Systems Inc., a semiconductor stock that once traded above 30. On Sept. 19, Cramer made it his pick of the week after it closed at 1.63. The next day, it opened at 1.94 and went as high as 2, a 23% spike, with 82 million shares traded, nine times the daily average. The effect Cramer has on the market is making professional fund managers pay attention. He has the ability to move the market, something very few people can do, but he does it because day trading has become easy and accessible to all.

It is necessary to reflect on and understand as many of factors that impact the market as possible prior to determining the focus of any investment firm. Unfortunately these factors are far more numerous than can be studied in the context of one research paper. Apart from day trading and stock pickers, there are economic influences, global influences, market sentiment, and many others. However these factors (aside from perhaps day trading) have existed as long as the stock market, and yet there were still people who were able to be extremely successful despite them.

It is clear that successful investing has many concepts in common, from searching for undervalued companies to examining management strategies to buying with a margin of safety. Although the adverse market effects continue to grow and change, there are many investors who continue to be successful using the same principles. Some are more successful than others, and some focus on different aspects than others, depending on their personal beliefs and their expertise. This is further evidence that there is no exact formula to successful investing, however there are correlations among certain principles that should be considered when determining a successful investment strategy.

At this point it is relevant to examine the desires of today's investors, prior to determining the most relevant principles of investing. Whether one invests for themselves, trusts their money to someone else, or perhaps manages someone else's money, understanding the expectations of investors today will help determine the principles that should guide anyone's stock market decisions.

Chapter III

Research Methodology and Field Research

Field research for this paper was conducted through personal interviews of five individuals of various backgrounds. The intent of the research was to have qualitative data to assist in determining relevant investment principles. These are principles that will support the goals of either individual investors or establish foundational principles for an investment fund. The demographics of the five individuals, with estimated net worth in parentheses, were as follows; mid 40's female administrative assistant (<$300,000); late 20's commercial real estate agent (>$500,000); late 40's commercial mortgage loan officer (>$1,500,000); early 50's semi-retired CFO (>$5,000,000); and late 40's real estate developer ($10,000,000). The reasoning behind interviewing individuals of differing backgrounds and net worth was to assist in determining principles that would apply to anyone.

The following questions were asked of each investor:

1. What does an ideal investment look like?
2. What percentage of return do you expect from your investments?
3. What percentage of risk are you comfortable with?
4. Do you prefer short-term trading or long-term investment?
5. Are you comfortable investing across asset classes as well as in derivative instruments?
6. Would you prefer a focus on growth or long-term value?

While there were some variances in answers, for the most part the overall goals of investors are the same. In terms of an ideal investment, all subjects responded that personal ownership or trust was important. In other words, an ideal investment was one they controlled themselves or one that they had some level of personal relationship with whoever was controlling it. This is interesting considering the growth of online investing firms allowing people to control their own funds, as well as the negative sentiment towards investment advisors and mutual fund managers. While none of the subjects provided a specific response in terms of a certain type of stock or mutual fund, they all stressed the importance of personal ownership. With this in mind there is significant value in having defined investing principles before one attempts to manage their investments on their own, or from which they can monitor the investment moves of whomever manages their money.

