Stock Market Trading Rules

Collected Wisdom From 80 International Stock Market Experts

Edited by Philip Jenks and
Stephen Eckett

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We also thank them for producing such thought-provoking rules. One of our worries when we started was that the book would end up with a series of variations on 'Cut losses and run profits'! As it turned out, the material was far more interesting and diverse than that. In all cases the personality of the contributor comes through strongly, confirming that investing is more than the dry science it is sometimes assumed to be.

Thank you, too, to everybody at Harriman House who helped on the book.

Philip Jenks, Stephen Eckett

Introduction

Back in 2001, now more than a decade ago, we compiled and published *The Harriman House Book of Investing Rules*. The project was a huge success – the rules provided by the contributors were fascinating, insightful and entertaining – and for the first time the book pooled together collected wisdom of 150 of the world's greatest traders in one place.

One of the many strengths of the rules that were written for and included in the original publication was their timeless quality – these gems of investing and trading wisdom apply to a range of markets across a spread of time periods and are not confined to one market or one set of circumstances.

And so it is that the decision was made to republish the original rules in a more condensed form and in a new format. In this eBook – *The Original Harriman House Book of Trading Rules: Collected Wisdom From 80 International Stock Market Traders* – you will find just that; 80 sets of trading rules from expert international traders. As with the original publication, these rules provide distilled knowledge from experts on what they consider to the key determinants of trading success.

You will notice that the experts do not agree – this is intentional as trading is a diverse and conflicting pursuit – and you will notice that the rules are not comprehensive – this is also intentional, as this is a reference guide to be dipped into and to encourage you to take up further reading elsewhere on subjects that appeal to you.

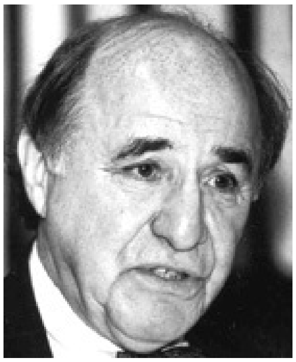
We hope you enjoy reading these rules and find them to be useful in clarifying some aspects of your trading approach.

The original publication of 150 rules is also available as an eBook, from all good online retailers.

www.harriman-house.com/investingrules

Philip Jenks, Stephen Eckett

Robert Z. Aliber



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His research activities include: the international financial system; exchange rate issues; international money, capital markets and capital flows; the multinational firm; international banking; public policy issues.

BOOKS

The New International Money Game, Palgrave, 2001

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The Selected Essays of Robert Aliber (Economists of the Twentieth Century.) Edward Elgar, 2004

The Multinational Paradigm, The MIT Press, 2003

Manias, Panics and Crashes: A History of Financial Crises (Charles P. Kindleberger), Palgrave Macmillan, 2005

International markets and capital flows

1. All propositions about rates of return in financial markets are clichés.

Market literature is full of rules about achieving above average returns. These rules are clichés rather than eternal truths. No scientific proposition about beating the market beats the market for an extended period.

2. Financial markets are mean-reverting.

Prices in financial markets always tend to move back toward equilibrium values when they are not moving away from these equilibrium values.

3. Currency markets overshoot and undershoot and equity markets overshoot and undershoot.

There are observable trend values in both the currency markets and the stock markets. The variations around these trends (overshooting and undershooting) reflect the variability of cross border flows of capital in the foreign exchange markets and changes in investor optimism and pessimism in the stock markets.

4. Buy and hold strategies generally are less rewarding than trading strategies.

The cliché that “markets can't be timed” may be right for some investors all of the time, and for all investors some of the time, but there are times when market prices are far above or far below their long run equilibrium prices.

5. Watch the capital flows in and out of countries.

An increase in the inflow of capital to a country is likely to be associated with an increase in the foreign exchange value of its currency and an increase in prices of stocks of firms headquartered in the country.

6. An increase in the inflation rate in a country is likely to be associated with a depreciation of its currency.

It is also likely to lead to a decrease in prices of stocks of domestic firms.

7. The smaller the country, the larger the impact of capital flows on currency values and stock prices.

Because of the positive correlation between changes in currency values and changes in stock prices, global investing is much more opportunistic than domestic investing.

8. Many firms have ‘fifteen minutes of fame’.

Few of the ‘Nifty Fifty’ firms that that were the market favorites in the 1960s are market leaders today.

9. The national location of the low cost center of production of particular products shifts among countries.

So does the national identity of the most profitable firms in an industry when viewed in a global context.

10. The size of the investor's domestic market matters.

The strength of the case for global investing by the residents of each country is inversely related to the size of the domestic market and the growth rate for new companies. Investors resident in relatively small countries have a much stronger need to diversify internationally than investors resident in larger countries.

11. U.S. investors may not need to invest internationally as much as investors from other countries.

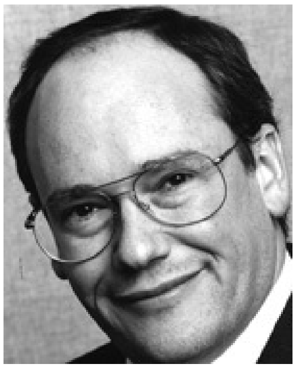
The share of rapid growth companies headquartered in the United States is disproportionately large relative to the U.S. share of global GDP.

12. Currency hedging is not useful for all.

The cost of hedging the foreign exchange exposure is likely to be positive for currencies with a tendency to depreciate and negative for currencies with a tendency to appreciate.

> *'Stocks are unquestionably riskier than bonds in the short run, but for longer periods of time, their risk falls below that on bonds. For 20 year holding periods, they have never fallen behind inflation, while bonds and bills have fallen 3 per cent per year behind inflation over the same time period. So although it might appear to be riskier to hold stocks than bonds, precisely the opposite is true if you take a long-term view.'*
>
> Jeremy Siegel

Nick Antill



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BOOKS

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Valuing Oil and Gas Companies: A Guide to the Assessment and Evaluation of Assets, Performance and Prospects (Robert Arnott), 2000

Company valuation

1. The most often-repeated mistake in finance is “It doesn't matter - it's only a non-cash item”.

While it is true that the value of a company is the discounted value of its future free cash flows, it does not follow that non-cash items do not matter. There is a clear difference between provisions for deferred taxation that are unlikely ever to be paid, and provisions for decommissioning a nuclear power station - a large future cost that will certainly be incurred.

2. It is easy to get to a high value for a company - just underestimate the capital investments that it will need to make.

There are three components to a cash flow forecast: profit, which is often analysed quite carefully; depreciation and other non-cash items, which are usually analysed adequately; and capital expenditure, which is often a banged-in number that is quite inconsistent with the other two, and generally much too low.

3. Valuations must be based on realistic long term assumptions - at best GDP growth rates and barely adequate returns.

It is tempting, when valuing fast growing companies with strong technical advantages over their rivals, to assume that these conditions will continue forever. They will not. As the saying goes, 'In the end, everything is a toaster'. If this means that the forecast needs to be a very long one, so be it - it will be less inaccurate than running a valuation off an accurate five year forecast, and then extrapolating this to infinity.

4. Don't spend too much time worrying about financial efficiency.

Playing mathematical games with the weighted average cost of capital is tempting and fun, but generally has a disappointingly small effect on valuation. Substituting debt for equity shifts value from the government to the providers of capital because the company pays less tax. That is it. And even then there is an offsetting factor - it is more likely to incur everyone the inconvenience of going bankrupt.

5. Remember the ‘Polly Peck phenomenon’, especially in countries with high inflation.

If a company operates in a weak currency with high inflation, its revenues, costs and profits will probably grow quickly. If it funds itself by borrowing in a strong currency, with low interest rates, it will pay little interest, but will tend to make large unrealised currency losses on its debt. It may still be looking very profitable on the day that it is declared insolvent.

6. Unfunded pension schemes should be treated as debt.

Many companies fund their employees' pensions by paying into schemes operated by independent fund managers. These schemes are off their balance sheets. Some companies operate a 'pay-as-you-go' system. They will show a provision for pension liabilities on their balance sheets, generally offset by a pile of cash among their assets. These companies are effectively borrowing from their employees - the provision should be treated as debt.

7. Remember to ask: ‘Who's cash flow is it anyway?’

Companies consolidate 100% of the accounts of their subsidiaries, even if they only own 51% of the shares in the subsidiary. In the profit and loss account the profit that is not attributable to their shareholders is deducted and shown as being attributable to third parties. Unless it is paid out in dividend, however, the cash remains inside the company. This means that the popular ‘cash flow per share’ measure implies that the shares should be valued by including something that does not belong to them - they should not.

8. Accounting depreciation is a poor measure of impairment of value.

If an asset is bought for £100 and has a five year life then it will be depreciated at a rate of £20 a year. This is not the same as saying that its value falls at a rate of £20 a year. The result is that the profitability of the asset is generally understated early in its life and overstated later in its life. This means that companies' profitability tends to be understated when they grow, and overstated when they stop growing.

9. You can’t judge an acquisition by whether it adds to earnings.

Acquisitions are just very big, very long term, investments. So they are extreme examples of the rule mentioned above that new investments tend to look unprofitable in the early years. This does not mean that they are bad investments. Company managers have preferred not to explain this awkward fact, but to evade it by using accounting tricks to avoid creating and amortising goodwill. New accounting rules are increasingly making this more difficult. It should not matter, but managers still believe that it does.

10. Operating leases are debt - they just don’t look like it.

Companies often lease assets - aeroplanes, ships or hotels, for example. If the lease effectively transfers the asset, it is a finance lease, and looks like debt in the accounts. If it doesn’t then the lease just appears as rental payments in the operating costs. But it is still debt, and the shares will still reflect that fact, being much more volatile than it looks as if they ‘ought’ to be.

> *‘The backlash against analysts is in full swing. Don’t be diverted by the spectacle, however enjoyable it might appear. Use the research available dispassionately. As in all human life, you’ll find there’s good and bad there. Just be sure, once you’ve digested, to formulate your own conclusions.’*
>
> Edmond Warner

Martin Barnes

Martin Barnes is Managing Editor of *The Bank Credit Analyst*. He has almost 30 years of experience in analyzing and writing about global economic and financial market developments. In recent years, he has written extensively about new technologies and long-wave cycles, the financial market implications of low inflation and trends in corporate profitability.

General principles and the role of liquidity

1. Know when to be a contrarian.

The crowd is often correct for long periods of time, so it does not always pay to be a contrarian. The time to bet against the crowd is when market prices deviate significantly from underlying fundamentals. For example, gold has been in a bear market for years and it has been correct to stay negative toward the market given the falling trend of inflation. Contrarian strategies have not worked. On the other hand, the surge in technology stocks in 1999/2000 in the face of suspect earnings trends clearly provided an excellent opportunity to take a contrarian stance and this paid huge dividends when the bubble inevitably burst.

2. Don’t use yesterday’s news to forecast tomorrow’s markets.

Many people make the mistake of forecasting the stock market on the basis of current economic data (which usually relate to developments of at least a month ago). This is a mistake because the stock market leads rather than follows the economy. It makes more sense to use the stock market as an indication of what the economy is likely to do in the future. By the time that the economic data has confirmed a trend, the market is often discounting the next phase of the cycle. The market is forward looking while economic data are backward looking.

3. Liquidity is key.

All great bull markets are rooted in easy money. Stimulative monetary conditions mean low interest rates that, in turn, encourage investors to take on more risk. Buoyant liquidity will always find its way into asset markets, pushing prices higher. The corollary is that a bull market cannot persist in the face of tightening liquidity. Thus, investors must pay close attention to the factors that drive monetary policy.

4. Understanding the inflation trend is critical to success.

Following on from the previous rule, inflation is the single most important economic variable when it comes to predicting the trends in financial markets. Rising inflation is toxic for both bonds and stocks because it points to tighter monetary policy and rising interest rates. On the other hand, falling inflation is extremely bullish for the opposite reasons. Most bear markets have occurred in response to rising inflation pressures. Correspondingly, falling inflation was the single most important force behind the powerful bull markets in bonds and stocks during the 1980s and 1990s.

5. Take a long-run view.

An increased focus on the short run has become one of the scourges of modern life. Companies are often more obsessed with propping up near-term earnings than with taking long-term strategic decisions, while investors are often looking for quick gratification when they buy stocks. The day-trading mania was the most extreme manifestation of this. Patience is a virtue when investing because even the best ideas sometimes take a while to play out. By all means abandon ship when fundamental conditions deteriorate. However, if you are confident that you have a purchased a good company, then don’t despair just because the price does not rise right away – as long as the fundamentals remain positive.

6. Allocate a small part of your portfolio to ‘play’ with.

It is okay to take speculative risks with some of your investments. However, don’t bet the ranch on a long shot. A good strategy is to have the vast bulk of your portfolio in a diversified group of blue-chip investments, and to leave a small amount for higher-risk opportunities. That way, you get the best of both worlds. The bulk of your assets is relatively protected, but you can still have some ‘fun’ chasing some hot ideas.

7. The stock market rises most of the time.

Bear markets are the exception rather than the rule. The market rises about two-thirds of the time. This means you should avoid being trapped in a bear market psychology for long periods of time. There are always reasons to be gloomy about the outlook, whether it relates to valuations, economic conditions or structural concerns such as debt levels. The U.S. economy is extremely resilient and it has generally paid to err on the side of bullishness. There have been long bear markets in the past, but these have usually occurred in the context of disastrous economic environments such as deflation (the 1930s) or high inflation (the 1970s). Neither environment is likely for the foreseeable future.

8. Know when you are speculating.

You invest in a company when you are buying shares in order to participate in its long-run growth. You are speculating when you are buying shares only because you expect to sell them at a higher price to someone else, and you are not even looking at the company’s fundamentals. It is okay to do both, but you must understand the difference. For example, the internet mania was all speculation because few companies were making profits and few investors were holding the shares for long enough to benefit from the discovery of the next Microsoft. When you know that you are speculating, then you will be more ready to bail out quickly when market conditions turn sour.

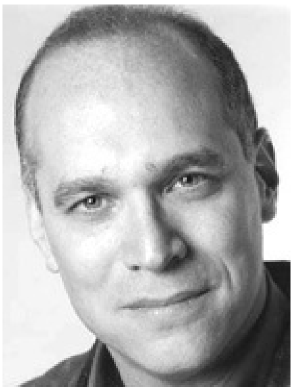
9. Have realistic expectations.

Between 1982 and 2000, Wall Street enjoyed its most powerful bull market of all time with average annual returns of about 15% a year after inflation. This was close to twice its historical average. The exceptional returns reflected falling inflation, a revival in corporate profitability and a revaluation of the market from cheap to expensive. Those forces have now been fully exploited and long-run returns are likely to average less than 6% a year after inflation in the next decade. Investor expectations are for much higher returns according to various surveys, and that can only lead to disappointment and increased risk taking.

> *'Research suggests we tend to become more confident and less accurate as we process increasing amounts of information. As most people can handle no more than seven pieces of information at once, it is wise to employ no more than seven criteria for choosing each stock.'*

Paul Melton

Gary Belsky



Gary Belsky was a writer at *Money* magazine from 1991 to 1998. From 1994 to 1998 he was a regular weekly commentator on CNN's *Your Money* and a frequent contributor to *Good Morning America*, *CBS This Morning*, *Crossfire* and *Oprah*. He is currently a deputy editor at *ESPN The Magazine*.

In 1990, Belsky won the Gerald Loeb Award for Distinguished Business and Financial Journalism, administered by The Anderson School at UCLA. He lives in New York.

BOOKS

Why Smart People Make Big Money Mistakes and How They Correct Them (co-authored with Thomas Gilovich), Fireside, 2000

ESPN the Magazine Presents: Answer Guy: Extinguishing the Burning Questions of Sports with the Water Bucket of Truth (Brendan O'Connor, Neil Fine), Hyperion Books, 2002

23 Ways to Get to First Base: The ESPN Sports Uncyclopedia, ESPN Books, 2006

Behavioral finance

1. Every dollar spends the same.

People tend to treat money differently depending on where it’s come from. They spend money received as a gift, bonus or tax refund freely and easily, while spending other money - money they’ve earned - more carefully. Try not to compartmentalise your money in this way. Treat it all the same. One way to do this is to park ‘found’ money in a savings account before you decide what to do with it. The more time you have to think of money as savings - hard-earned or otherwise - the less likely you’ll be to spend it recklessly.

2. Control your fear of losses.

A bedrock principle of behavioral economics is that the pain people feel from losing $100 is much greater than the pleasure they get from winning $100. Be careful that this does not lead you to cling on to losing investments in the hope that they'll return to profit, or to sell good investments during periods of market turmoil when holding them would be better in the long term.

3. Look at decisions from all points of view.

Too many choices make choosing harder. If you suffer from ‘decision paralysis’ try looking at the options from a different perspective. For instance, if you are trying to decide between different stocks or funds, imagine that you already own them all. Your decision then becomes one of rejection (“which one am I least comfortable owning?”) rather than of selection, and you may find this helps.

