The Five Rules for Successful Stock Investing

Morningstar's Guide to Building Wealth and Winning in the Market

Pat Dorsey
Director of Stock Analysis

WILEY
John Wiley & Sons, Inc.

The Five Rules for Successful Stock Investing

Morningstar's Guide to Building Wealth and Winning in the Market

Pat Dorsey
Director of Stock Analysis

WILEY
John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Dorsey, Pat.
The five rules for successful stock investing : Morningstar's guide to building wealth and winning in the market / Pat Dorsey.
p. cm.
Includes bibliographical references and index.
ISBN 0-471-26965-4 (CLOTH)
1. Investments. 2. Stocks. I. Morningstar, Inc. II. Title.
HG4521.D646 2004
332.63′22—dc22
2003018287

Printed in the United States of America.
10 9 8 7 6 5 4 3 2 1

Contents

Foreword

Because i'm the founder of Morningstar, you might think I invest most of my personal assets in mutual funds. The truth is I own few mutual funds. Nearly all of my assets are in stocks. Although I love funds, I have an even greater passion for stocks. Funds are great for those who don't want to spend a lot of time doing research. But if you enjoy analyzing companies—and I think it's a tremendous amount of fun—you can do perfectly well investing in equities yourself.

My interest in equity analysis began in business school at the University of Chicago. There I learned about efficient markets and how collectively security analysts add little or no value. That did little to excite me about stock investing. Why, after all, spend time studying companies if a market basket of stocks will do just as well? After graduation, though, I stumbled across *The Money Masters* by John Train and read about Warren Buffett.

Now that was exciting. Buffett used an approach I could readily grasp and inspired me by showing how much fun and intellectually challenging investing could be. Moreover, Buffett's track record—and the record of others who shared his philosophy—was stellar. I went back and read all the Berkshire Hathaway annual reports. My life changed course as a result.

I went to work as a stock analyst at Harris Associates in Chicago. I chose Harris because I admired its value-oriented, Buffett-like approach, and I liked the people. It was a great job, and I worked with some terrific financial minds—Clyde MacGregor, Chuck McQuaid, Bill Nygren, Ralph Wanger, Sherwin Zuckerman, to name a few. They all practiced a rigorous, bottoms-up investment style that involved looking for companies selling at a discount to their true worth. I spent my days reading annual reports, talking to company managers, and learning from my peers. And I got paid to do it.

The idea for Morningstar came from trying to teach myself equity analysis. I called regularly to get the mutual fund reports from managers I admired—people such as Kurt Lindner (Lindner Funds), George Michaelis (Source Capital), Michael Price (Mutual Shares), Bill Ruane (Sequoia Fund), John Templeton (Templeton Funds), and Ralph Wanger (Acorn). I examined their holdings to see what stocks they were buying and tried to figure out why they were buying them.

One day, when I had all these shareholder reports scattered across my dining room table, I thought it would be useful if someone compiled all that valuable information into a book. The proverbial light bulb clicked. I started to research the mutual fund industry. I could see that it was growing nicely and that there were few sources to help investors make intelligent decisions about funds. Thus, Morningstar was born.

I left my stock analyst job at Harris, cleared out the living room of my apartment, bought several PCs, and got started. I wrote to all the funds to get their materials, entered everything into a database, and six months later a 400-page *Mutual Fund Sourcebook* was sitting on my desk. In 1984, this in-depth fund information was very hard to get—and certainly not available for $32.50. The *Sourcebook,* for example, provided complete portfolio holdings. It took five pages just to list the 800 stocks in Peter Lynch's Magellan Fund. I sold 700 copies of that first publication, and Morningstar was on its way.

By bringing a stock perspective to the mutual fund world, we began to define the Morningstar approach to fund investing. It's hard to believe now, but back then investors purchased mutual funds based on recent returns and not much else. Morningstar brought rigorous, fundamental analysis to the industry. We realized that by looking carefully at the stocks a fund owned, we could understand the manager's strategy more clearly. So we developed our equity expertise as a way of doing better fund analysis.