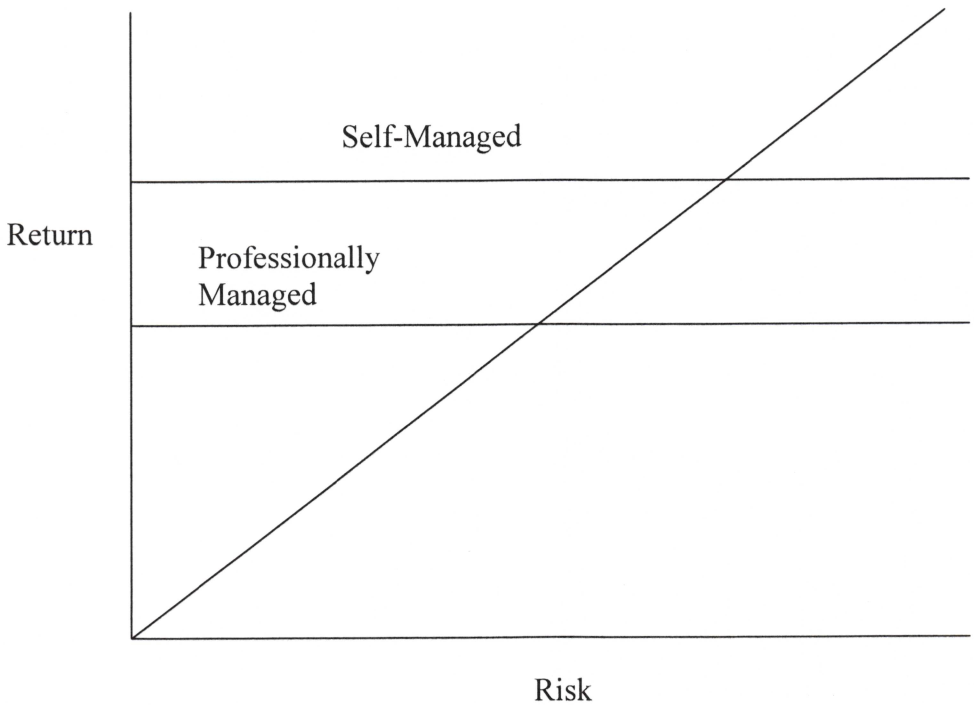
In terms of return, the range varied from 10%-25%, depending on risk. It was interesting to hear that greater returns were expected from investments that were self-managed or closely watched. One subject was content with 10% if the funds were managed in a mutual fund or by an investment advisor. Another was stringent on the fact that the funds be closely held and achieve greater than 25% returns annually. As mentioned in the introduction, none of the subjects stated they desired a negative return. Obviously the goals of the average investor are to achieve above-average returns, at least with regards to the long-term market average. This provides relevance to understanding and following the investment principles of previous successful investors who have achieved above average returns.

Risk varied as well, and as can be expected correlated with the amount of return desired. For money that was managed by someone else, risk was expected to be low and consequently returns around 10%. For money that was self-managed, risk was allowed to be higher, and the resulting returns expected to be higher as well. When further probing this question, those who allowed for greater risk also allowed for greater volatility, while those who preferred less risk expected less volatility. Psychologically it makes sense that those who managed their own money allowed for more risk, expected higher returns, and allowed for greater volatility because they usually trusted their decisions. On the other hand those who didn't manage their own money expected lower returns, allowed for less risk, and allowed for less volatility likely due to the anxiety that resulted. In other words, volatility would bring on thoughts of "maybe he/she made a bad investment decision." The principles outlined in this research will ideally help an investor achieve higher rewards with less risk and preferably less volatility (although this is hard to control for).

With regards to short-term trading versus long-term investing, this is where the greatest variance existed. Two of the subject's were comfortable with short-term investments that provided higher returns, while the other three subjects preferred long-term investments. This cannot necessarily be attributed to net worth or professional background, but may be attributed to investment knowledge. The two that were comfortable with short-term trading had made short-term investments previously and were familiar with the potential they offered, while the other three had a negative bias to short-term trading from their understanding of day trading. While it is possible to make money through short-term investments (not day trading), it involves significantly greater risk that is rarely offset by the potential reward. In addition short-term investments or trading increases transaction costs which cut into profit. While the researcher is not necessarily against short-term investing, it should only occur within the context of the investment principles. As detailed later, this would include situations where the reasons a certain stock was bought change, and as a result the investment should be sold (hopefully after a gain).