4. All numbers count, even if you don’t like to count them.

The tendency to dismiss or discount small numbers as insignificant - the ‘bigness bias’ - can lead you to pay more than you need to for brokerage commissions and fund charges. Over time, this can have a surprisingly deleterious effect on your investment returns. Avoid this ‘bigness bias’. Count all the numbers.

5. Acknowledge the role of chance.

A failure to fully grasp the role that chance plays in life leads many investors to be overly-impressed with short-term success and other random or unusual occurrences. Thus, many investors pour money into mutual funds that have performed well in recent years under the mistaken belief that the funds' success is the result of something other than dumb luck.

6. Your confidence is often misplaced.

Nearly everyone falls prey, at some time or another, to an overestimation of their knowledge and abilities. Most dangerous for investors is the delusion that, with a little knowledge or homework, you can pick investments with better-than-average success. In reality, there is little reason for even the most sophisticated investor to believe that she can pick stocks - or mutual funds - better than the average man or woman on the street.

7. It’s hard to admit mistakes.

This sounds basic, but we’re not talking about pride so much as the subconscious inclination people have to confirm what they already know or want to believe. Because of this ‘confirmation bias’ it’s important to share your financial decisions with others - seeking not only specific advice, but also critiques of your decision-making process.

8. The trend may not be your friend.

In the long term, conventional wisdom is often on target - as it has been over the past 25 years in the trend away from fixed income investments towards stocks. In the short run, however, the vagaries of crowd behavior - particularly ‘information cascades’ that result in dramatic shifts in tastes and actions - frequently lead to costly overreactions and missed opportunities. Treat trends and fads with skepticism and caution.

9. You can know too much.

Knowledge is power, but too much ‘illusory’ information can be destructive. Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, much of it meaningless.

10. Don’t check your investments too regularly.

The less frequently you check on your investments, the less likely you’ll be to react emotionally to the natural ups and downs of the securities markets. For most investors, a yearly review of their portfolios is frequent enough.

> *‘There is no such thing as a ‘hold’ decision. If you wouldn’t buy the stock again today, assuming you had additional money, you should either sell, or admit that you are confused.’*

Robert V. Green

William Bernstein

William Bernstein is a principal in Efficient Frontier Advisors, a Connecticut investment management firm. He also operates a nonprofit online journal of asset allocation and portfolio theory - www.efficientfrontier.com.

Bernstein has developed basic portfolio management principles for individual investors, contributed online pieces for *Money* and Morningstar.com, and is frequently quoted in *The Wall Street Journal* and other publications.

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The Four Pillars of Investment Success, McGraw-Hill, 2002

The Intelligent Asset Allocator, McGraw-Hill, 2000

The Birth of Plenty: How the Prosperity of the Modern World Was Created, McGraw-Hill Education, 2004

Intelligent asset allocation

1. The portfolio’s the thing.

Get used to the fact that, at any one time, a few parts of your portfolio will be doing terribly. Over a long enough time period, each and every component will have had a bad year or two. This is normal asset-class behavior and cannot be avoided. Focus on the performance of the portfolio as a whole, not the individual parts.

2. In asset allocation, job one is to pick an appropriate stock/bond mix.

This is determined primarily by your risk tolerance. Do not bite off more risk than you can chew - a classic beginner's mistake. Calmly and coolly planning for a market downturn is quite different from actually living through one, in the same way that crashing a flight simulator is different from crashing a real airplane. Time horizon is also important. Do not invest any money in stocks that you will need in less than five years, and do not invest more than half unless you will not need the money for at least a decade.

3. Allocate your stocks widely among many different asset classes.

Your biggest exposure should be to the broad domestic stock market. Use small stocks, foreign stocks, and real estate investment trusts (REITs) in smaller amounts.

4. It makes a difference where you put things.

Some asset classes, such as large foreign and domestic stocks, and domestic small stocks, are available in tax-efficient vehicles; put these in your taxable accounts. Other asset classes, particularly value stocks, REITs, and junk bonds, are highly tax-*in*efficient. Put these only in your tax-sheltered retirement accounts.

5. Don’t rebalance too often.

The benefit of rebalancing back to your policy allocation is that it forces you to sell high and buy low. Asset classes tend to trend up or down for up to a few years. Give this process a chance to work; you should not rebalance more often than once per year.

These rules apply to tax-sheltered accounts. In taxable accounts, rebalance only with outflows, inflows, and mandatory distributions; here, the rebalancing benefit is usually outweighed by the tax consequences.

6. The recent past is out to get you.

Human beings tend to be most impressed with what has happened in the past several years and wrongly assume that it will continue forever. It never does. The fact that large growth stocks performed extremely well in the late 1990s does not make it more likely that this will continue; in fact, it makes it slightly less likely. The performance of different kinds of stocks and bonds is best evaluated over the long haul.

7. If you want to be entertained, take up sky diving.

Investors like to have fashionable portfolios, invested in the era’s most exciting technologies. Resist the temptation. There is an inverse correlation between an investment’s entertainment value and its expected return; IPOs, on average, have low returns, and boring stocks tend to reward the most.

8. An asset allocation that maximizes your chances of getting rich also maximizes your chances of becoming poor.

Your best chance of making yourself fabulously wealthy through investing is to buy a few small stocks with good growth possibilities; you just might find the next Microsoft. Of course, it is far more likely that you will lose most of your money this way. On the other hand, although you cannot achieve extremely high returns with a diversified portfolio, it is the best way to avoid a retirement diet of cat food.

9. There is nothing new in investing.

A knowledge of financial history is the most potent weapon in the investor’s armamentarium. Since the dawn of stockbroking in the seventeenth century, every generation has experienced its own tech bust. The recent dot-com catastrophe was just one more act in finance’s longest running comedy. Be able to say to yourself, “I’ve seen this movie before, and I think I know how it ends.” The only thing that’s new is the history you haven’t read.

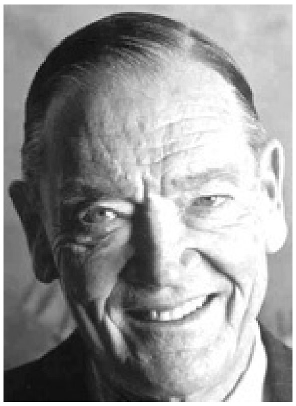
10. A portfolio of 15 to 30 stocks does not provide adequate diversification.

The myth that it does results from a misinterpretation of modern financial theory. While it is true that a 30-stock portfolio has no more short-term volatility than the market, there is more to risk than day-to-day fluctuations. The real risk is not that short-term volatility will be too high, but that long-term return will be too low. The only way of minimizing this risk is to own thousands of stocks in many nations. Or a few index funds.

> *‘Investment bankers are not driven by philanthropy or even by an intellectual motivation to understand the world of finance. They are out to make money and will sell the public anything within the bounds of the law.’*

Edward Chancellor

John C. Bogle



John C. Bogle is Founder of The Vanguard Group, Inc., and President of the Bogle Financial Markets Research Center.

The Vanguard Group is one of America's two largest mutual fund organizations, and comprises more than 100 mutual funds with current assets totaling more than $500 billion. Vanguard 500 Index Fund, now the largest mutual fund in the world, was founded by Mr. Bogle in 1975. It was the first index mutual fund.

For his 'exemplary achievement, excellence of practice, and true leadership', Mr. Bogle holds the AIMR Award for Professional Excellence, and is also a member of the Hall of Fame of the Fixed Income Analysts Society, Inc.

In 1999, he was named by *Fortune* magazine as one of the investment industry's four 'Giants of the 20th Century.'

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Common Sense Mutual Funds, John Wiley, 1999

John Bogle on Investing: The First 50 Years, McGraw-Hill, 2000

Common sense investing

1. There’s no escaping risk.

Once you decide to put your money to work to build long-term wealth, you have to decide, not whether to take risk, but what kind of risk you wish to take. ‘Do what you will, capital is at hazard,’ just as the Prudent Man Rule assures us.

Yes, money in a savings account is dollar-safe, but those safe dollars are apt to be substantially eroded by inflation, a risk that almost guarantees you will fail to reach your capital accumulation goals.

And yes, money in the stock market is very risky over the short-term, but, if well-diversified, should provide remarkable growth with a high degree of consistency over the long term.

2. Buy right and hold tight.

The most critical decision you face is getting the proper allocation of assets in your investment portfolio - stocks for growth of capital and growth of income, bonds for conservation of capital and current income. Once you get your balance right, then just hold tight, no matter how high a greedy stock market flies, nor how low a frightened market plunges. Change the allocation only as your investment profile changes. Begin by considering a 50/50 stock/bond balance, then raise the stock allocation if:

1. You have many years remaining to accumulate wealth.

2. The amount of capital you have at stake is modest (i.e. your first investment in a corporate savings plan).

3. You have little need for current income.

4. You have the courage to ride out the booms and busts with reasonable equanimity.

As these factors are reversed, reduce the 50 per cent stock allocation accordingly.

3. Time is your friend, impulse your enemy.

Think long term, and don’t allow transitory changes in stock prices to alter your investment program. There is a lot of noise in the daily volatility of the stock market, which too often is ‘a tale told by an idiot, full of sound and fury, signifying nothing’.

Stocks may remain overvalued, or undervalued, for years. Realize that one of the greatest sins of investing is to be captured by the siren song of the market, luring you into buying stocks when they are soaring and selling when they are plunging. Impulse is your enemy. Why? Because market timing is impossible. Even if you turn out to be right when you sold stocks just before a decline (a rare occurrence!), where on earth would you ever get the insight that tells you the right time to get back in? One correct decision is tough enough. Two correct decisions are nigh on impossible.

Time is your friend. If, over the next 25 years, stocks produce a 10% return and a savings account produces a 5% return, $10,000 would grow to $108,000 in stocks vs. $34,000 in savings. (After 3% inflation, $54,000 vs. $16,000). Give yourself all the time you can.

4. Realistic expectations: the bagel and the doughnut.

These two different kinds of baked goods symbolize the two distinctively different elements of stock market returns. It is hardly farfetched to consider that investment return - dividend yields and earnings growth - is the bagel of the stock market, for the investment return on stocks reflects their underlying character: nutritious, crusty and hard-boiled.

By the same token, speculative return - wrought by any change in the price that investors are willing to pay for each dollar of earnings - is the spongy doughnut of the market, reflecting changing public opinion about stock valuations, from the soft sweetness of optimism to the acid sourness of pessimism.

The substantive bagel-like economics of investing are almost inevitably productive, but the flaky, doughnut-like emotions of investors are anything but steady - sometimes productive, sometimes counterproductive.

In the long run, it is investment return that rules the day. In the past 40 years, the speculative return on stocks has been zero, with the annual investment return of 11.2% precisely equal to the stock market's total return of 11.2% per year. But in the first 20 of those years, investors were sour on the economy's prospects, and a tumbling price-earnings ratio provided a speculative return of minus 4.6% per year, reducing the nutritious annual investment return of 12.1% to a market return of just 7.5%. From 1981 to 2001, however, the outlook sweetened, and a soaring P/E ratio produced a sugary 5% speculative boost to the investment return of 10.3%.

Result: The market return leaped to 15.3% - double the return of the prior two decades.

The lesson: Enjoy the bagel’s healthy nutrients, and don’t count on the doughnut’s sweetness to enhance them.

Conclusion: Realistic expectations for the coming decade suggest returns well below those we have enjoyed over the past two decades.

5. Why look for the needle in the haystack? Buy the haystack!

Experience confirms that buying the right stocks, betting on the right investment style, and picking the right money manager - in each case, in advance - is like looking for a needle in a haystack.

When we do so, we rely largely on past performance, ignoring the fact that what worked yesterday seldom works tomorrow. Investing in equities entails four risks: stock risk, style risk, manager risk, and market risk. The first three of these risks can easily be eliminated, simply by owning the entire stock market - owning the haystack, as it were - and holding it forever.

Yes, stock market risk remains, and it is quite large enough, thank you. So why pile those other three risks on top of it? If you're not certain you're right (and who can be?), diversify.

Owning the entire stock market is the ultimate diversifier. If you can't find the needle, buy the haystack.

6. Minimize the croupier's take.

The resemblance of the stock market to the casino is not farfetched. Yes, the stock market is a positive-sum game and the gambling casino is a zero-sum game . . . but only before the costs of playing each game are deducted. After the heavy costs of financial intermediaries (commissions, management fees, taxes, etc.) are deducted, beating the stock market is inevitably a loser's game. Just as, after the croupiers' wide rake descends, beating the casino is inevitably a loser's game. All investors as a group must earn the market's return before costs, and lose to the market after costs, and by the exact amount of those costs.

Your greatest chance of earning the market's return, therefore, is to reduce the croupiers' take to the bare-bones minimum. When you read about stock market returns, realize that the financial markets are not for sale, except at a high price. The difference is crucial. If the market's return is 10% before costs, and intermediation costs are approximately 2%, then investors earn 8%. Compounded over 50 years, 8% takes $10,000 to $469,000. But at 10%, the final value leaps to $1,170,000—nearly three times as much . . . just by eliminating the croupier's take.

7. Beware of fighting the last war.

Too many investors - individuals and institutions alike - are constantly making investment decisions based on the lessons of the recent, or even the extended, past. They seek technology stocks after they have emerged victorious from the last war; they worry about inflation after it becomes the accepted bogeyman, they buy bonds after the stock market has plunged.

You should not ignore the past, but neither should you assume that a particular cyclical trend will last forever. None does. Just because some investors insist on ‘fighting the last war,’ you don’t need to do so yourself. It doesn’t work for very long.

8. Sir Isaac Newton's revenge on Wall Street - reversion to the mean.

Through all history, investments have been subject to a sort of Law of Gravity: What goes up must go down, and, oddly enough, what goes down must go up. Not always of course (companies that die rarely live again), and not necessarily in the absolute sense, but relative to the overall market norm.

For example, stock market returns that substantially exceed the investment returns generated by earnings and dividends during one period tend to revert and fall well short of that norm during the next period. Like a pendulum, stock prices swing far above their underlying values, only to swing back to fair value and then far below it.

Another example: From the start of 1997 through March 2000, NASDAQ stocks (+230%) soared past NYSE-listed stocks (+20%), only to come to a screeching halt. During the subsequent year, NASDAQ stocks lost 67% of their value, while NYSE stocks lost just 7%, reverting to the original market value relationship (about one to five) between the so-called 'New Economy' and the 'Old Economy.'

Reversion to the mean is found everywhere in the financial jungle, for the mean is a powerful magnet that, in the long run, finally draws everything back to it.

9. The hedgehog bests the fox.

The Greek philosopher Archilochus tells us, ‘the fox knows many things, but the hedgehog knows one great thing.’ The fox - artful, sly, and astute - represents the financial institution that knows many things about complex markets and sophisticated marketing. The hedgehog - whose sharp spines give it almost impregnable armor when it curls into a ball - is the financial institution that knows only one great thing: long-term investment success is based on simplicity.

The wily foxes of the financial world justify their existence by propagating the notion that an investor can survive only with the benefit of their artful knowledge and expertise. Such assistance, alas, does not come cheap, and the costs it entails tend to consume more value-added performance than even the most cunning of foxes can provide. Result: The annual returns earned for investors by financial intermediaries such as mutual funds have averaged less than 80% of the stock market’s annual return.

The hedgehog, on the other hand, knows that the truly great investment strategy succeeds, not because of its complexity or cleverness, but because of its simplicity and low cost. The hedgehog diversifies broadly, buys and holds, and keeps expenses to the bare-bones minimum. The ultimate hedgehog: The all-market index fund, operated at minimal cost and with minimal portfolio turnover, virtually guarantees nearly 100% of the market’s return to the investor.

In the field of investment management, foxes come and go, but hedgehogs are forever.

10. Stay the course: the secret of investing is that there is no secret.

When you consider these previous nine rules, realize that they are about neither magic and legerdemain, nor about forecasting the unforecastable, nor about betting at long and ultimately unsurmountable odds, nor about learning some great secret of successful investing. For there is no great secret, only the majesty of simplicity. These rules are about elementary arithmetic, about fundamental and unarguable principles, and about that most uncommon of all attributes, common sense.

Owning the entire stock market through an index fund - all the while balancing your portfolio with an appropriate allocation to an all bond market index fund - with its cost-efficiency, its tax-efficiency, and its assurance of earning for you the market's return, is by definition a winning strategy. But if only you follow one final rule for successful investing, perhaps the most important principle of all investment wisdom: Stay the course!

David Braun

David Braun founded and is President of Virtual Strategies Inc., a consultancy which advises clients on proactive acquisition or divestiture programs.

The firm has acted for small and family-owned businesses, as well as Fortune 500 and multinational companies, in a wide range of manufacturing and service industries.

Over the past 10 years, Mr Braun has lectured to over 10,000 top-level business executives, through the American Management Association and various industry organizations.