While Morningstar began by serving fund investors, over time, we broadened our mission to help all investors. And that meant stock investors, too. This wasn't soulless corporate expansion, but logical growth based on a passion for equity analysis. And the more we looked at information available for stock investors, the more we realized that we had something innovative, useful, and unique to offer. There was little new in equity research, and many existing products seemed dated and not particularly helpful. We thought we could do better.

Our approach to equity analysis builds on the Ben Graham and Warren Buffett school of investing. It would be hard to find two better mentors—and we're grateful and indebted to them for all that they have done for investors. You'll find some of their key lessons embedded in our advice—concepts such as *margin of safety* and *economic moats.* We add value by systemizing, broadening, and explaining their approach so you can do it yourself. The result is a robust framework that should serve you well in making your own investment decisions.

But we haven't cornered the market on advice. We've included a reading list, and I urge you to use it as a guide. There aren't many great books on investing, so you should be able to master most of them. If you aren't doing so now, I suggest you begin reading the major business magazines regularly—*Barron's, BusinessWeek, Forbes, Fortune,*—as well as *The Wall Street Journal* daily. You'd be surprised how many investors neglect to do these basic things. Among our own publications, you'll find Morningstar.com and *Morningstar StockInvestor,* our monthly newsletter, helpful. I also recommend all the Berkshire Hathaway annual reports and *Outstanding Investor Digest* for its lengthy interviews with leading money managers.

You need to read widely to build a "latticework of mental models," as Berkshire Hathaway's Charlie Munger says. By looking closely at many companies, you'll see common themes that drive their success or failure. And you'll begin to form models that you can apply to situations you want to analyze. Then you must ask some questions. How is the world changing? How will those changes affect this company's prospects? You can begin to see the challenge and the fun of investing.

The Five Rules for Successful Stock Investing: Morningstar's Guide to Building Wealth and Winning in the Market is the effort of Pat Dorsey, the head of equity research at Morningstar. Among his many talents, Pat can communicate in a clear and engaging way, and he has the rare ability to distill complex questions to a form so that the answer appears obvious. Pat works closely with Haywood Kelly, Morningstar's chief of securities analysis and editor-in-chief of Morningstar.com, and Catherine Gillis Odelbo, president of securities analysis and head of our retail business, to guide our equity effort. We're indebted to all three for what they've created at Morningstar and for defining the investment philosophy that is the framework for this book.

A common quality of successful investors is the steadfast ability to think independently. Don't be swayed by what the "experts" say—even us. Graham and Buffett often point out that if your reasoning is right, that's all you need to worry about. I hope you read this book with a questioning mind. I hope you challenge our thinking. Above all, I hope you learn guiding principles that will shape your personal investment philosophy. Although no one can guarantee success, if you apply the precepts in this book and think for yourself, you'll be well on your way.

JOE MANSUETO

Acknowledgments

Although only one name appears on the cover, this book was very much a team effort. Erica Moor kept the project on track and ably orchestrated text, graphics, deadlines, and schedules to produce a finished manuscript, while Amy Arnott worked tirelessly to tighten the initial muddled prose into something worthy of publication. Both deserve a great deal of credit. Dave Pugh at John Wiley & Sons also contributed valuable edits and a fresh perspective on the material. Morningstar designer Jason Ackley transformed complicated concepts into lucid graphics, while analyst Sanjay Ayer collected the data that underpin the tables and charts.