All of the subjects were comfortable with all asset classes, as they understood that different asset classes perform better at different times. Three of the subjects were comfortable with alternative investments such as derivatives; however two were not, due to their unfamiliarity. While derivative investments can produce greater gains, they are more risky and should be used under calculated risk situations. It is possible to increase profits through calculated use of derivative instruments using the same investment principles outlined in this paper, however their usage will not be discussed as they require additional knowledge and understanding. It is interesting to note that had this question been asked twenty years ago to the same mix of subjects, the familiarity level would have been much lower and it is likely that all five would not have been comfortable with derivatives. The increase in day trading and active trading through the internet has increased both the volume and familiarity with derivatives such as futures and options, as well as added to the volatility of some stocks. As a result there is opportunity to increase profits, as well as the possibility of greater losses, however trading derivatives is an advanced discipline that may not be suitable for the average investor.

The final question related to the subjects' preference between growth and long-term value. As expected, those that desired greater gains preferred growth investing, due to growth stocks' history of providing greater gains. In situations where investments are not self-managed, long-term value was preferred due to its limited volatility. The researcher hypothesized that investors would prefer to mix growth and long-term value stocks in a portfolio, however this was not the case. Subjects that wanted to manage their own money wanted greater returns, therefore their preference was to focus on growth stocks. They felt that value stocks may provide stability but dilute returns. The research discussed the success of notable investors, and as expected the majority of their profits came from investing in undervalued or little known growth stocks. As a result the principles outlined in the next section will fit well with the goals of these five subjects, as well as the average investor who desires above average results.


Self-Managed
Return
Professionally
Managed
Risk

Chapter IV

Analysis of Research Data

After reviewing the research it is necessary to simplify the vast wealth of knowledge acquired from it. Like every investor or fund, it is the intention of the researcher to have some differentiation as well as individual style. With the thousands of investment funds available today, the only way to attract investors is to differentiate and perform. Performance, in the researcher's opinion, is best achieved by replicating the success of the top performers of the past. As a result, the following principals, gleaned from the gurus, will reflect the foundational investment principals recommended by this researcher for successful investing:

1. **Distinguish between investment and speculation**

One of the most attractive features of investing in the stock market is the opportunity to hit a home run, or invest in a stock in its early days and profit from a stratospheric rise. This often involves speculation, or taking a chance on an unknown company with potential. While this adds excitement to any portfolio, it also adds risk, sometimes at a higher multiple than the potential returns. Many investors have invested capital in biotechnology firms with a promising drug, only to see that drug fail to get FDA approval and the stock lose half its value or more in a single day. It is the opinion of this researcher to allocate no more than 5% of capital to speculative stocks, and even then they must meet additional criteria. The majority of capital should be allocated to quality investment opportunities, represented as strong stocks with solid fundamentals and growth potential. While speculation can provide the occasional home run, it more often than not returns strikeouts.

2. Look for a margin of safety

The importance of a margin of safety is greater than ever in this time of extreme market fluctuation. Although it is impossible to always buy at the bottom and sell at the top, from a valuation standpoint one should attempt to come close. Investors should look to buy at anywhere from a 10-25% discount of the company's book value, taking into account prospective growth if it's relevant (it may not be for blue chip dividend stocks). This may occur any number of ways, from a news related pullback, industry change, or undervaluation by Wall Street. Often times technical analysis can provide insight into potential buying opportunities, such as overselling of a stock or a decrease in volume. It is wise for investors to maintain a list of potential investments and the price at which they would be willing to buy them including a margin of safety. This takes out some of the emotion of investing, as it forces one to buy solely based on fundamental reasons as opposed to market hype or investor sentiment.

3. Trust the Data

Without question this may be one of the most important principles. Many investors are swayed by market sentiment or fast run-ups of stocks and buy in hoping to benefit. Unfortunately many times these run-ups are not based on fundamental data and often result in run-downs. Once an investment has undergone its initial analysis and a margin of safety has been determined, there should be no other circumstances that impact the price an investor is willing to pay. If a stock experiences a sudden price-run up, the only reason it should be bought is if the data still meets the criteria that categorizes it as a solid investment. One of the most difficult things for an investor is to complete their analysis and find a stock that has solid fundamentals and can be bought with a margin of safety, only to see it increase in price shortly before it is bought. There is incredible temptation to still buy the stock because after extensive analysis one becomes attached to their choices, however if the discount is gone the investment must be passed on. Most investors have short term memories and believe that they'll never find another deal like this one, forgetting that a similar deal was available last week or last month, and another will be available soon. It is critical to always trust the data, and make decisions accordingly.