How to make gains from M&A activity

1. Invest in experienced buyers.

If you’re investing in a company that is entering acquisition mode, make sure the people running it are experienced in M&A. A company that has executed a few successful deals recently is a better bet than one which has just started to think about making acquisitions.

2. Back an acquiror with a comprehensive strategy.

To maximize the chances of making successful acquisitions, an acquirer needs to have a compelling external growth strategy, with associated milestones and timeline. Avoid investing in ‘one-trick ponies’ – those companies looking for the one silver bullet acquisition that will propel them to where they want to be.

3. The acquisition of a great company is only as good as its integration plan.

The acquiring company needs to have a solid integration plan that solicits involvement from key management in every major functional area. Look for evidence of a '100-Day Plan' which illustrates in detail exactly how the two companies will be fully integrated 100 days after 'go live' day (the close).

4. Ignore the financials.

Well, not entirely. But avoid investing in a company that is making acquisition decisions based on its CFO saying “we can get a great price on this company.” Remember, a balance sheet doesn’t generate profits - people do. Accretion/dilution should not be the number one acquisition criterion. Simply stated, you can overpay for a good company and recover your earnings with time, but you can underpay for the wrong company and never recover.

5. The customer is always right.

When deciding whether consolidation makes sense for a company whose stock you own, consider its customers. The mere fact that a sector is fragmented does not make it ready for consolidation, and conversely, there are plenty of fairly concentrated industries that are still managing to consolidate with impressive multiples (e.g. banking). A good rule of thumb is to look at the industry's customer base and determine if there is *demand* for consolidation. Good industries to watch are those that have major, multinational customers that will demand a wider-spreading presence.

6. When investing in potential takeover targets, do your homework.

Don’t rely on hunches, gut instinct, or market rumors. Identify companies that are likely sellers due to below average stock performance (and restless shareholders), older senior management, ownership base, *etc.* The market may unfairly undervalue some companies by painting them with the same brush as an entire underperforming industry group.

7. Don’t be duped by a target’s stock that is ‘on sale’.

Avoid arbitrarily investing in a stock that seems to be underpriced in the hope that it will later be sold for a premium. Many stocks, while appearing to be bargains, are simply ‘broken’ or long-term underperforming stocks. Just because the stock was once trading at a much higher level it is by no means certain that the stock will ever return to its previous high.

8. An acquisition premium may already be built in to a stock price.

Do not necessarily vote *against* the sale of control in a stock you own because the offer price is not at a significant premium to the current market price. The market may already have incorporated an acquisition premium into the stock, therefore minimizing the potential for an additional premium offered by a buyer.

9. A receding economy creates novel M&A opportunities.

Many people assume that a downturn in the economy will drag M&A volume down with it. In fact, shifting market dynamics of any kind will change the complexion of deals, but not necessarily the volume. For instance, a company that has been on a buying spree to diversify its business may decide, in a tightening market, to return to its fundamental competencies and sell off a non-core business line, thus creating an acquisition opportunity for a buyer.

10. Question the Board of Directors before voting to accept an offer.

When confronted with an attractive offer, the Board of a target company may need to be reminded of its fiduciary responsibility to shop the deal around for the highest sale price possible. Many buyers will finagle their way into an exclusive offer, which may appear attractive enough to woo a Board that is eager to complete the sale.

> *'Stock prices are anchored to 'fundamentals' but the anchor is easily pulled up and then dropped in another place. Given that expected growth rates and the price the market is willing to pay for growth can change rapidly on the basis of market psychology, the concept of a firm intrinsic value for shares must be an elusive will-o-the-wisp.'*

Burton Malkiel

John P. Calamos

John P. Calamos has specialized in investment research and portfolio management of convertible securities for major institutional and individual investors for over 20 years.

A frequent speaker at investment seminars and conferences, he has taught graduate level courses on finance and investments and is frequently quoted as an authority on convertible securities.

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Convertible bonds

1. The key to building wealth lies in controlling risk - a favorable risk/reward profile is critical to superior performance.

Successful investors manage risk while pursuing returns, recognizing the importance of both to the investment equation. Explore the use of convertible bonds as a unique risk-control measure. Their bond features help cushion the impact of stock market declines, while their potential participation in rising stock prices has no ceiling.

2. The upside/downside risk of convertible bonds is different from that of the underlying stock.

Historically, convertible bonds have offered about two-thirds of the upside performance and about one-third of the downside risk of the underlying common stock. One reason the two dimensions are unequal is because the bond's interest payments and fixed-income principal help moderate the downside but do not impact the upside.

3. Convertible bonds enhance yield in comparison to common stock.

That is because they often pay interest far greater than the dividends paid on the underlying common stock. Growth-oriented companies often issue convertibles because they expect their rising stock prices to change debt to equity, and these companies in particular may pay low dividends or none at all.

4. Convertible bonds' credit ratings don't tell the whole story in evaluating risk.

Credit ratings are an important consideration - but not the only one - in assessing risk. They simply evaluate the ability of the company to repay principal and interest, but in selecting a convertible, the portfolio manager also considers the potential performance of the underlying stock, the unique risk characteristics of the convertible, and the role each position plays in the portfolio's risk/reward profile.

5. The convertible market is not efficient in the short run.

Today’s knowledgeable investor can still unearth inefficiencies and profit from them.

6. Any time can be the right time to buy a convertible bond.

Convertibles have both offensive and defensive traits. When the stock market is barreling forward, they participate, unlike straight bonds. And when stocks are retreating, they act more like bonds. There is no wrong time for convertibles as an asset class.

7. In taming convertibles, remember that they are social animals.

They function best in ‘packs’. They probably won’t function as effectively individually as they do in a portfolio that is carefully structured for overall risk/reward, as well as diversification.

8. Consider a convertible portfolio for diverse roles in your asset allocation strategy.

Convertibles are versatile. As part of a fixed-income portfolio, they can provide a competitive income stream while enhancing diversification and decreasing overall risk. As an equity alternative, they offer potential capital gains and can help protect against interest rate volatility. And since the performance of convertibles does not correlate directly to that of either the straight bond or stock markets, as a separate asset class they can enhance the portfolio's diversification.

9. There’s no free lunch in convertible investing.

Convertibles offer the potential benefits of both stocks and bonds. However, there is a tradeoff - they generally pay a lower coupon rate than the equivalent straight bonds since the convertibility feature provides potential upside participation in the stock’s performance.

10. Don’t try this at home - convertible investing is best left to the professionals.

Unless you are trained and have the time to devote to security analysis, use managed money (mutual funds or professional investment advisors). Let experts do the work for you - but check their investment philosophy and be sure it agrees with your investment plan.

A convertible portfolio must be actively managed to help reap the benefits of its unique risk/reward characteristics. Convertible investing benefits from extensive quantitative analysis, and the pros also have access to trading opportunities that are not available to the individual investor.

> *‘Your best chance of making yourself fabulously wealthy investing is to buy a few small stocks with good growth possibilities; you just might find the next Microsoft. Of course, it is far more likely that you will lose most of your money this way. On the other hand, although you cannot achieve extremely high returns with a diversified portfolio, it is the best way to avoid a retirement diet of cat food.’*
>
> William Bernstein

Thom Calandra

Thom Calandra is executive vice president of news and editor-in-chief of MarketWatch.com.

He returned to San Francisco in July 2001 after spending a year in London masterminding the successful launch of FT MarketWatch. Thom writes StockWatch, a popular daily column about U.S. investment trends, and has been named one of the 100 most influential financial journalists in the US.

General principles and the growing importance of debt analysis

1. Paint a contrarian streak across your portfolio.

Dare to be different. Everyone can’t be right, as the tech sell-off is teaching us. The minority can’t always be wrong. That doesn’t mean you need to convert your entire wad into cash or gold. But it does mean respecting divergent opinions.

2. Understand dominant trends - they can make or save you money.

Stock markets the world over are experiencing sharper intra-day swings, for example. That’s an age-old trend called volatility - which you can now trade as a security in the form of the CBOE Nasdaq Volatility Index.

3. Don’t trust equity professionals - their research is besmirched.

A backlash is building against stock analysts, who essentially are paid to generate positive research for clients. Less than 10% of the pros’ recommendations are ‘sell’ downgrades. When the ‘sell’ proclamations do come, it’s way too late for most investors. A day of reckoning is ahead for Wall Street and London’s self-serving equity analysts.

4. Trust the debt analysts.

Their financial models for companies are far more rigorous than those of the equity crowd. Start tracking corporate bond prices as barometers of your favorite companies.

5. Don’t take tips.

That market tip from a newsletter or a friend has a 1-in-10 chance of coming good. Instead, be your own tipster. If your assumptions turn out to be wrong, at least you’ve learned a valuable lesson.

6. Be very picky with your mutual funds.

Most funds sport fees that eat into investment performance over multi-year spans. The best rationale for buying into a fund is when you cannot easily ‘own’ its chosen securities - like below-grade corporate bonds.

7. Understand the psychology of investing.

If you’re overly confident about an idea, you may need to re-think your premises. If you’re terrified, you’ve probably done your research and should take the plunge.

8. Got a hunch, bet a hunch.

It's tried and true. I've heard it a hundred times. Never put yourself in a position where you were absolutely correct but didn't take enough of a bet to make a difference in your life.

9. Don’t short yourself.

We’ve heard it plenty of times and it’s genuine. Most investors sell their winners too soon. Let it ride.

10. Be in the game for the long-term - meaning decades.

This is the hardest one because it takes the courage of your convictions. Since hitting its December 1989 peak of 38,915, Japan's Nikkei Index has had plenty of 50 percent rallies. But it was still a bear market. If you believed Japanese stocks were suffering for the long-term, and bet against the market, you'd have an annuity going on 12 years. This year's biggest winners are the professionals who shorted technology stocks in March and April of 2000 and still hold their positions.

Donald Cassidy

Donald Cassidy is a senior analyst with Lipper Inc., a Reuters company, doing research on money flows and closed-end investment funds. He conducts frequent seminars across the U.S.A., can be heard as a guest on radio talk shows, and has been quoted in *The Financial Times*, *The Wall Street Journal*, *Barron's*, *Worth*, *Kiplinger's Personal Finance*, *The New York Times*, and *Smart Money*.

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30 Strategies for High Profit Investment Success, Dearborn, 1998

Which stocks to sell, and when

Principle #1: Always force yourself to move toward discomfort!

Investment/trading success cannot come from actions that make you comfortable. Buying or holding when stocks are high (following the crowd because you cannot abide ‘missing the action’) is a comfort-seeking decision. Likewise, fearful selling in a collapsing and low market is moving toward the comfort of cash - again at just the wrong time. Good decisions involve thoughtful analysis including pro-and-con lists. When leaping in/out rapidly, you’ve thought of only one side and are moving to what is apparently obvious. The crowd, a few million in size, doing the same thing thus collectively is creating temporary maximum pressure and so a predictable price-reversal point. Hold and/or buy when it is scariest and sell when the majority celebrate their brilliant conquests. Right, contrarian actions are always lonely and very uncomfortable.

Principle #2: Avoid the losers' game of owning favorite stocks for the long term (a.k.a. Heresy #1).

Rapid and relentless change (technology, regulation, internationalization, competitors' ascendancy) makes the odds of extended corporate dominance extremely low. In the five highly prosperous years 1996-2000, of more than 8,000 U.S. stocks, only 20(!) managed to avoid a single down quarter in earnings - a 99.8% failure rate. Companies rarely control the top of the hill for long; those situated there are priced very dearly. Holding them exposes your capital to sudden devastating loss at any sign of faltering momentum.

A tiny number of mutual fund managers compiles consistent above-average records. Their shares are worth holding while individual stocks of current corporate winners are at extreme statistical risk of obeying gravity. Xerox, Polaroid, Memorex, Digital Equipment, Sears, and AT&T are a few examples of the article-of-faith names of a generation ago. In the long term, there is no 'business as usual'.

Principle #3: Never buy a stock without simultaneously placing a sell order at your target.

Failing to have a target reveals fuzzy thinking. Your target should include all three of these: a *price* objective, driven by a *scenario*, in a specific *time frame.*

If your price is reached, or if the scenario does not play in the anticipated time, you must sell rather than rationalize. Don't buy stocks merely because you like the industry, respect management, or agree with their social goals. Require a driver that will push the stock higher - not those other nebulous 'reasons'. The object is profit, not good feelings!

Principle #4: Believe deeply in the ‘cockroach theory’ and act on it.

Like those lowly bugs, bad news for a company seldom appears solo; a first disappointment is very likely followed by others.With thousands of stocks available, why remain loyal to under-performers? Stocks are not insulted by your selling them! Move on to what is working rather than sticking with the sleeping dogs or bad ones.

Especially, stocks heavily owned by institutions take long periods to regain money managers’ trust and to overcome overhanging stock held by those wishing they’d sold before bad news hit. The widely heralded ‘dead-cat bounce’ after a terrible fall is small and brief.

Principle #5: Untie that second hand from behind your back: become able to sell short! (Heresy #2)

I dearly wanted to list this first but feared most readers would quickly turn the page. Undoubtedly you’ve noticed that stocks both rise and fall. Then why be biased and seek profit in only one of two available directions? Shorting is not unpatriotic, morally wrong, or foolish - just an underutilized tool. Stocks get overpriced (fundamentally) and overbought (technically) exactly as many times as they’re cheap and oversold - because prices move in waves, whose tops and bottoms are equal in number. Don’t cut your opportunity to half the distance prices move. Would you fervently eschew a raincoat or umbrella because the weather is fair more days than not? Discard this self-imposed limitation!

Tactic #1: Always, always sell all large-cap and high-P/E stocks before earnings are due to be reported!

Good news is rewarded only slightly, but disappointment drives immediate, steep price declines. So holding literally stacks the payoff odds against you. Institutional ownership raises the size of selling deluges, as does a long record of prior successes.

Today's minimal commissions make stepping aside before the event very cheap insurance. Besides, learning to place sell orders readily is good practice that will make this unfamiliar activity seem more natural over time. Internet databases list expected EPS-report dates; phone the company to check.

Tactic #2: Be nimble, or the crowd will surely trample you!

Neither buying nor selling is a for-life decision; learn doing both as readily as ordering lunch when the situation requires. Instantaneous worldwide internet transmission of fact and opinion means the crowd takes virtually no time to move a stock’s price. To avoid consensual victimhood, you must move rapidly. Investors/traders are paid well to anticipate change, but badly for reacting with the crowd after new facts arise. Companies change, so your opinion and position must. Today’s price already reflects whatever you’ll find in print or databases; you are not the first to see it!

Tactic #3: Gracefully and promptly accept unreasonable profits!

Draw a line from your buy price and date to your target price and time. When fortuitous news, a major brokerage recommendation, favorable media coverage, or market euphoria shoots a stock notably above that line, sell! Not doing so means you're now accepting a lower future return rate from today to your target

Think opportunity cost of capital. You can always buy back. When the buying crowd swells well beyond normal that condition is unsustainable, so the stock must retreat. Understanding that, why hold on? Constantly ask if you'd buy today what you're presently holding, at today's price. (Holding is buying again!) What you'd not buy, you should sell.

Tactic #4: Rid your decision process of ego’s misguiding influences!

Overcome perfectionism: humans cannot always be right or routinely get the best price. Admitting mistakes early reduces money loss and ego pain. Resist temptations to ‘demand your money back’. Too many investors refuse to sell unless they get back every cent paid (for what has proved not a great choice). Meanwhile, many opportunities elude those ‘locked in’. Why demand getting back those last few percents in your proven laggard? Think opportunity cost, not blind loss aversion!

Forget three irrelevant facts: what you paid for the stock (the worst mental anchor), what it sold for at its all-time high (now proven a market mistake by subsequent evidence), and its high since your purchase (a strong but often wrong goal). Stocks over-run both up and down. A high was a temporary price error, not a deserved value.

Tactic #5: Watch the wider world for clues that a trend reversal is due.

Not all relevant information about markets is found in the *Financial Times*, *The Times* or *The Wall Street Journal*. Watch humor and advertisements (whose success requires wide, understanding consensus) for signs of a bubbly, overconfident societal mindset. Cartoons, TV sitcoms, and print and electronic-media ads reflect well-established (late) trends. Do jokes feature easy riches (time to sell), or instead people leaping from bridges and windows (panic, a bottom)? When auto and holiday-trip ads refer to our market gains, time has come to hit the exits!

Edward Chancellor

Edward Chancellor is a financial journalist and author. After reading history at Cambridge and Oxford universities, he worked for Lazard Brothers in London. He has written freelance for a number of publications, including the *Financial Times* and *The Economist*, and is currently assistant editor at Breakingviews, the award-winning financial commentary service. He also writes for Fred Hickey's *High Tech Strategist*, Smithers & Co, and *Grant's Interest-Rate Observer*.