I have the great fortune to work with a group of very talented and dedicated analysts, and a round of applause is due to the entire Equity Analyst team at Morningstar. They contributed the lion's share of this book's second half. This book could not have been written without their accumulated industry expertise. I'm also indebted to Mark Sellers for helping develop Morningstar's investment philosophy; and to Mike Porter, Jason Stipp, and Rich McCaffery for valuable editorial feedback. Mike also deserves credit for shouldering many of my duties while I completed the book. Special thanks go to Haywood Kelly for being not only the world's most patient boss, but a great editor, mentor, and friend. Thanks also to Catherine Odelbo, president of securities analysis and our retail business, for her ongoing support of this project and our equity research efforts at Morningstar, and to founder Joe Mansueto for having the vision to take a risk and build Morningstar. Joe's unwavering commitment to independence and objectivity sets the example for the whole firm.

On a more personal note, my late grandfather, E. V. Patrick, deserves credit for introducing me to investing at a relatively young age, while my parents, Herb and Carol, have given me enormous support throughout my career. None, however, are more deserving of gratitude than my wife Katherine, whose good humor and unflagging patience are my most valuable assets. This book could not have been written without her support.

P. D.

Introduction: Picking Great Stocks Is Tough

Successful investing is simple, but it's not easy.

One of the big myths of the bull market of the 1990s was that the stock market was essentially a savings account that returned 15 percent per year. You picked up a copy of *Fortune,* you watched a little CNBC, you opened an online account, and you were on the road to riches. Unfortunately, as many investors discovered when the bubble popped, things that look too good to be true usually are.

Picking individual stocks requires hard work, discipline, and an investment of time (as well as money). Expecting to make a large amount of money with only a little effort is like expecting to shoot a great round of golf the first time you pick up a set of clubs. There's no magic formula, and there's no guarantee of success.

That's the bad news. The good news is that the basic principles of successful stock-picking aren't difficult to understand, and the tools for finding great stocks are available to everyone at a very low cost—you don't need expensive software or high-priced advice to do well in the stock market. All you need are patience, an understanding of accounting and competitive strategy, and a healthy dose of skepticism. None of these is out of the average person's grasp.

The basic investment process is simple: Analyze the company and value the stock. If you avoid the mistake of confusing a great company with a great investment—and the two can be *very* different—you'll already be ahead of many of your investing peers. (Think of Cisco at 100 times earnings in 2000. It was a great company, but it was a terrible stock.)

Remember that buying a stock means becoming part owner in a business. By treating your stocks as businesses, you'll find yourself focusing more on the things that matter—such as free cash flow—and less on the things that don't—such as whether the stock went up or down on a given day.

Your goal as an investor should be to find wonderful businesses and purchase them at reasonable prices. Great companies create wealth, and as the value of the business grows, so should the stock price in time. In the short term, the market can be a capricious thing—wonderful businesses can sell at fire-sale prices, while money-losing ventures can be valued as if they had the rosiest of futures—but over the long haul, stock prices tend to track the value of the business.

It's the Business that Matters

In this book, I want to show you how to focus on a company's fundamental financial performance. Analyst upgrades and chart patterns may be fine tools for traders who treat Wall Street like a casino, but they're of little use to investors who truly want to build wealth in the stock market. You have to get your hands dirty and understand the businesses of the stocks you own if you hope to be a successful long-term investor.

When firms do well, so do their shares, and when business suffers, the stock will as well.

Wal-Mart, for example, hit a speed bump in the mid-1990s when its growth rate slowed down a bit—and its share price was essentially flat during the same period. On the other hand, Colgate-Palmolive posted great results during the late 1990s as it cut fat from its supply chain and launched an innovative toothpaste that stole market share—and the company's stock saw dramatic gains at the same time. The message is clear: Company fundamentals have a direct effect on share prices.

This principle applies only over a long time period—in the short term, stock prices can (and do) move around for a whole host of reasons that have nothing whatsoever to do with the underlying value of the company. We firmly advocate focusing on the long-term performance of businesses because the short-term price movement of a stock is completely unpredictable.

Think back to the Internet mania of the late 1990s. Wonderful (but boring) businesses such as insurance companies, banks, and real estate stocks traded at incredibly low valuations, even though the intrinsic worth of these businesses hadn't really changed. At the same time, companies that had not a prayer of turning a profit were being accorded billion-dollar valuations.