4. Understand the business and its managers

Understanding the business provides knowledge security when the stock price moves. Investors who purchase shares based on hype or non-fundamental reasons will often fall into the trap of buying high and selling low, simply because their faith rests in the movement of the price. When an investor takes the time to understand a business and its managers, they will have the knowledge necessary to hang on through rough times because they know the fundamentals are still there. In addition they will often have a greater success of predicting exit times because they will know when the business has changed negatively. This reiterates the concept of buying the business and not the stock.

In looking at the business, it's important to examine the focus of the company. Very few companies operate in multiple industries with any success. Those that do have been around for quite some time have done so usually through the acquisition of other companies that are already successful at it. A company that is unable to focus its energy on its core business is a potential liability, due to the fact that the business world is so competitive and it is survival of the fittest. If Yahoo or Apple suddenly decided to start manufacturing automobiles, this would be cause for concern, as it's obviously outside of their core business. The only exception would be if a company acquired outright a business that complemented their core, or a business that acted as a hedge to their industry. Warren Buffett has been extremely successful at this, however his success is attributed to the fact that he leaves the business intact as much as possible, to the extent of retaining the same management team, and does his best to allow them to do what they do best. A solid understanding of the business will help investors make rational, fact-based decisions and give them confidence during probable price fluctuations.

The final piece of understanding the business involves examining the company's competitive advantage. Ideally one would invest in a top performing company, although often these companies will not experience significant growth. Therefore the best growth companies are those with a competitive advantage that may not have been discovered. An example of this would be Google. Before Google went public, it had already established itself as the best in the search engine industry. Once the shares were available they continued to go up and have yet to stop. Their competitive advantage continues to garner them additional market share, increasing earnings and stimulating growth. The best investments are those that have a recognizable competitive advantage with growth potential.

5. Examine retained earnings, return on equity, long-term debt

While there a number of ratios that one can examine when analyzing an investment, these three are of particular importance. This paper will not expound on the other ratios because it is the opinion of the researcher that analyzing an investment requires a personal touch. Some may value Price/Earnings ratio, some may value Price/Sales ratio, some may look at Price/Earnings growth, however in most cases there is no defined right or wrong number when examining these ratios, nor is there one that provides a definitive decision on whether a stock is a good investment or not. As a person gains in experience analyzing stocks, they will attain a certain comfort level with the ratios and determine their own thresholds. Many investors have been successful looking at completely different things.

However, when it comes to retained earnings, return on equity, and long-term debt, it is difficult for a company to manage these incorrectly and still be successful. With regards to retained earnings, an investor should specifically look at how a company manages its profit. Buying back shares and reinvesting them into the company are good signs, while boosting corporate level salaries and bonuses is not. One should try to remember what Buffett said about retained earnings: if the company can't be more profitable with it than I can, I'd prefer they distribute it to me as dividends and let me manage it. Therefore there is value in specifically examining what a company does with its retained earnings.

Return on Equity is a valuable ratio for an investor because simply put it is the return on invested capital. This ratio will give investors a valid measure of what the money they've invested in the company is actually doing. One should examine this ratio in addition to long-term debt, as return on equity can be inflated due to a high debt/equity ratio. Ideally an investor wants to look for a long-term debt to equity ratio no higher than 2/1. A company that is highly leveraged may provide a greater return on equity, due to the small equity number in relation to returns, however they are a greater risk due to their debt load. As interest rates increase the cost of debt grows and a highly leveraged company can see their profits quickly vanish. 2/1 is a conservative debt to equity ratio, and after meeting this criteria one can safely examine return on equity to determine how well the company is using investors' money.