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Lessons from history

1. ‘Put all your eggs in one basket and watch that basket!’

This saying comes from Mark Twain, but has been applied to stock market investment more or less verbatim by both John Maynard Keynes and Warren Buffett. Modern portfolio theory suggests that one can reduce risk by diversification. However, it also suggests that the index represents the optimal portfolio, in which case one might as well purchase a tracker fund. However, most active investors would do better to concentrate their shareholdings in a limited number of companies which they feel they understand. This can actually reduce risk.

2. ‘When the ducks quack, feed them.’

This is an old Wall Street adage relating to initial public offerings. Investment bankers are not driven by philanthropy or even by an intellectual motivation to understand the world of finance. They are out to make money and will sell the public anything within the bounds of the law. In recent years we have seen a flood of second-rate IPOs, most of which are now trading at below their offer price. Research suggests that, in general, IPOs rocket upwards on the first day’s trading but tend to underperform comparable companies over a three-year period. Since small investors don’t receive fair allocations of the best IPOs but are landed with the duds, they should avoid the new issue market entirely.

3. ‘Markets make opinions, not the other way round.’

This is another Wall Street saying, which has been revived by James Grant, editor of *Grant’s Interest Rate Observer*. When markets rise, commentators find a way of rationalising the gains. Take the recent bull market. We were told that the ‘valuation clocks’ were broken and that companies deserved to trade on a higher price-earnings ratio. We were also told that US productivity had risen and that the US would experience a higher growth rate in the past. We were also told that Greenspan *et al* would prevent another cyclical downturn. All these comments were spurious rationalisations of an ‘irrationally exuberant’ market.

4. ‘Buy low, sell high.’

This advice seems obvious, but investors always ignore it. The demand curve for investment assets is like that for a luxury good - the higher the price, the greater the demand. Hence we see turnover rising during a bull market (when assets are getting more expensive) and falling during a bear market (when they are getting cheaper). Investors should always be prepared to act contrary to the market, and should always be prepared to question both the optimism at the top and the pessimism at the bottom.

5. ‘When the rest of the world is mad, we must imitate them in some measure.’

This observation came from the mouth of an eighteenth-century banker, John Martin, during the South Sea Bubble of 1720. It is another expression of the ‘greater fool’ theory, namely that you can buy over-priced shares and sell them on at a profit to some sucker. This speculative attitude has been much in evidence in recent years in the form of momentum investing. Of course, you can make money if you find a greater fool, but you also will lose your money if you don’t. Would you put $10,000 into a chain-letter? If the answer is no, then avoid momentum investing. Incidentally, Martin lost all his money when the bubble collapsed and complained miserably of being ‘blinded by other people’s advice’.

6. ‘During a bull market nobody needs a broker. During a bear market nobody wants one.’

This is another Wall Street saying, cited recently by Alan Abelson in Barron’s. An unkind English version comes in the form of a question: ‘What’s the difference between a good broker and a bad one?’ Answer: ‘Not a lot.’ We are now more aware than ever that most brokerage research is generally of a low quality and that broker recommendations cannot be followed profitably. This has always been the case, but the problem is exacerbated by the conflicts created by uniting brokerage and corporate finance under the same investment bank roof. Investors should avoid reading research by brokers whose parent company provides financial services for the company concerned.

7. ‘Every man his own broker.’

This is, in fact, the title of the first investment book, written by Thomas Mortimer in the 1750s. It was republished several times. If you can’t trust brokers, you must replace them. The problem is that the private investor is not well-equipped to do so. He doesn’t have access to company management and probably can’t read financial accounts with any sophistication. As a result, he is likely to make decisions on whim, many of which will be regretted later at leisure. Bull markets are periods of ‘people’s capitalism’ when the private investor figures prominently. Inevitably, the private investor gets burnt after the market collapses and withdraws from the market, handing it back to the professionals.

8. ‘Markets can remain irrational longer than you can remain solvent.’

This saying comes from John Maynard Keynes, the great English economist. He was also an acute observer of markets and a speculator. Keynes held his stock-market investments on leverage and was an active player in the commodities market. It is sometimes said that he lost three fortunes, but made four. So he died rich. The point of Keynes’s comment is that your observation may be fundamentally correct but it can take the market a long time to catch up. For example, the dotcom bubble ran for almost five years from the flotation of Netscape in the summer of 1995 to the Nasdaq collapse in March 2000. Many people lost a lot of money shorting the likes of eToys and Amazon.com before the market woke up to its absurd overvaluation of the sector.

9. ‘A mine is a hole in the ground with a liar standing over it.’

This saying also comes from Mark Twain. It should remind investors to be wary of all projectors, whether they are promoting gold mines, biotech or some other new-fangled technology. In general, the promise of outsize profits are followed by the reality of painful losses. You will make more money in the long run by restraining your greed. Incidentally, Twain had a personal investment maxim: ‘I never spotted an opportunity until it ceased to be one.’

10. ‘Be diffident when others exalt, and with a secret joy buy when others think it in their interests to sell.’

This advice comes from the English writer, Sir Richard Steele, in an article for *The Spectator* in the early 1700s. To my knowledge it is the first expression of a contrarian investment philosophy. The art of investment lies in judiciously going against the crowd. It is both intellectually more fulfilling to refute the market consensus and in the long run should be more profitable. Academic research suggests that unloved ‘value shares’ tend to outperform so-called ‘growth stocks’ over the long run.

Moorad Choudhry

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Prior to joining JP Morgan, he traded gilts and sterling Eurobonds at ABN Amro Hoare Govett and Hambros Bank. He has lectured on the bond markets at International Faculty of Finance and London Guildhall University, and is a Fellow of the Centre for Mathematical Trading and Finance, City University Business School.

BOOKS

The Bond and Money Markets, Butterworth-Heinemann, 2001

Bond Market Securities, FT Prentice Hall, 2001

Capital Market Instruments, FT Prentice Hall, 2001

Investing in bonds

The views, thoughts and opinions expressed in this article are those of the author in his individual capacity, and should not in any way be attributed to JP Morgan Chase, or to Moorad Choudhry as a representative, officer or employee of JP Morgan Chase.

1. The oldest rule in the book: diversify. Always have bonds in your portfolio.

Not all of your investments should be looking for the quick profit. That’s high risk, and therefore unnecessary. In a bull market you’re buying bonds at a lower relative price, but receiving a regular income (coupon) at a time when fewer and fewer equities pay dividends; when the stock market starts falling and we start the transformation to a bear market, your investment is exposed to less downside, and as interest rates start to fall you’ll also register capital gain.

2. Go with the business cycle, not against it.

Familiarise yourself with the interest rate cycle. Corporate debt spreads are at their lowest at the top of the business cycle - not the best time to buy. In reality its easier to discern a slowing down economy than a falling market. A better way of looking at this is as the ‘interest-rate cycle’. As interest rates start to fall and corporate debt spreads start to widen, the market entry point becomes clearer. What’s the consensus with the interest rate cycle? The UK’s Monetary Policy Committee has rarely, if ever, surprised the markets. So that means the market knows roughly where interest rates are going. So if the consensus is open knowledge, you can base your buy and sell decisions on the interest rate cycle. Contrast this with equities - its anybody’s guess where the buy or sell point is.

3. Everyone should have a safe haven for a portion of their savings - hold government bonds like gilts.

Gilts outperformed UK equities in 1998 and 1999, but with none of the risk of any of the equities in the FTSE 100. That’s a risk-reward combination that’s unbelievable and unmatchable. It almost invariably makes sense to place some funds with this kind of product irrespective of where the market or the business cycle is.

4. Buy the downgrades, sell the upgrades.

The market is usually marking down debt ahead of any formal announcement by the ratings agencies. But not all the news is priced in; after a downgrade the sharp sell-off signals a buying opportunity, as spreads have already widened considerably and widen still further. Similarly its too late to buy after the upgrade announcement, which implies a sell signal. But keep an eye on the interest rate cycle.

5. Heed the credit rating, but look ahead of it.

The formal credit rating is there for a reason, so heed it. But consider the statistical probabilities. A BBB-or BB-rated company has more upside potential, statistically speaking, than an AA-rated company, which is unlikely to go much higher. So with the higher-rated company you’re looking at smaller capital gain potential.

6. The current yield spread is telling you something - heed it.

Very wide spreads are there for a reason. So if you’re holding the debt, sell it. If you’re not, look at buying it. Check where the equity is trading: how is it viewed? But go with the fundamentals, not media fad.

7. Don’t hold corporate debt if you don’t like the corporate equity.

Simple psychology of the self: if you don’t like the company full-stop, you’re not going to like the company’s debt, and you won’t feel happy holding it.

8. Don’t invest going into important announcements.

Markets are unpredictable. We know that. So don’t make it any harder for yourself by buying, or indeed selling, just before an important announcement such as an FOMC meeting. Sit on your hands until after the announcement and then plan accordingly.

9. Corporate bond prices are good bell-weathers of corporate health generally. Use them as a guide for all your investment decisions.

Bond market analysts will tell you that, unlike equities, the bond market is a proper market. A greater fall in a company's bond price relative to other debt of the same sector, is a good indicator of the falling positive perception of the company's overall health and financial well-being.

10. Look at established names in a slowing economy or recession.

Corporate debt spreads widen in a slowing economy or recession. However established names (such as FTSE 100 companies, etc) are often viewed positively as the economy starts to recover, and their debt is a strong contender for upside growth as the economy starts to grow again. Consider buying into the market at this point.

11. When interest rates are historically high, buy bonds.

Check recent history. If interest rates are at historically high levels (go back say, three or five years), that means they will be going down at some point. It might be next week or next year, but they are going down. Jump on board now, sit back with your coupon income, and wait. A capital gain is a certainty. Especially with new issues.

12. Don’t look for the bottom of the market, or for that matter the top.

It’s very difficult to pick the bottom of any falling market. Look at the business cycle and interest rate cycle, and go with it. If you’ve lost confidence in your holding, sell it.

My one regret: Not joining Giles Fitzpatrick’s equity sales team at Hoare Govett Securities Ltd in 1993, after being offered a job by him.

> *‘Be sceptical of track records. There are so many funds and forecasts that at any point in time, someone has to have been right. With enough monkeys in the room, one of them will type out Hamlet. But it doesn’t mean the same monkey will then go on to write Macbeth.’*

Paul Ormerod

Tim Congdon

Professor Tim Congdon founded Lombard Street Research, the economic research and forecasting consultancy, in 1989, and is currently its Chief Economist.

He was a member of the Treasury Panel of Independent Forecasters (the so-called ‘wise men’) between 1992 and 1997, which advised the Chancellor of the Exchequer on economic policy.

Economic drivers of asset prices

INTRODUCTION

What are the ultimate drivers of asset prices? Perhaps no question in investment management is more basic or more disputed. But some rules are reliable, as they depend ultimately only on economic common sense. Five are proposed below, although they are best understood as broadly correct generalisations which need, in particular circumstances, to be interpreted with care. The first rule cannot really be disputed and the next four follow, more or less, as a matter of logic.

1. Nations cannot make themselves rich by printing more money.

This is simply an elaboration of the obvious statement, "there is no such thing as a free lunch". (Investment bank clients may sometimes think their lunches are free, but they are kidding themselves.) A crucial implication is that, however fast the money supply increases, it cannot make people better-off in the long run. The excess monetary expansion is dissipated in higher prices.

A fair generalisation is that, over periods of many decades, the growth of the money supply is related - although not identical - to the growth of nominal gross domestic product.

2. High inflation is associated with high money supply growth.

This is an extension of the first rule. As bonds have to offer a positive real return if they are to attract investors, high money supply growth is also associated with high bond yields. The crucial investment messages are, ‘if money supply growth is high and rising, sell bonds’ and, conversely, ‘if money supply growth is low and falling, buy bonds’.

A good illustration is provided by Britain in 1972 and 1973, when the annual rate of money supply growth soared into the mid-20s ahead of an appalling bear market in gilt-edged bonds (and other asset classes, including equities and commercial property) in 1974.

3. High money supply growth is likely when banks have ample capital and can easily expand their balance sheets by extending new credit.

This is because the money supply consists mostly of banks' deposit liabilities. Further, a well-capitalised and highly profitable (an under-capitalised and unprofitable) banking system is bad (good) for bond yields, because it will try to grow quickly (contract), which will add to (subtract from) both bank credit and the quantity of money.

Japan in the 1990s exemplifies the argument. The banks suffered severe loan losses as the bubble of the late 1980s unravelled in the early 1990s. The result was a crippled banking system, a decade of stagnant bank credit and low money supply growth, and a decline in inflation which eventually became a deflation. Bond yields collapsed to the lowest ever recorded in modern times, with the yield on ten-year government debt hovering a little above 1 per cent for a few years.

4. Although high money supply leads to more inflation in the long run, it may not do so in the short run for all sorts of reasons.

Two common reasons are that the economy has a big margin of spare capacity ahead of the monetary injection or that it enjoys heavy capital inflows which cause exchange rate appreciation.

In these cases high money growth may for several quarters be accompanied by low inflation, encouraging investors to believe that the economy has achieved some sort of ‘miracle’. The bubbles in the Asian stock markets in 1993 and in the USA’s NASDAQ stocks in 1999 and early 2000 can be interpreted in these terms.

The rational investor has a difficult problem with bubbles like these. On the one hand, he knows that they must come to an end. (To repeat, there is no such thing as a free lunch.) On the other hand, an investment adviser who misses a big asset bubble may lose all his clients in the short run, while trying to prove to them that he is right in the long run. In monetary economics the short run and the long run are like Punch and Judy, and squabble with each other endlessly.

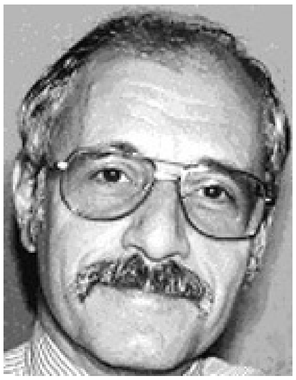
5. For any given rate of money supply growth, a large budget deficit is likely to do more damage to asset prices than a small budget deficit.

The reason is that the non-monetary financing of large budget deficits requires high short-term interest rates. High interest rates are unhelpful for medium-and long-dated bond yields, and so for other asset classes. The ideal conditions for a stock market boom are a falling budget deficit, low inflation, moderate but rising money supply growth, and a well-capitalised and profitable banking system. That is a fair description of the USA in the five years to 1999, which saw the biggest equity bull market in history. The most serious threat to a bull market of this kind is rising inflation, as indeed has been recorded in 2000 and 2001.

> *'Privatization has made a great impact in the UK.The impact is only starting to be felt in much of the euro area. As inefficient state enterprises are moved to the private sector, look for efficiency gains to generate attractive returns to stockholders.'*

Paul Temperton

Laurence Copeland



Laurence Copeland holds the Chair of Finance at Cardiff University. His papers in academic journals cover a range of subjects including: inflation and the Phillips Curve, exchange rates and currency markets, stock and bond markets, index futures, mutual funds, Asian markets and the impact of the 1997-8 crisis.

BOOKS

Exchange Rates and International Finance (3rd ed.), Pearson Education, 2000

Exchange Rates and International Finance (4th ed.), FT Prentice Hall, 2004

Currencies

1. All things in moderation, especially greed.

Don’t try too hard to buy at the bottom and sell at the top. Either be a long term investor, holding through ups and downs, or be prepared to sell out when you have made a reasonable profit, even if you subsequently find you could have done better by holding on. A short term investor is a gambler, so he or she should be ready to leave something on the table when they leave.

2. Market gurus repeat themselves, but history never does.

The past often seems to provide hints about the future, but usually the hints are unreliable signposts. So exchange rates may always have risen when the central bank raised interest rates, but that doesn’t mean it’ll be the same this time around. Like the weather, there are always new records being set, and that means precedents are no help.

3. “Ripeness is all” (Shakespeare).

The fruit falls when it’s ripe. Any later and it goes rotten. Timing is everything, in the markets as elsewhere - something economists often forget. For example, it didn’t take a genius to figure out that tech stocks were overvalued long before the peak of the boom. But you could have lost a lot of money going short on the way up, and several fund managers lost their jobs because they kept out of the market bonanza. Another example is the overvaluation of the US dollar in the first half of the 1980’s. So figuring out which stocks or currencies are mispriced is no help. The key to making money is knowing when the mispricing is going to be corrected (or, as is usually the case, overcorrected).

4. The more extreme the conditions, the more efficient the market.

The higher the inflation rate, the more rationally the money and currency markets behave, perhaps because the cost of getting it wrong is simply too high. So, in the extreme cases of hyperinflation, every 1% rise in the inflation rate leads almost immediately to an increase in interest rates and fall in the value of the currency.

5. Fixed exchange rates: the triumph of hope over experience.

No fixed exchange rate ever stayed fixed forever. At some point, the system offers speculators a one-way bet. Why not take it?