The Long-Term Approach

Given the proclivity of Mr. Market to plead temporary insanity at the drop of a hat, we strongly believe that it's not worth devoting any time to predicting its actions. We're not alone in this. After talking to literally thousands of money managers over the past 15 years or so, we've discovered that none of the truly exceptional managers spend any time at all thinking about what the market will do in the short term. Instead, they all focus on finding undervalued stocks that can be held for an extended time.

There are good reasons for this. Betting on short-term price movements means doing a large amount of trading, which drives up taxes and transaction costs. The tax on short-term capital gains can be almost double the rate of long-term capital gains, and constant trading means paying commissions more frequently. As we'll discuss in Chapter 1, costs such as these can be a huge drag on your portfolio, and minimizing them is the single most important thing you can do to enhance your long-term investment returns.

We've seen this borne out in long-term studies of mutual fund returns: Funds with higher turnover—ones that trade more—generally post lower results than their more deliberate peers, to the tune of about 1.5 percentage points per year over 10 years. This may not sound like much, but the difference between a 10 percent annual return and an 11.5 percent annual return on a $10,000 investment is almost $3,800 after 10 years. That's the price of impatience.[1]

Having the Courage of Your Convictions

Finally, successful stock-picking means having the courage to take a stance that's different from the crowd. There will always be conflicting opinions about the merits of any company, and it's often the companies with the most conflict surrounding them that make the best investments. Thus, as an investor, you have to be able to develop your own opinion about the value of a stock, and you should change that value only if the facts warrant doing so—not because you read a negative news article or because some pundit mouths off on TV. Investment success depends on personal discipline, not on whether the crowd agrees or disagrees with you.

Let's Get Started

My goal in this book is to show you how to think for yourself, ignore the day-to-day noise, and make profitable long-term investment decisions. Here's our road map.

First, you need to develop an investment philosophy, which I'll discuss in Chapter 1. Successful investing is built on five core principles:

1. Doing your homework
2. Finding companies with strong competitive advantages (or economic moats)
3. Having a margin of safety
4. Holding for the long term
5. Knowing when to sell

Building a solid stock portfolio should be centered on these five ideas; once you know them, you'll be ready to start learning how to look at companies.

Second, I'll take a step back and review what *not* to do—because avoiding mistakes is the most profitable strategy of all. In Chapter 2, I'll go over the

---

[1] Alice Lowenstein, "The Low-Turnover Advantage," *Morningstar Mutual Funds,* 30 (August 15, 1997): S1–S2.

most common mistakes that investors make. If you steer clear of these, you'll start out ahead of the pack.

In Chapter 3, I'll show you how to separate great companies from mediocre ones by analyzing competitive advantages, which we call *economic moats.* I'll explain how economic moats are what help great companies keep their top-tier status and why they're a big part of what separates long-run winners from flashes in the pan. Understanding the sources of a firm's economic moat is critical to thoroughly analyzing a company.

Chapters 4 through 7 show you how to analyze companies by reading their financial statements. First, I'll describe how financial statements work—what the line items mean and how the different statements fit together. Once you know how to read balance sheets and income statements, I'll show you a five-step process for putting all the numbers in context and finding out just how solid a company really is. I'll also show you how to evaluate management.

In Chapter 8, we'll look at how you can detect aggressive accounting, and I'll tell you what red flags to watch out for so you can minimize the odds of a big blowup in your portfolio.

In Chapters 9 and 10, I'll show you how to value stocks. You'll learn the underlying theory of investment value, when ratios such as price-to-earnings are (and aren't) useful, and how to figure out whether a stock is trading for more or less than its intrinsic value. The cheapest stock isn't always the best investment, and what looks expensive may actually be cheap when viewed from another angle.

Chapter 11 provides two case studies. I'll apply the tools presented in the previous chapters to two real-world companies, so you can see for yourself how the process of fundamental analysis works in practice.