6. Examine the story

This principle is similar to understanding the business, however in understanding the story one determines the growth prospects. Growth is often preceded by change, which usually presents a story. Recently McDonald's shares have experienced some growth due to the fact that they are splitting off a subsidiary company, Chipotle Mexican Grill, in an initial public offering. This will provide added cash for the company as well as future growth as they will undoubtedly retain some of the Chipotle shares. The IPO has yet to occur, therefore a story exists in the fact that the IPO should push the shares up in early 2006. In addition they have introduced a new gift card, and due to the success of the Starbucks gift card, this should also provide some growth for McDonald's in the near future. Story's can be short or long term, however what's important is determining their viability and impact on the bottom line for the company. Ideal investments have a good story behind them that will provide increased earnings and are appealing to the average person. The longer-term the story, the better the investment, as often the impacts of a long-term story snowball as time goes on, creating more and more value every quarter.

7. Diversify

While our research was not conclusive with regards to diversification, it is an element worthy of discussion. The researcher's conclusion concerning diversification is to diversify to the extent that one finds suitable investments. There is no benefit in diversifying for the sake of diversity, however if one finds ten solid growth stocks with good stories and excellent potential, then by all means invest in all ten. Obviously, the more stocks one is invested in, the more they have to follow. However there is no need to limit one's holdings simply because one doesn't believe in diversification. More often than not diversification will provide added stability during economically influenced fluctuations, adding piece of mind (which can be very valuable). The key with regards to diversification is to hold as many positions as one deems necessary, given the stocks' ability to meet the other criteria.

8. Have a three-to-five year window

Ideally any investment made would be held for three-to-five years. The reason for this is that while all the previous criteria may have been met, one still has to wait for Wall Street to recognize the same potential before the stock price will experience growth. Unfortunately it is impossible to predict when this will occur. As long as a stock still has a great story and solid fundamentals, one should hold it in their portfolio, even if the price isn't moving very much. What an investor should plan for is that at some point the stock will match its intrinsic value, and when that occurs the gains will occur as well. Three to five years should be enough time, and if growth still hasn't occurred in that time, one should consider re-evaluating the stock and their criteria. Regardless an investor should examine their holdings quarterly for any changes, and should the story change or the fundamentals change, it is wise to sell the stock even if it hasn't been in the portfolio for three years. As with the previous point, the most important fact is whether or not the stock is meeting the fundamental requirements.

In addition to the window, one should never attempt to time the market. This coincides with determining a margin of safety. There will be many times when an investor is swayed by market movement, however it is critical to stay committed to the price that was determined using the margin of safety. Failure to do so will usually result in buying high and selling low. It is near impossible to time the market, and in the context of these principles it is completely unnecessary.

9. Be aware of adverse influences

The final point is less about analysis and more about comfort. As mentioned previously, one of the difficulties of today's market is that the constant fluctuations and price swings can wreak havoc on an investor's psychological well-being. Many times investors have greeted their portfolio only to find a Wall Street analyst had downgraded one of their stocks and it promptly lost 20% of its value. It's important for investors to understand that this will occur, sometimes regularly, however the strong stocks will quickly regain their value, and in the long term will perform as they should. Once again the most important thing is the fundamental analysis of the stock. Without a doubt one has to be aware of the adverse market influences that impact today's investors, but only to the extent that they not allow those influences to change their opinion of the stocks they own. At most these influences may prompt a re-evaluation, however if nothing has changed one should continue to hold the stock and allow it to achieve its expected price.

In conclusion, when evaluating stocks for portfolio selection, there are two components that affect the choice. One is the rational component, the other is emotional. Ideally, every investor will make rational choices, considering only hard data and quantifiable reasons why they believe the stock will provide long-term value. However, it is impossible to completely rule out the emotional component. Beyond adverse market effects, emotions can significantly impact an investor's decisions.