6. The predictive power of forward rates is more or less nil.

Forward rates simply track spot rates. The forward premium or discount is no guide to whether a currency is going to appreciate or depreciate.

7. Long calm spells, punctuated by stormy periods.

Even with a floating exchange rate, a currency market will often seem to have gone to sleep, with nothing much happening for months or years. Invariably a storm will blow up sooner or later, with a sudden sequence of high volatility days, often with no obvious news to trigger the activity.

8. The Anglo-Saxon Block.

The English-speaking currencies (Pound, US and Canadian Dollars) move together most of the time, in the Northern hemisphere at least. In particular, the Pound and the Dollar are highly correlated, and membership of the EU and the single market (and the foundation of NAFTA) seems to have made little difference to this pattern.

9. Don’t bet against the dollar . . .

It’s not that it will never again fall from its pedestal. It’s simply that we don’t know when. So, as long as the US was booming, all the pundits said the strong economy was pushing up the dollar’s value. When the US economy took a dive in Winter 2000-1, what happened? You guessed right, the dollar was even stronger. A safe haven in a world threatened by an impending US recession, many pundits said. Hence, the final piece of advice . . .

10. . . . get a job as a currency guru.

The great thing about mission impossible is that nobody expects you to be successful. Failing to work miracles is not adequate ground for dismissal. The pay is good too.

Richard Cragg

Richard Cragg has over 30 years' experience in investment, spanning financial centres in three continents, and has consistently been at the forefront of opening up new and emerging markets to investors.

BOOKS

The Demographic Investor, FT Prentice Hall, 1998

Demographic investment

1. Crisis equals opportunity.

Almost forty years of falling birth rates coupled with rising life expectancy have created ageing populations throughout the developed world. Economists predict serious consequences in the decades ahead:

- Declining workforces, leading to slower output growth and wealth creation.

- Fewer workers supporting more pensioners, leading to steep rises in taxes and National Insurance to pay for rising state pensions and health provisions - or a decline in expenditure on them.

Demographic investment techniques provide the tools to turn this emerging crisis into an investment opportunity, enabling investors to devise long term pension strategies that actually benefit from ageing populations. In conjunction with other screening tools, it can help select which countries and sectors offer the best growth.

2. Manners maketh man, but money moveth markets.

Only buying and selling move share prices. Whether money is invested directly or via mutual funds and pension schemes, it has first to be generated in the form of discretionary income - what's left after paying for the house, the car and family outlays on food, clothing *etc.* - and this depends on your age.

3. Some age groups can save more than others.

As individuals move through life, their earnings and consumption patterns change markedly over the years. Until their first job, they are significant net consumers, and while earning capacity might then rise substantially until their mid-40s, their savings generally do not, since they have acquired partners, children and mortgages in the meantime. By their mid-50s however, despite a marked slowdown in wage growth, their discretionary income takes a Great Leap Forward, as the mortgage is paid off, school fees finish and the kids leave home. This age group is also likely to receive sizeable legacies from their parents. It is the growth of the 45-55 age group relative to the young and elderly dependents that determines changes in a population’s discretionary income.

4. Goldilocks demographics - not too young, not too old.

What constitutes an ideal age profile? A country where both the workforce and the proportion of 45-55 year-olds is growing rapidly but the proportion of retirees is small relative to the workforce and not growing rapidly. Choose your countries carefully, because your pension depends on it. If you choose Japan, you’ll be working until you’re 100.

5. Surfing the demographic waves.

Demographics allows us to project population breakdowns for 20 years into the future with a fair degree of accuracy, enabling investors to switch from a country where savings growth is slowing into one where the savings wave that will power the next market boom is building.

6. A demographic road map.

Japan’s demographic wave crested a decade ago and is still in decline. Germany and Italy become similarly dangerous after 2005, the UK and France after 2010, and the US after 2015. But the big bet from now to 2020 is China, where collapsing birth rates will create a huge bulge in the proportion of 45-55 year-olds.

7. Selecting the sectors.

In a world where annual births are static, you won't make your fortune investing in baby clothes companies. Follow the growth age groups; they're buying holidays, hollyhocks, healthcare and hearing aids. If you can select consumer items that are in growing demand from an ageing population but are benefiting from new technologies (digital hearing aids) or patent protection (drugs for diabetes, osteoporosis, cancer and heart disease), you should do well.

Anthony Cross

Anthony Cross manages Liontrust Intellectual Capital Trust, a fund which invests in smaller companies using precepts which evolved from ‘The Cross Report’. The Cross Report argued that intellectual capital and employee equity participation are of paramount importance in successful companies.

The investment attractions of intellectual capital

INTRODUCTION

If asked to list a company's assets, most people would probably give the accountants list of plant and equipment, property, raw materials, stocks, finished goods and cash. Whilst these assets are important, they are rarely unique and they represent a declining proportion of the value of companies. Research by Deutsche Bank shows that over the last ten years, the value of intangible assets has become a much greater proportion of total enterprise value. Fixed assets now comprise only 16% of the enterprise value of an average company compared with 42% in 1989.

So what are these intangible assets that enable companies to add value to their products and services and thereby retain pricing power? The answer is *intellectual capital*: it is frequently difficult to replicate, and its successful exploitation lies at the heart of today's growth companies.

1. Finding good investments should not be easy.

The world is becoming more competitive. More competition means that there are fewer good investments.

2. Look for intellectual capital assets, such as customer relationships and intellectual property.

They are the most important assets in companies. Competitors find it difficult to replicate these intangible assets.

3. Make sure directors and employees own shares.

Intellectual capital assets are created and exploited by employees. Equity ownership helps retain employees and aligns their interests with those of outside shareholders.

4. Target companies with proven organic growth.

Organic growth is the clearest evidence of success. Be wary of those who need to acquire growth.

5. Beware of companies that claim to be an exception to the rule.

Companies rarely miss out on wider negative industry trends.

6. Declining margins during a time of economic stability are a sell signal.

Companies that are difficult to replicate should earn superior returns but they will also attract competition.

7. Sell when directors make material equity sales.

Ignore their stated optimism for the company.

8. Protect the downside.

Think about what could go wrong as well as right and limit the size of your bet accordingly.

9. Spread your bets.

Investing is about protecting wealth as well as adding to it. Companies are valued on a multiple of optimism. When optimism turns to pessimism share prices collapse. Today’s winner could be tomorrow’s loser.

10. Be patient.

A good bet might take a couple of years to attract the attention of the broader market.

Lawrence Cunningham

Professor Cunningham is Director of The Samuel and Ronnie Heyman Center on Corporate Governance, and Professor of Law and Business at Cardozo Law School. He has taught and lectured widely in the US and to investor groups in London. He also serves as a consultant to corporate boards of directors, law and accounting firms, and regulatory and standard-setting bodies.

BOOKS

The Essays of Warren Buffett (editor), John Wiley, 2000

How to Think like Benjamin Graham and Invest like Warren Buffett, McGraw-Hill, 2000

How to Think Like Benjamin Graham and Invest Like Warren Buffett, McGraw Hill Higher Education, 2002

The investing methods of Warren Buffett

1. Don’t be the patsy.

If you cannot invest intelligently, the best way to own common stocks is through an index fund that charges minimal fees. Those doing so will beat the net results (after fees and expenses) enjoyed by the great majority of investment professionals. As they say in poker, ‘If you’ve been in the game 30 minutes and you don’t know who the patsy is, you’re the patsy’.

2. Operate as a business analyst.

Do not pay attention to market action, macroeconomic action, or even securities action. Concentrate on evaluating businesses.

3. Look for a big moat.

Look for businesses with favorable long term prospects, whose earnings are virtually certain to be materially higher 5, 10, 20 years from now.

4. Exploit Mr. Market.

Market prices gyrate around business value, much as a moody manic depressive swings from euphoria to gloom when things are neither that good nor that bad. The market gives you a price, which is what you pay, while the business gives you value and that is what you own. Take advantage of these market mis-pricings, but don’t let them take advantage of you.

5. Insist on a margin of safety.

The difference between the price you pay and the value you get is the margin of safety. The thicker, the better. Berkshire’s purchases of the Washington Post Company in 1973-74 offered a very thick margin of safety (price about 1/5 of value).

6. Buy at a reasonable price.

Bargain hunting can lead to purchases that don’t give long-lasting value; buying at frenzied prices will lead to purchases that give very little value at all. It is better to buy a great business at fair price than a fair business at great price.

7. Know your limits.

Avoid investment targets that are outside your circle of competence. You don’t have to be an expert on every company or even many - only those within your circle of competence. The size of the circle is not very important; knowing its boundaries, however, is vital.

8. Invest with ‘sons-in-law’.

Invest only with people you like, trust and admire - people you’d be happy to have your daughter marry.

9. Only a few will meet these standards.

When you see one, buy a meaningful amount of its stock. Don’t worry so much about whether you end up diversified or not. If you get the one big thing, that is better than a dozen mediocre things.

10. Avoid gin rummy behavior.

This is the opposite of possibly the most foolish of all Wall Street maxims: ‘*You can’t go broke taking a profit*’. Imagine as a stockholder that you own the business and hold it the way you would if you owned and ran the whole thing. If you aren’t willing to own a stock for 10 years, don’t even think about owning it for 10 minutes.

Frank Curzio

Frank Curzio founded F.X.C. Investors Corp. in 1974 and has been a money manager since 1988. With over 25 years of experience in the financial industry, Mr. Curzio has become one of the most well-known analysts on Wall Street as well as one of the most quoted.

BOOKS

Awareness of Indirection, Vantage Press, 1987

Safeguards and buying opportunities

1. Speculate with a small portion of your funds.

Preferably only 30% in aggressive situations. Invest a little to make a lot, and not a lot to make a little.

2. Do not buy on margin.

All securities involve risk. Some of the most prestigious and highest rated ‘A’ securities have had temporary devastating plunges. (Sears Roebuck from $61 to $15, Con Edison from $18 to $3, GM, Ford and Citicorp A rated bonds from $1,000 to $490, etc.). If a stock drops 50%, given time it may come back and may trade over your original cost.

3. The best buying opportunities usually prevail when a company reports lower earnings and when adverse economic news is widespread.

Purchase of stocks immediately after glowing earnings reports or optimistic press releases often results in buying at the top.

4. Only invest in companies audited by one of the big five accounting firms.

These accounting firms audit about 90% of the companies listed on the New York Stock Exchange (NYSE). Their clients account for most of all sales in the U.S. and approximately 90% of corporate income taxes. There are over 10,000 public corporations trading on the various stock exchanges and in the over-the-counter markets. One of the leading reasons why investors lose money is due to financial statements that are not prepared in accordance with Federal regulations (Section 13 or 15 (d) of the Securities Act of 1934). If the figures are incorrect, your investment in the stock is subjected to substantial or complete loss.

5. Watch company credit ratings.

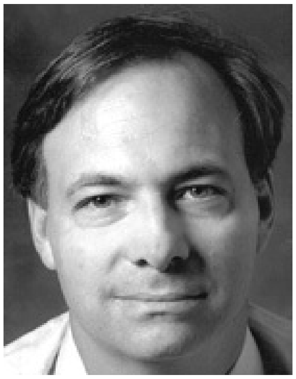
Institutional fund managers pay close attention to credit rating from agencies such as S&P and Moody's. Increases in credit ratings ultimately result in higher quotes due to additional monies available for investment in these stocks. Decrease in ratings usually result in lower stock quotes.

6. Exploit institutional window-dressing.

The institutional funds represent approximately 80% of all monies in the U.S. market. The managers of these funds must answer to their shareholders and superiors - mutual pension funds are required to issue quarterly reports to their respective shareholders. Near the end of the quarter, stocks which were down or close to their yearly lows, are usually sold by the institutions (so they do not show as holdings in the quarterly report), causing even lower stock quotes. And stocks near their highs are purchased, thus enforcing higher quotes.

If you choose to purchase a stock because it is low, wait until after the end of the quarter. Chances are, it will be trading lower. Of course, there is no guarantee the stock will not trade even lower in the upcoming quarter. If you are going to bottom-fish, be patient. Or, if you want to sell a stock that is trading near its high, chances are it will be higher just before the quarter ends.

Ray Dalio



Ray Dalio is President and Chief Investment Officer of Bridgewater Associates, a global investment manager with over $34 billion in assets under management. Bridgewater follows a fundamental and quantitative approach to investment decision-making. All investment criteria are thoroughly researched and systemized. Fundamental analysis is supported by advanced risk management techniques. This approach has led to Bridgewater's top decile performance.

Systemizing fundamentals

INTRODUCTION

There are some general principles that most winners of this game employ that losers neglect. If you want to win any game, you must know what the principles of the game are, and then work to develop the required skills - *e.g.* counting the cards and calculating odds for poker. What I describe here is my approach to playing the game, which is a mix of these general principles and my own twists on them. For me, the following are required.

1. A deep understanding of the fundamentals so that pricing inefficiencies can be identified.

Adding value (getting a return greater than that available from passive investing) requires one to see how markets are mispriced, and this requires an understanding of how they should be priced. This is required to be a winner over time. It is the equivalent of being able to count cards and calculate the odds of a winning hand in poker - it is the fundamental assessment that allows you to discern a good bet from a bad one.

Some people say that understanding the fundamentals isn't required and that one can play and win the game by playing it technically. If by technical they mean an approach that is devoid of understanding fundamental cause-effect relationships - like trend following - then I believe that they are wrong. Sometimes markets trend, and sometimes they chop, and they do so for reasons. So, without an understanding of these reasons, one will be blindly betting that markets trend more than they chop. Do markets trend more than they chop? This is one of those cosmic questions that can't be definitely answered, and certainly not without an understanding of the fundamentals that determine market behavior.

There is no escaping the need to have a deep understanding of the fundamentals so that one can sensibly assess what is cheap and what is expensive. In playing poker, I would rather place my bet based on my ability to count the cards and calculate odds than on the likelihood of a hot streak continuing (e.g. betting that I will do well because I won the last few hands).

2. Focus.

Adding value is a zero-sum game - for me to add value I must be a better player than my opponents. The markets are extremely competitive. That means that my understanding must be very deep, which requires focus. I have rarely seen investors that win over time who trade a lot of different markets. The winners I know discuss their markets with the same depth that specialists in other professions (e.g. physicians, scientists, etc.) discuss the subjects of their focus.

In addition, successful market players have the capacity to think conceptually and independently. Equipped with knowledge and perspective, they can justifiably have the confidence to stand apart from the crowd, which is essential for being able to buy low and sell high.

3. Perspective without data-mining.

Many years ago I did a lot of discretionary trading based on the flow of information I was seeing at the time. I wrote down the criteria I used to make each trade so that I could reflect on the trade later. I learned that if I specified the criteria clearly I could see how these criteria would have worked in the past, and in different countries, which gave me perspective. That perspective was invaluable.

In many cases I learned that the criteria wouldn't have worked in the past and I could see why. In other cases I learned how well my decision rule worked so that I would not abandon it when it lost (all rules lose sometime) or put too much on it because it has recently been hot and I thought it was better than it really was. As a result, I developed a good sense of what I could expect from my criteria.

I learned that I could program the computer to scan the world for opportunities, according to these criteria. And I learned a lot more. I learned to be especially wary about data mining - to not go looking for what would have worked in the past, which will lead me to have an incorrect perspective. Having a sound fundamental basis for making a trade, and an excellent perspective concerning what to expect from that trade, are the building blocks that have to be combined into a strategy.

4. Strategy.

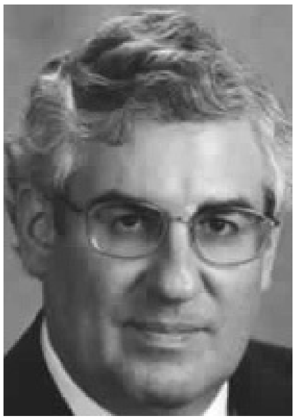
Knowing how to identify good bets is only the first step. Knowing how to balance these bets - how much to place to on each based on their different expected returns, risks and correlations - is at least as important. This requires an understanding of probabilities, statistics, and money management principles. It requires the ability to simulate how this strategy would have worked in the past and to stress test its performance under varying conditions.

5. Substantial resources.

The days that an astute individual trader equipped with little more that his wits, being able to be a substantial winner at this game are over. Now, world class teams consisting of conceptual thinkers suppported by specialists and advanced technology set the standard of play. While technology has radically advanced the average level of play, in markets as in warfare, it has served to widen the gap between the resource-rich and the resource-constrained players.

> *'Buy and hold strategies generally are less rewarding than trading strategies. The cliché that markets can't be timed may be right for some investors all of the time, and for all investors some of the time, but there are times when market prices are far above or far below their long run equilibrium prices.'*
>
> Robert Aliber

David DeRosa



David DeRosa is the president of DeRosa Research and Trading, Inc. He is also an Adjunct Professor of Finance and Fellow of the International Finance Center at the Yale School of Management.