In Chapter 12, I'll explain the 10-Minute Test, a quick-and-dirty checklist that can help you separate firms that are unlikely to be worth your time from the ones that deserve a thorough, in-depth examination.

In Chapters 13 through 26, I'll lean on Morningstar's team of equity analysts to give you tips for analyzing different sectors of the stock market. From semiconductors to drugs to banks, we'll tell you exactly what you need to know to analyze companies from every corner of the market. You'll learn what industry-specific characteristics separate the great firms from the also-rans, what industry jargon means, and which industries are more (and less) likely to offer fertile hunting ground for great investment ideas.

Finally, we'll wrap up with some recommended readings for those who want to learn more.

The structure of the book is the same as the basic investment process that we advocate: Develop a set of investing principles, understand the company's competitive environment, analyze the company, and value the stock. If you can follow this process while avoiding most big mistakes, you'll do just fine as an investor.

I

The Five Rules for Successful Stock Investing

It always amazes me how few investors—and sometimes, fund managers—can articulate their investment philosophy. Without an investing framework, a way of thinking about the world, you're going to have a very tough time doing well in the market.

I realized this some years ago while attending the annual meeting of Berkshire Hathaway, the firm run by billionaire superinvestor Warren Buffett. I overheard another attendee complain that he wouldn't be attending another Berkshire meeting because "Buffett says the same thing every year." To me, that's the whole point of having an investment philosophy and sticking to it. If you do your homework, stay patient, and insulate yourself from popular opinion, you're likely to do well. It's when you get frustrated, move outside your circle of competence, and start deviating from your personal investment philosophy that you're likely to get into trouble.

Here are the five rules that we recommend:

1. Do your homework.
2. Find economic moats.
3. Have a margin of safety.
4. Hold for the long haul.
5. Know when to sell.

Do Your Homework

This sounds obvious, but perhaps the most common mistake that investors make is failing to thoroughly investigate the stocks they purchase. Unless you know the business inside and out, you shouldn't buy the stock.

This means that you need to develop an understanding of accounting so that you can decide for yourself what kind of financial shape a company is in. For one thing, you're putting your own money at risk, so you should know what you're buying. More important, investing has many gray areas, so you can't just take someone else's word that a company is an attractive investment. You have to be able to decide for yourself because one person's hot growth stock is another's disaster waiting to happen. In Chapters 4 through 7, I'll show you what you need to know about accounting and how to boil the analysis process down to a manageable level.

Once you have the tools, you need to take time to put them to use. That means sitting down and reading the annual report cover to cover, checking out industry competitors, and going through past financial statements. This can be tough to do, especially if you're pressed for time, but taking the time to thoroughly investigate a company will help you avoid many poor investments.

Think of the time you spend on research as a cooling-off period. It's always tempting when you hear about a great investment idea to think you have to act now, before the stock starts moving—but discretion is almost always the better part of valor. After all, your research process might very well uncover facts that make the investment seem less attractive. But if it is a winner and if you're truly a long-term investor, missing out on the first couple of points of upside won't make a big difference in the overall performance of your portfolio, especially since the cooling-off period will probably lead you to avoid some investments that would have turned out poorly.

Find Economic Moats

What separates a bad company from a good one? Or a good company from a great one?

In large part, it's the size of the economic moat a company builds around itself. The term *economic moat* is used to describe a firm's competitive advantage—in the same way that a moat kept invaders of medieval castles at bay, an economic moat keeps competitors from attacking a firm's profits.

In any competitive economy, capital invariably seeks the areas of highest expected return. As a result, the most profitable firms find themselves beset by competitors, which is why profits for most companies have a strong tendency over time to *regress to the mean.* This means that most highly profitable companies tend to become less profitable as other firms compete with them.