For example, many employees take no second thoughts when investing all of their 401K allocation to the company they work for, without considering the strength of their companies financials. Many Enron employees suffered as a result of this emotional decision. Another common emotional decision is "falling in love" with a particular stock. This often happens when a stock has made a significant amount for an investor, then begins to drop in value. The investor fell in love during the high times and now finds it extremely difficult to sell the stock because of emotional ties. While it is impossible to control for all emotional factors, the more rational an investor can be, the better. The critical factor in managing the rational and emotional components is to continually review the rational analysis when emotions become evident. When the stock begins to drop and the investor hesitates selling, it is necessary to review the reasons why they bought. If those reasons are still valid, they should hang on to the stock. However if they aren't, a rational decision must be made. Successful stock investors are able to manage these components and remember that investing isn't a game, but a business.

Chapter V

Conclusions and Recommendations

The intent of this study was to provide today's investor with relevant principles they can use to achieve above average returns in today's market. Much has changed since the stock market's inception in the early 1800's, and it's likely that much more will change in the coming decades. There are so many factors that can influence the market, but the important thing to remember is that many of those same factors already have. Those that have been successful in the past have had a disciplined approach and followed the principles they established for themselves.

This paper is by no means an end-all on how to invest successfully in the stock market. The research validates that different styles can be successful, and there is no one right way. What this paper attempted to do is to try to find similarities between those who have been successful and stress those similarities as critical whether one manages their own investments or allows someone else to do it for them. These nine principles are not conclusive, each individual may wish to add more or use less. However the point is that there is documented proof that it's possible to perform better than the average of 10%-12%, and those that have done so had a lot in common.

As today's investment world continues to change, there is a growing body of research dedicated to the study of behavioral finance. Behavioral finance examines the psychological factors that influence investment decisions. Much of the research is challenging long-held ideas about the market, such as it always operates rationally and efficiently. This is mentioned in relation to point nine, that today's investor must be aware of what is occurring in the investment world. Much of the advent of day trading, the popularity of investment advisors such as Jim Cramer, and the large price swings can be attributed to psychological factors. Information is everywhere, stock tips flood investors' e-mail boxes, everyone has a strategy to double one's money in 90 days, and every investment advisor is beating the market. Somehow today's investor has to find a way to ignore most of that information and focus on the principles they have established for themselves. What has worked in the past will work again, the only difference is in the past investor's didn't have to hear as much noise.

It is the hope of this researcher that the principles outlined in this paper will help the reader achieve above average returns. Stock market investing has never been meant to be a get rich quick scheme. Indeed, those who do, such as during the dot-com bubble, often see their gains dissipate just as quickly. Those that are successful over the long term have much in common. More importantly, they are a testament to the fact that it is possible to beat the market. David and Tom Gardner are further examples that anyone can do it as long as they are willing to put in the time and effort and follow sound investment principles.

The chief recommendation of this paper is that investor education never stops. As this paper has done, the intelligent investor would be wise to study the successful investors and emulate their principles. Much insight can be gained from understanding how Graham, Buffett, Lynch, and many others produce market beating returns. In addition what made these investors even more successful was their understanding of the business and economic world around them. Beyond the fundamental analysis of a specific company, these investors understood the impact of interest rates, inflation, and the health of the economy. Graham noted many historical periods in which it was more profitable to invest entirely in bonds than in stocks (The Intelligent Investor, Graham, 1973). An investor can further increase their returns if they are able to recognize these times. Finally an understanding of investor psychology is also beneficial, not necessarily to beat the market, but to understand one's own psychological influences. The more rational an investor can be, the more success they will experience.

While investing should be viewed as a business, many who partake in it enjoy investing immensely. However success often dictates the degree of joy one experiences. Every investor wants to be successful, and this author believes every author can if they are willing to invest time and energy into learning the successful principles, along with their hard-earned money.

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