He writes a thrice-weekly column for Bloomberg News on international finance and world politics.

In Defense of Free Capital Markets, Bloomberg Press 2001

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General principles and the dangers of financial engineering

1. Don’t confuse trading with investing.

I think of investing as a long-term process of wealth accumulation. If you want to speculate that is fine, but you should have a predefined portion of your total portfolio reserved for that activity. Use stop-loss orders and buy options to hold potential trading losses to non-catastrophic levels.

2. Avoid investment ‘products’ . . .

Financial engineering is more the friend of the broker than it is of the investor. Often these products are laden with fees. They are hard to understand, too, in a risk context. Get as close as possible to the primary securities as possible.

3. . . . except build your core portfolio with index funds.

I am a huge fan of common stocks held in diversified portfolios for the long haul. One exception to my remark about investment products is index funds. They are tax efficient and cost efficient.

4. Don’t be fooled by high yields or high coupons.

Investors frequently expose themselves to great risk by seeking superior cash returns in emerging markets debt and distressed sectors. Often the risk-return trade off for these sectors is pitifully inadequate.

5. Sovereign risk can be just as lethal as private sector risk.

Many investors learnt the hard way in the decade of the 90s that sovereign risk can be significant when they saw their Mexican bonds, Brady bonds, and Russian bonds suffer steep and sudden loses.

6. Never trust mechanical risk models.

As I was quoted in Roger Lowenstein's book on Long-Term Capital Management, 'statistical risk models are lighthouses for the soon to be shipwrecked'. In the same way, don't be overly concerned about track records and Sharp ratios when considering investing with a professional investment advisor.

7. Never make an investment that is predicated on a fixed exchange rate regime's survival.

Fixed exchange rate regimes are prone to explosive convulsions, as we saw in Thailand, Indonesia, Mexico, Europe (the famous Exchange Rate Mechanism crises), Brazil, and Russia.

8. Never try to ‘catch a falling knife’.

Markets may at times overreact but there is no way to know what is real and what is exaggeration.

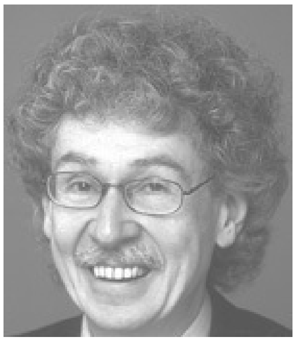
9. Avoid naked options.

Never write naked puts or calls unless you are a professional option trader.

10. Be very cautious about the use of leverage.

In a market panic, margin calls will force you to liquidate at prices and times not of your choosing.

Richard H. Driehaus



Richard Driehaus is widely regarded within the investment industry as an expert in the specialty of aggressive growth investing.

He founded Driehaus Securities Corporation in 1979, followed by Driehaus Capital Management, Inc. in 1982. He is the architect of the firm's investment philosophy and is primarily responsible for all domestic portfolio management and investment analysis within the firm.

In early 2000, Mr. Driehaus was named in Barron's "All-Century" team of the 25 individuals who have been the most influential within the mutual fund industry over the past 100 years.

Mr Driehaus was one of the portfolio managers profiled in *The New Market Wizards* (Jack Schwager, HarperBusiness 1992) and in *Investment Gurus* (Peter Tanous, New York Institute of Finance, 1997). He has contributed a chapter on growth investing to *Expert Financial*

Planning: Investment Strategies from Industry Leaders by Robert Jaffra, John Wiley, 2001.

Investment paradigms worth avoiding

INTRODUCTION

Paradigms are beliefs that most people have. Unfortunately, they are often outdated and really no longer true, yet people tend to hold on to these paradigms. In fact, they search for evidence to support them and reject information that conflicts with their beliefs.

Mistaken Paradigm 1: ‘Buy low and sell high.’

Perhaps the best known investment paradigm is ‘buy low, sell high’. I believe that more money can be made by buying high and selling at even higher prices. I try to buy stocks that have already had good price moves, that are often making new highs and that have positive relative strength. These are stocks that are in demand by other investors.

What is the risk? Obviously, the risk is that I’m buying near the top. But, I would much rather be invested in a stock that is increasing in price and take the risk that it may begin to decline than invest in a stock that is already in a decline and try to guess when it will turn around.

Mistaken Paradigm 2: ‘Just buy stocks of good companies and hold onto them.’

Another mistaken belief: ‘just buy stocks of good companies and hold on to them; that way you don’t have to pay close daily attention.’ I would say: ‘buy good stocks of good companies and hold on to them until there are unfavorable changes.’ Closely monitor daily events because this will provide the first clues to long-term change. Remember, just as the business value does not equal the stock price, things are always changing, and yesterday’s good company may not be today’s great investment.

Mistaken Paradigm 3: ‘Don’t try to hit home runs; you make money hitting a lot of singles.’

I couldn’t disagree more. I believe you can make the most money hitting home runs. But, you also need a discipline to avoid striking out. That is my sell discipline. I try to cut my losses and let my winners run. Perhaps that’s a paradigm too, but it is one that works.

Mistaken Paradigm 4: ‘A high turnover strategy is risky.’

Most people believe high turnover is risky. I think just the opposite. High turnover reduces risk when it is the result of taking a series of small losses in order to avoid larger losses. I don’t hold on to stocks with deteriorating fundamentals or price patterns. For me, this kind of turnover makes sense. It reduces risk.

Mistaken Paradigm 5: 'An investment process must be very systematic.'

Many people believe an investment process needs to be rigidly systematic. I believe a good process involves discipline, but must be flexible enough to respond to changing market conditions. Let me give you an example:

At the end of November 1991, the Dow Jones Industrial Average was trading at 2895 and the market's price to earnings ratio was 23. The price-to-book ratio was a lofty 2.7 and the market's yield was only 2.8%. A rigid, systematic value-based process would have told you to get out of the market with at least a portion of your assets. After all, the market was higher relative to those valuation measures than it had been 90% of the time, on a historical basis.

But, I believed that there were other relevant factors that suggested the market could go much higher. This was not a time to rigidly adhere to valuation disciplines. People who stayed fully invested benefited. From that time, through January, 2000, the Dow Jones Industrial Average quadrupled.

Don't invest because of what you think should be happening. Invest because of what is happening.

Mistaken Paradigm 6: ‘You must have a value-based process.’

Often when I talk to consultants, they like to see a very systematic, value-based process. They think that each stock has to be submitted to some type of disciplined, precise and uniform evaluation. But the real world is not that precise. I’m convinced that there is no universal valuation method. In fact, in the short run, valuation is not the key factor. Each company’s stock price is unique to its place in the market environment and to its own phase in its corporate development.

Mistaken Paradigm 7: ‘The best measure of investment risk is the standard deviation of return.’

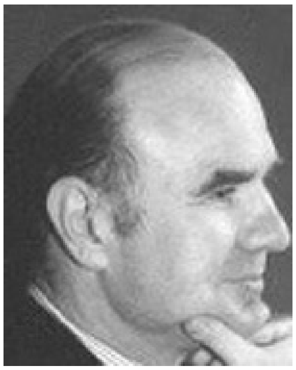
Another paradigm and one that I deal with frequently is that ‘the best measure of investment risk is the standard deviation of return’. In other words, volatility. But volatility only measures risk over the short-term yet a long-term perspective is far more important. For most investors, a major long-term risk is portfolio underperformance due to insufficient exposure to high returning, more volatile assets. In my opinion, investment vehicles that provide the least short-term volatility often embody the greatest long-term risk.

Mistaken Paradigm 8: ‘It’s risky to place your money with a ‘star system’ manager.’

I disagree! In any industry, performance is achieved by the stars. Working with a diversified group of investment management stars is probably the safest way to invest. Great ideas, inventions and works of art have always been created by individuals, not groups or committees. This is also true in the investment business: good long-term results have been achieved by talented individuals.

> *‘Buying on fundamentals is fine, but you need to be patient. The long term normally wins in the end. Always remember that fundamentals are bad for selling. Charts will get you out much faster.’*
>
> David Linton

Marc Faber



Dr Marc Faber writes and edits *‘The Gloom, Boom & Doom Report’* - a monthly newsletter regarded as an essential alternative investment manual. He is a regular contributor to *Forbes* and contributes to several websites, such as Financial Intelligence and Asian Bond Portal.

Tomorrow's Gold: Asia's Age of Discovery, Clsa Ltd, 2005

Contrarian advice from Dr Doom

Rule #1: There is no investment rule that always works.

If there was one single rule, which always worked, everybody would in time follow it and, therefore, everybody would be rich. But the only constant in history is the shape of the wealth pyramid, with few rich people at the top and many poor at the bottom. Thus, even the best rules do change from time to time.

Myth #1: ‘Stocks always go up in the long term.’

This is a myth. Far more companies have failed than succeeded. Far more countries’ stock markets went to zero than markets which have survived. Just think of Russia in 1918, all the Eastern European stock markets after 1945, Shanghai after 1949, and Egypt in 1954.

Myth #2: ‘Real Estate always goes up in the long term.’

While it is true that real estate has a tendency to appreciate in the long run, partly because of population growth, there is a problem with ownership and property rights. Real estate was a good investment for Londoners over the last 1,000 years, but not for America’s Red Indians, Mexico’s Aztecs, Peru’s Incas and people living in countries which became communist in the 20th century. All these people lost their real estate and usually also their lives.

Problem rule #1: ‘Buy Low and Sell High.’

The problem with this rule is that we never know exactly what is low and what is high. Frequently what is low will go even lower and what is high will continue to rise.

Problem rule #2: 'Buy a basket of high quality stocks and hold.'

Another highly dangerous rule! Today's leaders may not be tomorrow's leaders. Don't forget that Xerox, Polaroid, Memorex, Digital Equipment, Burroughs, Control Data were the leaders in 1973. Where are they today? Either out of business or their stocks are far lower than in 1973!

Problem rule #3: 'Buy when there is blood on the street.'

It is true that bad news often provides an interesting entry point, at least as a trading opportunity, into a market. However, a better long term strategy may be to buy on bad news which has been preceded by a long string of bad news. When the market no longer declines, there is a chance that the really worst has been fully discounted.

Rule #2: Don’t trust anyone!

Everybody is out to sell you something. Corporate executives either lie knowingly or because they don’t know the true state of their business and the entire investment community makes money on you buying or selling something.

Rule #3: The best investments are frequently the ones you did not make!

To make a really good investment, which will in time appreciate by 100 times or more, is like finding a needle in a haystack. Most ‘hot tips’ and ‘must buys’ or ‘great opportunities’ turn out to be disasters. Thus, only take very few investment decisions, which you have carefully analyzed and thought about in terms of risk and potential reward.

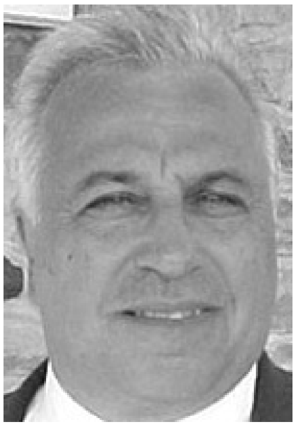
Rule #4: Invest where you have an edge!

If you live in a small town you may know the local real estate market, but little about Cisco, Yahoo and Oracle. Stick with your investments in assets about which you may have a knowledge edge.

Rule #5: Invest in Yourself!

Today’s society is obsessed with money. But the best investments for you may be in your own education, in the quality of the time you spend with the ones you love, on your own job, and on books, which will open new ideas to you and let you see things from many different perspectives.

Frank J. Fabozzi



Frank J. Fabozzi is editor of the *Journal of Portfolio Management*, an Adjunct Professor of Finance at Yale University's School of Management, and a consultant in the fixed-income and derivatives area.

From 1986 to 1992, he was a full-time professor of finance at MIT's Sloan School of Management. Frank is a Chartered Financial Analyst and Certified Public Accountant who has edited and authored many acclaimed books in finance.

Frank Fabozzi has written and edited many books on fixed income and equity markets. His *Handbook of Fixed Income Securities*, published by McGraw-Hill, is now in its seventh edition.

Bond investing

INTRODUCTION

The investment world can be divided into retail investors (i.e. individual investors) and institutional investors (e.g. insurance companies, mutual fund managers, depository institutions). The investing rules below focus on the institutional investor. One can probably trace some well known financial fiascos by institutional investors to a violation of one or more of these rules.

1. Know your benchmark.

Institutional investors manage money relative to a benchmark. The benchmark may be either some market index or future liabilities that are contractually determined. The institutional investor should clearly understand the characteristics of the benchmark. A strategy that is appropriate for one institutional investor may be disastrous for another because of different benchmarks. Moreover, understanding the benchmark means that the primary risks that drive returns are identified and they are the risks that the institutional investor can focus on to control risk and attempt to outperform the benchmark.

2. Securities are only appropriate relative to a strategy.

The fundamental principle of modern portfolio theory is that the risk of an individual security is not its risk in isolation but the contribution of risk to a portfolio. This means that given the benchmark and given the strategy that is consistent with that objective, an investor should focus on how much an individual security adds to the risk of the strategy.

At professional conferences I have heard two portfolio managers from the same investment management firm give two very different views of the same bond structure. Both were right given that one managed money relative to a bond index and the other relative to actuarially determined liabilities.

3. For bond investors, modeling risk is an important risk that should never be underestimated.

For bond investors, the valuation of bonds introduced into the market in the last two decades have been difficult to value. Their valuation depends on several assumptions. To value these securities and to assess how they will perform under different scenarios in order to control risk, it is necessary to assess the impact of these assumptions to cope with modeling risk.

4. Hedging is not the same as risk control.

Too often institutional investors state they want to hedge risk. Hedging risk means eliminating risk and unless markets are inefficient, the elimination of risk means that the potential return will be approximately equal to the risk-free return. Institutional investors who manage portfolios want to control the primary risks associated with the benchmark based on their view of the primary risk factors.

5. For bond funds, understand what duration means and how it is measured.

A commonly used measure of interest rate risk for a bond portfolio is duration. Unfortunately, too often duration is interpreted as some temporal measure (i.e., in terms of years). Duration is simply a measure of the sensitivity of the change in the value of a bond (or a portfolio) to a change in interest rates.

A useful working definition is that duration is the approximate percentage change in the value of a bond (or a portfolio) for a 100 basis point change in rates. So, for example, a duration of 4 for a bond means that the value of the bond will change by approximately 4% for a 100 basis point change in rates.

For portfolios that include complex securities (that is, securities that have considerable cash flow uncertainty), the calculation of a bond's duration is difficult and therefore there is modeling risk associated with the computed duration.

6. Yield is not return.

A yield measure calculated for a bond - yield to maturity, yield to call, or cash flow yield - is only a measure of the potential return from investing in a bond under limited circumstances.

7. Understand why a yield spread exists.

The practice in the bond market is to calculate the yield on a security and then compare that yield to a benchmark security. The difference is called the yield spread. An investor should understand what characteristics of a security (i.e., what risks) the yield spread is seeking to compensate the investor for and determine if that spread is adequate given the risks.

8. Always perform attribution analysis when evaluating managers.

In analyzing the performance of a portfolio manager it is important to decompose the actual return into the reasons why that return was generated. This activity is called attribution analysis.

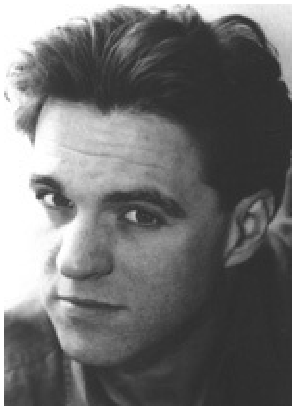
9. Watch with great concern money managers with far superior returns than the rest.

A client employing the services of several money managers to invest in a specific sector (e.g. bonds) should be most concerned with the manager that generated a return that is considerably better than the rest. Using attribution analysis the client can determine the reason for the superior performance and should clearly understand the risks accepted by the manager. The client may find that the particular risks (or equivalently, bets) are not the ones that the client wants to accept in the future.

> *'The most highly paid people in the country work on Wall Street. They become highly paid because they persuade people to buy and sell securities. It would be hyperbole to say that they had no interest in the fate of the transaction - but only a little bit.'*

Robert A.G. Monks

Niall Ferguson



Niall Ferguson is Professor of Political and Financial History at Oxford University and Visiting Professor of Economics at the Stern Business School, New York University.

The Cash Nexus, Allen Lane, 2001

The House of Rothschild, Penguin 2000

Lessons from the Rothschilds

INTRODUCTION

When I began work on the history of the Rothschild family I was not myself an investor. Naturally, I hoped that studying the correspondence of the nineteenth century's richest dynasty would reveal to me the secret of their success and endow me with the Midas touch. I certainly learned a great deal in the bank's immense archives, but I remain unsure as to whether the rules by which the Rothschilds operated then have any validity today. Of course, members of the family still offer professional financial advice through a variety of firms bearing the Rothschild name. Anyone who seriously wants to know how to invest their money today should contact one of them. As an historian whose biggest investment is a seventeenth-century Oxfordshire farmhouse, all I can offer is past Rothschild advice, which may or may not be perennial.