Economic moats allow a relatively small number of companies to retain above-average levels of profitability for many years, and these companies are often the most superior long-term investments. Longer periods of excess profitability lead, on average, to better long-term stock performance.

Identifying economic moats is such a critical part of the investing process that we'll devote an entire chapter—Chapter 3—to learning how to analyze them. Here's a quick preview. The key to identifying wide economic moats can be found in the answer to a deceptively simple question: How does a company manage to keep competitors at bay and earn consistently fat profits? If you can answer this, you've found the source of the firm's economic moat.

Have a Margin of Safety

Finding great companies is only half of the investment process—the other half is assessing what the company is worth. You can't just go out and pay whatever the market is asking for the stock because the market might be demanding too high a price. And if the price you pay is too high, your investment returns will likely be disappointing.

The goal of any investor should be to buy stocks for less than they're really worth. Unfortunately, it's easy for estimates of a stock's value to be too optimistic—the future has a nasty way of turning out worse than expected. We can compensate for this all-too-human tendency by buying stocks only when they're trading for substantially less than our estimate of what they're worth. This difference between the market's price and our estimate of value is the margin of safety.

Take Coke, for example. There's no question that Coke had a solid competitive position in the late 1990s, and you can make a strong argument that it still does. But folks who paid 50 times earnings for Coke's shares have had a tough time seeing a decent return on their investment because they ignored a critical part of the stock-picking process: having a margin of safety. Not only was Coke's stock expensive, but even if you thought Coke was worth 50 times earnings, it didn't make sense to pay full price—after all, the assumptions that led you to think Coke was worth such a high price might have been too optimistic. Better to have incorporated a margin of safety by paying, for example, only 40 times earnings in case things went awry.

Always include a margin of safety into the price you're willing to pay for a stock. If you later realize you overestimated the company's prospects, you'll have a built-in cushion that will mitigate your investment losses. The size of your margin of safety should be larger for shakier firms with uncertain futures and smaller for solid firms with reasonably predictable earnings. For example, a 20 percent margin of safety would be appropriate for a stable firm such as Wal-Mart, but you'd want a substantially larger one for a firm such as Abercrombie & Fitch, which is driven by the whims of teen fashion.

Sticking to a valuation discipline is tough for many people because they're worried that if they don't buy today, they might miss the boat forever on the stock. That's certainly a possibility—but it's also a possibility that the company will hit a financial speed bump and send the shares tumbling. The future is an uncertain place, after all, and if you wait long enough, most stocks will sell at a decent discount to their fair value at one time or another. As for the few that just keep going straight up year after year—well, let's just say that *not making* money is a lot less painful than *losing* money you already have. For every Wal-Mart, there's a Woolworth's.

One simple way to get a feel for a stock's valuation is to look at its historical price/earnings ratio—a measure of how much you're paying for every dollar of the firm's earnings—over the past 10 years or more. (We have 10 years' worth of valuation data available free on Morningstar.com, and other research services have this information as well.) If a stock is currently selling at a price/earnings ratio of 30 and its range over the past 10 years has been between 15 and 33, you're obviously buying in at the high end of historical norms.

To justify paying today's price, you have to be plenty confident that the company's outlook is better today than it was over the past 10 years. Occasionally, this is the case, but most of the time when a company's valuation is significantly higher now than in the past, watch out. The market is probably overestimating growth prospects, and you'll likely be left with a stock that underperforms the market over the coming years.

We'll talk more about valuation in Chapters 9 and 10, so don't worry if you're still wondering how to value a stock. The key thing to remember for now is simply that if you don't use discipline and conservatism in figuring out the prices you're willing to pay for stocks, you'll regret it eventually. Valuation is a crucial part of the investment process.

Hold for the Long Haul

Never forget that buying a stock is a major purchase and should be treated like one. You wouldn't buy and sell your car, your refrigerator, or your DVD player 50 times a year. Investing should be a long-term commitment because short-term trading means that you're playing a loser's game. The costs really begin to add up—both the taxes and the brokerage costs—and create an almost insurmountable hurdle to good performance.