There are at least two pieces of folklore about Rothschild investment strategy. One, often attributed to Nathaniel, the first Lord Rothschild, is that investment should be like a cold shower: 'Quick in, quick out'. This is the very opposite of today's 'Stocks for the Long Run'. But I doubt that was ever said, at least not in earnest.

Another apocryphal story is that the Rothschilds invested a third of their wealth in securities, a third in real estate and a third in objets d'art. That certainly was not the case: big though their houses were (and they were the biggest private residences built in the nineteenth century) and no matter how dazzling their collections of Old Masters, their immense securities portfolios were always worth a lot more.

So what did the Rothschilds really say about investment? As they were primarily though not exclusively bond-issuers and traders, much of what they wrote in their voluminous correspondence is relevant to investors in government securities, not equities.

1. Look for governments in trouble.

Mayer Amschel Rothschild, the founder of the bank, used to tell his sons: ‘It is better to deal with a government in difficulties than with one that has luck on its side.’ That sounds like another way of saying a government in real financial trouble will pay higher yields and commissions. (Note: That should not be read as a recommendation to buy Ukrainian government bonds today.)

2. Spread the sugar . . .

The Rothschilds were bond wholesalers as much as investors, so it is worth listening to what they had to say about trading. In 1836 James de Rothschild, Mayer Amschel's youngest son, gave his nephews some advice about how to sell securities on the Paris stock exchange:

'When you are buying or selling rentes, try not to look at making a profit, but rather your aim should be to get the brokers used to the idea that they need to come to you . . . [O]ne initially has to make some sacrifices so that the people then get used to the idea to come to you, my dear nephews, and as such one first has to spread the sugar about in order to catch the birds later on.'

3. . . . or spread the fear.

But if sugar didn't work, James had an alternative strategy: 'If one can't make oneself loved then one has to make oneself feared,' he told his nephews, a rule he himself had been taught by his father.

4. Insider dealing rules.

The Rothschilds were of course able to act in ways that nowadays might invite allegations of 'insider dealing'. It was said of James's brother Nathan, for example, that 'If he possessed news calculated to make the funds rise, he would commission the broker who acted on his behalf [initially] to sell half a million.' Then, when the price had gone down and the rest of the market was looking the other way, Rothschild would buy in a big way. Only then would the 'news' break, driving up the price to new heights.

Of course, this kind of activity was easier in the days before the telegraph (Bloomberg screens and CNBC were undreamt of). The Rothschilds' private couriers were generally first into town with any hot news from abroad. So the Rothschilds could easily steal a march on less well-informed investors. They were also adept at cultivating influential politicians, who had a habit of revealing their intentions to the Rothschilds in return for a cut of any ensuing speculation.

5. Know when to hold back.

The next generation lacked the hard-nosed ethos of their ghetto-born fathers. Nathan's son Nat was exceedingly risk averse, though his advice against investing in railways may strike a chord with those modern investors who were lured into the market for UK railway privatisation shares in the 1990s:

'I am against [investment in railways] because I am afraid of the anxiety, bother & trouble which it will surely occasion us - the moral responsibility of it will rest entirely on us, & I wd sooner leave to others the profit which the shares are likely to bring than engage in a concern of such magnitude without the possibility of attending to it properly. I think the best thing is . . . not to have anything to do with them.'

6. Sell too soon.

As might be expected, the Rothschilds were frequently badgered for free investment tips. Asked if he had a formula for financial success, the first Lord Rothschild habitually replied, ‘Yes, by selling too soon.’

7. Don’t go bust.

The above caution had its disadvantages and helps explain why the Rothschilds - still in terms of capital the biggest bank in the world in 1905 - were overhauled by joint-stock banks in the twentieth century. When Sir Edward Guinness sought to float the famous brewing company on the stock market in 1886, the London Rothschilds refused to handle the £6 million flotation, which was snapped up by Barings and yielded the rival bankers a handsome profit. Yet when asked by a journalist if he regretted turning the business down, Lord Rothschild replied: ‘I don’t look at it quite that way. I go to the House every morning and when I say "No" to every scheme and enterprise submitted to me, I return home at night carefree and contented. But when I agree to any proposal, I am immediately filled with anxiety. To say "Yes" is like putting your finger in a machine: the whirring wheels may drag your whole body in after the finger.’ Risk averse, yes - but then one of the secrets of success in banking is not to go bust.

8. Be a rich man.

Buy my favourite Rothschild story is an old German-Jewish joke: ‘Herr Baron, Herr Baron,’ asks the archetypal stock market hanger-on, ‘What will the markets do tomorrow?’ ‘If I knew that,’ replies Rothschild, ‘I’d be a rich man.’

> *‘A major pitfall to any investment strategy is the discrete start of the investment program. If all funds are committed at the start of the program, the overall performance of the investment program will depend significantly on the specific entry point. Build up positions over time.’*
>
> Richard Olsen

Kenneth L. Fisher

Ken Fisher is best known for his ‘Portfolio Strategy’ column in *Forbes.* He is the sixth longest running columnist in *Forbes’* 83 year history. He is the founder, Chairman and CEO of Fisher Investments, Inc., an $8 billion dollar money management firm with offices in Woodside, CA, and in London, serving large corporate and public pension plans, as well as endowments, foundations and high net worth individuals.

Ken has written three major finance books and been published and/or interviewed in virtually every major American finance or business periodical.

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The Warren Buffett Way (Bill Miller, Robert G. Hagstrom) John Wiley & Sons Inc, 2005

Common Stocks and Uncommon Profits and Other Writings, John Wiley & Sons Inc, 2003

Engaging The Great Humiliator

1. Engage The Great Humiliator without ending up humiliated by it.

The market is effectively a near living, near spiritual entity that exists for one goal and one goal only - to embarrass as many people as possible for as many dollars as possible for as long a time period as possible. And it is really effective at it. It wants to humiliate you, me and everyone else. It wants to humiliate Republicans and Democrats and Tories. It is an equal opportunity humiliator. Your goal is to engage The Great Humiliator without ending up humiliated by it.

2. Never forget - you are really Fred Flintstone.

If you always remember you have a stone age mind genetically trying to deal with post-industrial revolution problems, you will better understand your cognitive difficulties in seeing the market correctly. We got our brains from our ancestors and they are both genetically identical to those that existed before markets did, but also the ways we process information are almost identical to they way information was processed thousands of years ago. When you think of a tough stock market problem in terms of how would a stone age person think of this, it takes you to rudimentary evolutionary psychology, which is closely linked to behavioral finance and leads quickly to being able to see yourself better and better understand your problem.

3. The Pros are always wrong.

For decades people have presumed that the little guy is wrong and the sophisticated pro is more likely to be right. The concept is cute but is inconsistent with finance theory. The reality is that professional consensus is always wrong. Why?

The market is a discounter of all known information. That is core finance theory. Everyone has information, but on average professionals have a lot more access to information than normal people. Professionals as a group have access to all essentially known information. So, if you can figure out what professionals as a group believe will happen you know what has been discounted into current pricing from all known information and therefore cannot happen. It is theoretically and empirically perfect.

The pros as a group are a perfect guide to what won’t happen. Knowing what won’t happen doesn’t tell you what will but eliminates a big part of the possibility spectrum and gives you a leg up on figuring out what may happen.

4. Nothing works all the time.

Sometimes growth is hot. Sometimes it’s not. Sometimes value leads. Sometimes small caps do. Sometimes foreign stocks lead and sometimes domestic stocks do.

Investors have layered their thought processes on top of thousands of years of a prior process we did well that we now call collecting. Thousands of years ago people collected food, stone points for spears, firewood and much more. Now people collect for fun because our brains are adept at it. Collectors collect consistent with their biases and their access to information and or stuff. Their collections tell you more about who they are than the stuff.

In equities they collect in categories consistent with their biases, like value, growth, etc.... The value guy and growth guy both think their categories are basically and permanently better. But in the long run they all end up with almost exactly identical average annualized returns, and *must* - it is core to how capitalism’s pricing mechanism works.

5. Most investors will go to hell or die not understanding why.

If you don't fathom number 4, above, and actually believe that some category of equities is basically better or worse than others, you are not alone. Most investors, being collectors, believe that, including most professionals, most of whom are collectors.

But to say some equity category is basically better permanently is to say that you either disbelieve in capitalism, in which case you are sure destined to hell, or that you don't fully fathom its pricing mechanism.

In the long term supply is much more powerful in setting securities prices than demand and the only marginal costs of new supply are distribution. All other costs can be amortized over large unit volume to drive them to zero if the price of the equities is high enough. What that means is that as soon as investment bankers see any excess demand for any equity category they busily go about the process of starting to create new supply to meet it. To the extent they do so, which may take some time, they pull that category's pricing back into line with all other categories. When you look at 30 year average annual returns of equity categories they are all essentially identical and always will be. It is core finance theory.

6. Heroes are myths.

The great investors of the past were mostly innovators, but because they were if they were alive today they wouldn’t do it now the way they did it then. That was then; this is now. Almost everything from the past is obsolete now.

Think of it like being Intel. If Intel made semiconductors now like it did 15 years ago, it would be broke. You have to keep learning, changing, adapting and adopting the latest and newest capability. If you don’t you will get left behind. If you don’t believe that, watch me leave you behind. Hence it is a mistake to say things like, “I want to be an investor like Ben Graham (or any past guru) was” - because they wouldn’t do it like they did themselves - *now*.

7. Pray to The Luck God.

In behavioral finance theory the ultimate sin is accumulating pride and shunning regret. Accumulating pride is a process that associates success with skill or repeatability. Shunning regret associates failure with bad luck or victimization. Accumulating pride and shunning regret is something people have done in our normal lives for more than 25,000 years, since *Homo Sapiens* first walked as modern man. It motivates us to keep trying in non-financial activities and is surely good.

But in financial activities it cause us to become overconfident and enter into transactions for which we have no particular training, background, experience or special knowledge and when we enter into overconfident decisions we get bad luck - we become unlucky.

To become lucky reverse the process and learn to shun pride and accumulate regret. Then you assume success was materially luck, not skill and not particularly repeatable. You assume failure was not bad luck or victimization but your own lack of skill and hence mandating introspective lessons to self-improve. When you do that you make less overconfident decisions and become fundamentally lucky instead of unlucky. This is just using finance theory to get lucky.

8. Market timing is terrible unless you time it right.

Most of the time the market rises. Unless it is a real bear market, all attempts at market timing backfire and become very costly. But when you actually encounter a real bear market, recognizing it and taking corrective actions is near life saving. But it is hard to do because you have to build and maintain the skills for so doing while not deploying them for years and sometimes many years during bull markets. Usually people who don’t use skills for a long time eventually lose them. Not very many folks can do this.

9. A bear is bullheaded until you can’t bear it.

The change in psychology that is the sign of a shift from a bull market to a bear market is that early in a bear market downdrafts are met with increased optimism. In a bull market, because the market has been rising more than folks expected, every correction is short, sharp and strong and met with near hysteria from panicky investors who fear the bull markets up-move will be largely retraced on the down side. They didn’t expect or understand the up-move so they fear wild stories about things that could make it vanish.

But after a long bull market they have learned to always buy the break, and that long-term investors always come out ahead. And then as the market drops they see it as an opportunity and become more optimistic (which you can measure by watching professional investor sentiment), and spend their cash, using up their spare liquidity and leaving none to support stocks later.

10. When you get really good: quit.

Kids aren't so good as investors. They don't know anything yet. They are impulsive and have very short senses of time. Old investors aren't very good either. They get rigid and can't change with the winds. The best investors get best between the ages of about 35, after they've gotten some real experience, and peak by about 60 or maybe even a little earlier, by which time they start slowing down.

Different people are different but I've never seen a really old investor who hadn't pretty well lost most of his prior skill set. Part of what makes a great investor is his ability to adapt but when you get too old you lose that ability. So if you've been really good, and hit it really well, plan in advance when to quit and when you get there, just stop making decisions. Let go.

> *'Ignore almost all bullish comment in newspapers about takeovers, especially hostile ones. Most of these deals destroy value, though you will not hear this from hacks, because writing about these life-or-death contests is too much fun.'*
>
> Robert Peston

Foster Friess

Foster Friess is best known as the founder of Friess Associates and its flagship mutual fund, Brandywine.

Kiplinger's listed Brandywine as one of the top three no-load growth funds in America for results in the 10 years through 1997. *The Wall Street Journal* highlighted Brandywine as one of only eight funds with over $1 billion in assets to outpace the Wilshire 5000 Index by at least 15 percentage points in 1999 and 2000. What about 1998? That might be the Fund's best year because Foster and his team adhered to their investment disciplines, forgoing short-lived gains to avoid the eventual implosion of the dot-com and tech-stock bubble. *Money* magazine concluded: "Today, after the collapse of many high-priced stocks, Friess' caution looks a lot like prescience."

Investing in growth companies

1. Never invest in the stock market; invest in individual businesses.

The benefits of focusing on the strength and promise of individual companies outweigh the effects of more difficult to predict broad factors such as interest rates, foreign currency values and general market trends. For more than 26 years, we have capitalized on the historic relationship between earnings performance and stock prices by isolating rapidly growing companies that sell for reasonable multiples of forward earnings.

2. Buy earnings, not dreams.

Three things ultimately determine a company's value: the first is earnings, the second is earnings and the third is earnings. Sure, other factors drive stock prices, but our strategy is committed to the earnings power of individual companies. We require three years of earnings history and three years in after-tax income before a stock crosses our researchers' radar screens, keeping us out of short-lived trends like the recent dot-com debacle.

3. Prefer modest P/E ratios over high P/E ratios.

We typically avoid over-researched, big-name, highly visible, high-P/E companies - the Microsofts, WalMarts and Home Depots of the world. If a shoe maker grows earnings 40 percent a year in a mature industry and sells at 10 times estimates, we’d find it much more exciting than an optical networking company that grows earnings 30 percent with a forward P/E of 50.

4. ‘Pigs at the Trough’.

Replace good ideas with great ones. Like a pig that has eaten its fill is displaced by a hungrier pig at the barnyard trough, potential holdings must earn their way into the portfolio by having more upside potential than an existing holding. Our system of forced displacement allows us to nimbly maneuver toward companies with earnings strength despite broad changes that often catch other investors off guard.

5. Don't buy 'market leaders'.

Find a #7 company in an industry headed for the # 3 spot because its recognition increases and its P/E expands. There's more money to be made in finding tomorrow's winners than in chasing yesterday's.

We were early buyers in Cisco in 1990, one year after it went public, and the second largest holder of Dell years back. When they become household names with hefty prices relative to their earnings growth, we sold for lesser knowns with substantially more earnings upside per dollar invested.

6. Don’t subscribe to the ‘I Love Lucy’ investment strategy.

Lucy believed the 10 cents a jar she and Ethel lost on their kitchen-based jam business could be ‘made up on volume.’ The strategy didn’t work for them, it didn’t work for the dotcoms and it will never work.

In 1998 and 1999, analysts hyped internet start-ups preaching ‘earnings don’t matter’ in the ‘new economy,’ focusing instead on price-to-sales ratios and website ‘hits’. Only companies that turn an innovative idea into a consistent profit-generating business deserve our attention.

7. Don’t let the tax tail wag the investment dog.

Gains can and do evaporate. We operate under the premise that shareholders would rather make money than risk losing it in order to avoid a tax bill. Brandywine’s taxable shareholders made over $3 billion dollars in 1999 and 2000. Sales of Nortel, Nokia and other technology stocks near all-time highs on signs of deteriorating fundamentals saved $1 billion.

8. Indexing makes no sense.

Investing in a pre-constructed basket of stocks, including the sick and outrageously over-valued ones, has never made sense to us. There are just too many variables. After a tremendous run-up in the 'Nifty-Fifty,' the S&P 500 peaked in 1973, failing to reach that level again for nine years. In the 24 months ended March 31, the S&P 500 as a proxy for index investors fell 8 percent while Brandywine grew 40 percent. Our challenge is to uncover fundamental developments, both good and bad, before others pick up on them.

9. Embrace entrepreneurship through teamwork.

Make the ultimate measure of success how well clients and shareholders perform. The Friess research team structure is unique. Our seven research teams are not in competition. They cooperate, sharing information from each contact they make in a real-time database and alerting others to potential opportunities. Team decisions are surprisingly selfless. There have been years when the largest bonus did not go to the person with the best raw performance, but to someone who helped other teammates excel.

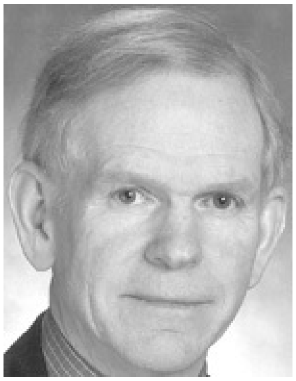
10. Accentuate the positive.