If you trade frequently, you'll rack up commissions and other expenses that, over time, could have compounded. Every $1 you spend on commissions today could have been turned into $5.60 if you had invested that dollar at 9 percent for 20 years. Spend $500 today and you could be giving up more than $2,800 20 years hence.

But that's just the beginning of the story because frequent trading also dramatically increases the taxes you pay. And whatever amount you pay in taxes each year is money that can't compound for you next year.

Let's look at two hypothetical investors to see what commissions, trading, and taxes can do to a portfolio. Long-Term Lucy is one of those old-fashioned fuddy-duddies who like to buy just a few stocks and hang on to them for a long time, and Trader Tim is a gunslinger who likes to get out of stocks as soon as he's made a few bucks (see Figure 1.1).

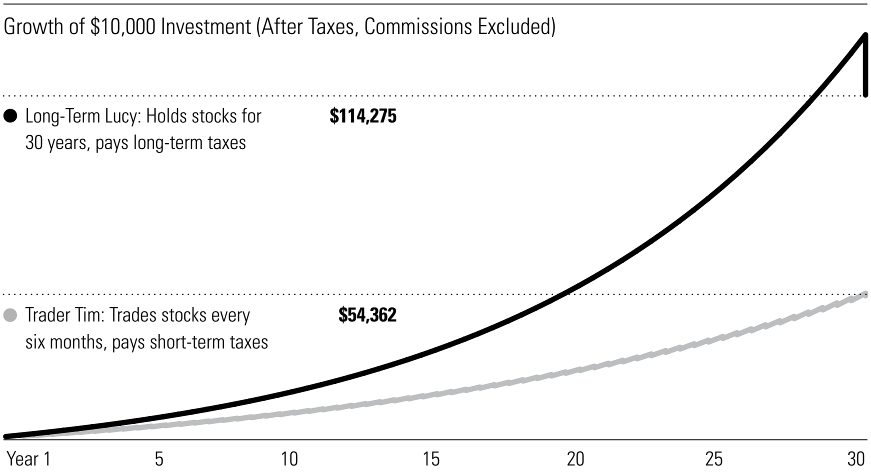

Figure 1.1 Tim turns over his portfolio every six months, incurring a 35% short-term capital gains tax. Lucy's gains are taxed at only 15% thanks to her buy-and-hold strategy, and more of her money compounds over a longer time. *Source:* Morningstar, Inc.

Lucy invests $10,000 in five stocks for 30 years at a 9 percent rate of return and then sells the investment and pays long-term capital gains of 15 percent. Tim, meanwhile, invests the same amount of money at the same rate of return but trades the entire portfolio twice per year, paying 35 percent short-term capital gains taxes on his profits and reinvesting what's left. We'll give them both a break and not charge them any commissions for now.

After 30 years, Lucy has about $114,000, while Tim has less than half that amount—only about $54,000. As you can see, letting your money compound without paying Uncle Sam every year makes a huge difference, even ignoring brokerage fees.

And since holding a single stock for 30 years may not be realistic, let's consider what happens if Lucy sells her entire portfolio every five years, reinvesting the proceeds each time. In this case, she winds up with about $96,000—which is not much less than $114,000 and is still much more than Tim's $54,000 (see Figure 1.2).

These examples look at just the tax impact of frequent trading—things look even worse for the traders once we factor in commissions. If we assume that Tim and Lucy pay $15 per trade, Tim nets only about $31,000 after 30

Growth of $10,000 Investment (After Taxes, Commissions Excluded)

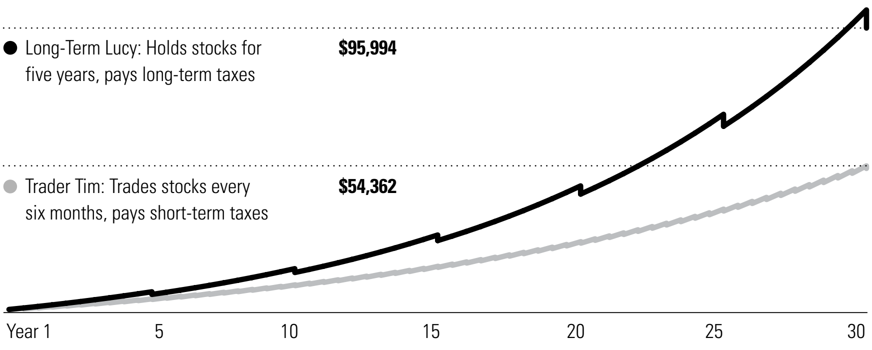

Figure 1.2 Lucy decreases her holding period to 5 years from 30 years, but the benefit of lower taxes and a longer compounding period still nets her significantly more than Tim. *Source:* Morningstar, Inc.

years and Lucy nets $93,000, again assuming she holds her stocks for five years (see Figure 1.3).

The real-world costs of taxes and commissions can take a big bite out of your portfolio. Extending your average holding period from six months to five years yields about $62,000 in extra investment returns. Lucy gets a lavish reward for her patience, don't you think?

One final thought: To match Lucy's $93,000 portfolio value, Tim would need to generate returns of around 14 percent each year instead of 9 percent. That's the true cost of frequent trading in this example—about five percentage points per year. So, if you really think that churning your portfolio will get you five extra percentage points of performance each year, then trade away. If, like the rest of us, you were taught some humility by the bear market, be patient—it'll pay off.

Know When to Sell

Ideally, we'd all hold our investments forever, but the reality is that few companies are worth holding for decades at a stretch—and few investors are savvy enough to buy only those companies. Knowing when it's appropriate to bail

Growth of $10,000 Investment (After Taxes, Commissions Included)

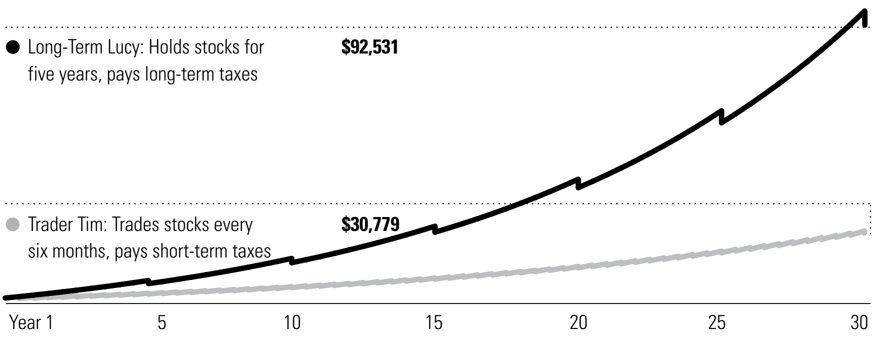

Figure 1.3 When commissions are taken into account, Tim's returns suffer far more than Lucy's. *Source:* Morningstar, Inc.

out of a stock is at least as important as knowing when to buy one, yet we often sell our winners too early and hang on to our losers for too long.

The key is to constantly monitor the *companies* you own, rather than the *stocks* you own. It's far better to spend some time keeping up on the news surrounding your companies and the industries in which they function than it is to look at the stock price 20 times a day.

Before I discuss when you *should* sell a stock, I ought to point out when you *shouldn't* sell.

The Stock Has Dropped

By themselves, share-price movements convey no useful information, especially because prices can move in all sorts of directions in the short term for completely unfathomable reasons. The long-run performance of stocks is largely based on the expected future cash flows of the companies attached to them—it has very little to do with what the stock did over the past week or month.

Always keep in mind that it doesn't matter what a stock has done since you bought it. There's nothing you can do to change the past, and the market cares not one whit whether you've made or lost money on the stock. Other