Anyone who doesn’t admit to making mistakes in the investment business hasn’t been in it long enough. Foster is motivated by Philippians 4:8, which says, ‘Whatever is true, whatever is noble, whatever is right, whatever is pure, whatever is lovely, whatever is admirable - if anything is excellent or praiseworthy - dwell on such things.’ We refer to mistakes as ‘adjustment opportunities,’ or AOs, since each AO provides insight into how we might address the situation better next time.

> *‘It is easy to get to a high value for a company – just underestimate the capital investments that it will need to make.’*

Nick Antill

Jeremy Grantham



Jeremy Grantham co-founded Grantham, Mayo, Van Otterloo & Co. LLC (GMO) in 1977.

GMO is an institutional investment management firm with over $20 billion under management. Jeremy Grantham serves as its chief investment strategist and oversees its quantitative products and investment strategies.

The firm runs over 35 equity investment products both traditionally and quantitatively managed for the U.S. and foreign markets including emerging countries.

Investment management

1. Indexing is hard to beat, and relative passivity is not a vice.

The investment management business creates no value, but it costs, in round numbers, 1% a year to play the game.

In total, fund managers are the market and given the costs they collectively must underperform. The U.S. stock market is approximately efficient - 95% or more of all market moves are unknowable noise and perhaps 5% are manageable (or predictable).

2. Historically, equity investors have over-paid for comfort and excitement.

Paying up for comfort (stability, information, size, consensus, market domination, and brand names) and excitement (growth, profitability, management skills, technological change, cyclicality, volatility, and most of all, acceleration in all these) as growth managers do for example, is not necessarily foolish, for their clients also like these characteristics.

Conversely, when a value manager is very wrong - as he will be sooner or later - he will be fired more quickly than a growth manager.

3. One of the keys to investment management is reducing risk by balancing Newton (momentum & growth) and regression (value).

Bodies in motion tend to stay in motion (Newton’s First Law). Earnings and stock prices with great yearly momentum tend to keep moving in the same direction for a while, perhaps because economic cycles are, on average, longer than a year.

Be aware that everything concerning markets and economies regresses from extremes towards normal faster than people think (e.g., sales growth, profitability, management skill, investment styles, and good fortune).

4. Ability to handle illiquidity is a major advantage for long-term investors.

Because everyone's time horizons are shorter than they should be, liquidity is overpriced. A long-term investor should always try to exploit the other guy's short-term horizon and be paid for taking illiquidity.

5. Confidence factors are the primary influences on price levels in the U.S. market, not fundamental factors like growth and real interest rates.

Confidence is primarily affected by inflation, volatility of the economy and corporate profit margins (not growth) and the importance and make-up of confidence has been remarkably stable for 100 years or more.

Because rising margins drive confidence and p/e’s up and sales growth does not, market cycles tend to double count: rising margins x higher p/e’s followed by falling margins x lower p/e’s. Therefore, the market deviates far more from economic trend than strictly financial logic would allow. Trading noise further adds to this non-economic volatility.

6. The single most important advantage for traditional investors vs. quants is a tight focus.

Quants will never win in U.S. Electric Utilities. For quants, the relative advantages are complexity and speed of price moves (however because quants can handle more variables they can’t resist using them -they can easily end by throwing in the kitchen sink and drowning in detail and data mining). In addition, liquidity problems and risk control are also more easily addressed by quants. Quantitative models tend, like chess models, to get a little better every year. While traditional managers can only handle so much data. (But unlike chess models, quants do not have to beat Kasparov but only the average market player.)

7. Asset allocators must be picked on faith.

With a 60% hit rate it takes a good manager only 1.5 years to prove he can pick stocks because of many decisions a year, but 55 years to prove he can pick stocks vs. bonds (assuming only one decision every 3 years).

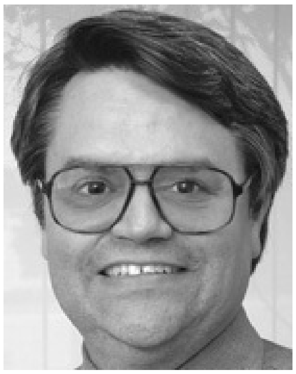
8. Investment managers are harder to pick than stocks.

Clients have to choose between facts (past performance) and the conflicting marketing claims of several potential managers. As sensible businessmen, clients will usually feel they have to go with the past facts. They therefore rotate into previously strong styles which regress (since opportunities by style regress, past performance tends to be negatively correlated with future relative performance), dooming most active clients to failure. 90% of what passes for brilliance or incompetence in investing is the ebb and flow of investment style (growth, value, small, foreign).

> *'Why look for the needle in the haystack? Owning the entire stock market is the ultimate diversifier. Buy the haystack!'*

John C. Bogle

Robert V. Green



Robert V. Green is an accomplished investor, entrepreneur, and business writer. He was the founder and President of Numetrics, which created a personal portfolio management product for individuals. He was also the president and founder of 401(k) Today, the first internet based advisory service for participants in 401(k) plans. He writes about investing at Briefing.com, where he does original research on companies and follows trends in technology.

Handling the emotional side of investing

1. There is no such thing as a good stock.

There are only good companies. When someone tells you “this is a good stock” you need to look beyond the stock chart. *Why* is the company a good company? How will it grow its business? If you can’t answer these questions, you don’t know what you own.

2. Have a premise.

When you buy a stock you must have a premise. A premise is a reason why that particular stock will go up. For best results, the premise will be one that explains why the company's line of business will increase, and why the marketplace will value that business at current or higher multiples. Without a premise, you don't own an investment, you just own a stock.

3. Think trends. Buy stocks.

If you really want to invest in big growth stocks, you need to invest in secular trends. Secular trends are events unrelated to either the economy or individual company events. The advent of the PC, the birth of the internet, and the desire for wireless phones, are all secular trends. The biggest investment winners are those companies which are ideally placed to reap the benefits of large secular changes. Microsoft and Intel rode the transition to PCs as computing power became cheaper and cheaper. Nokia, Motorola, Qualcomm, and Ericsson all found themselves unable to keep up with demand in the mid 1990s, when wireless phones finally reached the critical price points. If you want really big winners, find the trend, then find the stocks.

4. Know your risk tolerance.

The biggest mistake most investors make is to buy positions with more risk than they can really tolerate. This is where most people got hurt in the internet bubble burst. They had no idea they owned risky stocks. If you can always tolerate, both financially and emotionally, the complete loss of your entire position, you obviously will be okay. But most people aren’t in that position. Figure out how much downside you can live with without having to sell. Figure this out before you buy the stock.

5. Don’t average down to feel better.

‘Averaging down’ is often a way to lose more. If you believe in the company, and the price goes down, you may want to invest more. But if you, like many others, purchase more simply to lower your ‘break even’ stock price, you are making a mistake. If you find yourself calculating new ‘average price per share’ points, you might be averaging down for the wrong reason.

6. Don’t miss the train to shave a dime.

If you are investing in a major trend through a stock, and have a multi-year investment horizon, what difference does a few cents per share make on your purchase? Many investors try to place buys with limit orders just below the ask, and wind up missing the purchase. If you really want a stock, particularly a big position, place a limit order at the ask, or even slightly higher. You will at least get the order. This is especially important if you are trying to buy far more shares than the current ask size. If you are right about the trend, you will never miss the extra ten cents per share.

7. Don’t buy hot and watch cold!

Many investors buy a ‘hot stock’ and immediately look for big gains. When they don’t happen, the stock falls away from the daily attention list. Pretty soon it starts to edge downward, and, emotionally, the investor stops watching it. Pain avoidance is common to us all. But you can’t let pain avoidance prevent you from watching your stock. If you do, you often take a look two months later and find the stock is far from hot, and you are now presented with a really painful decision.

8. A hold is as good as a buy!

There is no such thing as a ‘hold’ decision. If you wouldn’t buy the stock again today, assuming you had additional money, you should either sell, or admit that you are confused. Resolve the confusion. The hold condition often happens when you have owned a stock for years, are way ahead of your basis, and are basically happy. But what is driving the stock today? What will make the price rise in the future? Why would you buy the stock today, assuming you didn’t own it? If you don’t know, you don’t have a premise for this stock. See rule 2.

9. Don’t be an inadvertent long-term holder!

When your premise doesn’t work out, or you no longer believe in the stock, you must sell, even if it means a loss. Holding on just to ‘get my money back’ is the single biggest reason for losing more money. Who owns all those stocks that have lost 98% of their value in 2000? A good percentage is owned by people who turned into long-term holders inadvertently, when they made the decision to just stick it out.

10. You will lose money!

You won't be right every time. If you are going to be an investor, you need to become accustomed to losing money on some positions. This rule is the natural consequence of living up to rules 5, 7, and 9. Taking losses is often the only way you can save your capital from further losses.

'Historically, convertible bonds have offered about two-thirds of the upside performance and about one-third of the downside risk of the underlying common stock.'

John P. Calamos

Herb Greenberg

Herb Greenberg is senior columnist for TheStreet.com. Before joining TheStreet.com he was a columnist for 10 years at the *San Francisco Chronicle*, and a reporter for the *Chicago Tribune*. He also spent a year as an analyst at an arbitrage partnership.

Avoiding problem stocks: lessons from Lernout & Hauspie

Lernout & Hauspie, a Bulgarian developer of voice recognition software, found a fast audience with Wall Street with its sexy story: *software that will eliminate the need to type*. But the sizzle was more than the substance, causing the company to catch the eye of shortsellers who began probing its underbelly. Not only was it run by Gaston Bastiaens, known in Silicon Valley for the fast rise and fall of Quarterdeck, but it was engaged in various related party dealings that questioned the quality of its financial results. The company denied there were problems, but in the end Lernout filed for bankruptcy and within months the company’s co-founders and former CEO were arrested on securities fraud charges. The stock, which once traded as high as $72 USD in its high flying days, now trades for just pennies.

1. Don’t be fooled by a supposedly hot new technology that is a better story than a business.

Lernout & Hauspie is the poster child for this. Speech-recognition technology is likely to be big one day, but in all likelihood it will be a low margin product that is given away.

2. If one analyst drops coverage of a company, veering from a crowded pack, find out why.

This could be the first sign of trouble.

3. Don’t ignore stories about shortsellers who are raising critical issues about a company.

This is often the first sign of trouble.

4. Take note if a company picks a public fight with shortsellers and/or refuses to return calls to reporters.

This IS the sign of trouble!

5. Beware of companies that say they are immune from issues hurting their competitors.

In very few cases is this so.

6. Beware of companies that rely heavily on related-party or too-close-for-comfort transactions, no matter how well they're disclosed.

In Lernout's case there was a wide web that, in the end, helped inflate revenue and reduce expenses.

7. Don’t be fooled by companies that boast investments by well-known companies like Intel and Microsoft.

Both held big stakes in Lernout & Hauspie.

8. Don’t get fooled by a rapidly rising stock price.

It doesn’t necessarily reflect underlying fundamentals and sometimes means nothing more than . . . the stock is rising! Lernout’s went from $20 to $72 in a flash, making its investors feel like geniuses.

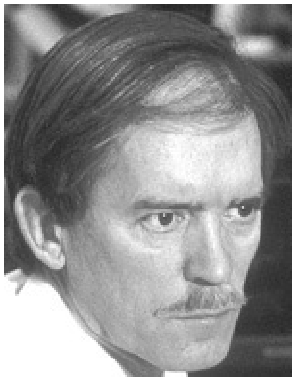
9. Be leery of any company in which the analysts raise their target price while cutting earnings estimates.

It simply doesn’t make sense unless they’re trying to hype it to issue stock.

10. The minute you think you're a genius - that you have it all figured out - start looking over your shoulder.

You are about to get blindsided.

Bill Gross



Mr. Gross is a founder and Managing Director of Pacific Investment Management Company (PIMCO) and has been associated with the firm for 30 years. As Chief Investment Officer of PIMCO he oversees the management of over $220 billion of fixed income securities. He is the author of numerous articles on the bond market, and has frequently appeared in national publications and media.

Morningstar named Mr. Gross, and his investment team, Morningstar's Fixed Income Manager of the Year for 1998 and for 2000. When presenting the award to Mr. Gross, Morningstar stated that he had earned the award by "demonstrating excellent investment skill, the courage to differ from consensus, and the commitment to shareholders necessary to deliver outstanding long-term performance."

BOOKS

Bill Gross on Investing, John Wiley, 1997

Everything You've Heard About Investing Is Wrong, Times Books, 1997

Cost reduction and other essential lessons

1. Where are the customer’s Gulfstreams?

Instead of yachts, the brokers and money managers own Gulfstreams these days – but no difference. The point is you must work intensely to keep your investment expenses as low as possible. Reduce commissions and trades. Make sure your mutual fund expenses are .5% or less annually. Keep the money in your pocket and out of the hands of those who need it the least.

2. Stocks don’t always outperform bonds.

Stocks are the best liquid investment for the long term, but not for all terms. From 1930-1955, Treasury Bills outperformed the stock market. Same thing from 1960-1974, as well as for much of the first part of the Nineteenth century. Stay diversified consistent with your ability to weather an equity thunderstorm or two - and remember, slow and steady sometimes wins the race.

3. When you think you've found 'the answer' – think again.

Formulas, models, and anything that assures you that the next twenty years will resemble the last twenty years are all hokum. Examples of historical sure thing dinosaurs include a focus on money supply statistics, the Philip's 'unemployment' curve, and relevant factors which determine P/E ratios and currency levels. By the time you've got it figured out, somebody else probably has too and the predictive ability disappears.

4. The long term is the right term.

Short term fixation on economic and market movements is confusing and often leads to emotional reactions to sell at bottoms and buy at peaks. By focusing on longer term, more stable trends (demographics, globalization, political shifts) an investor gives himself a better chance to follow the right road map.

5. Turn over your portfolio at a snail's pace.

Turnover can eat into an investors profits in several ways. First of all, commissions add up and depending upon your broker can be 1%+ annually. Secondly, rapid turnover plays into the hands of Uncle Sam by providing him capital gains to feed off of. Slow and methodical changes are best for these and the reasons stated in #4 above.

6. Risk and return are Siamese twins.

Risk and return are attached at the hip. You rarely can get high returns unless you increase your risk levels. Conversely you rarely can invest in a low risk portfolio unless you sacrifice return. If you think today's equity markets offer double-digit type annual returns, you're going to have to take a lot of risk to get them. Remember NASDAQ 5000!

7. "It's different this time" is generally a losing proposition, but when it is different watch out.

Economic, business, and investment cycles invariably repeat, if only because human nature itself is so consistent. Investors and business people become overly optimistic at just the wrong times. The same goes for pessimism at market bottoms.

Thus the perpetual cycle is born. Every once in a while though, something dramatic changes the routine – a new technology, a change in politics, a catastrophic series of human errors. Be on the lookout. Sometimes it *is* different, but not often.

8. Beware of the snake oil and its salesmen.

Wall Street and Main Street are full of hucksters – hocking their opinions like touts at the nearest racetrack, except in this case with apparent sophistication and worldly knowledge. Know that they almost always are working for themselves and not you. Analysts' recommendations are primarily meant to line their own pockets not yours, so filter what they have to say very carefully.

9. A guru not busy being born, is busy dying.

There are very few authentic gurus in this world of investments. I've seen almost all of them come and go for nearly 30 years now. Their moment in the spotlight is rarely longer than the proverbial 15 minutes. Listen to only a few chosen experts and then with the knowledge that they are fallible and made of plaster, not marble.

> *'Avoid the losers' game of owning favorite stocks for the long term. Rapid and relentless change makes the odds of extended corporate dominance extremely low.'*

Donald Cassidy

Steve Harmon

Steve Harmon is one of the technology industry's most-recognized analysts and investors. He was named by *Worth* in its list of fifteen top visionaries (1999); by CBS.MarketWatch as one of four 'Best of Wall Street' analysts (1998), and by *Smart Money* as one of three rising stars in technology investing (2000).

Harmon is CEO of High Velocity Ventures (www.highvelo.com), which consults entrepreneurs and venture capitalists in building businesses, and investors understand the shifts in technology with research and information about private and public companies.

Commonsense lessons on technology stocks

1. Earnings matter.

Don’t pay for promises, pay for actual earnings. Things change too fast to pay for next year’s performances. If a company lacks earnings it’s higher risk. Debate whether or not you’re comfortable with that but limit your exposure anyway by making it a small part of your overall investment strategy. Every other metric in the world is only a piece whereas earnings makes the whole.

2. Don’t be wowed with the technology.

Be wowed with the business model, management team, market share, technology and most of all, cash flow and earnings. The best technology doesn’t always win. Xerox PARC developed most of the key improvements for PCs and networks but yielded none of the benefit directly to Xerox the company.

3. Forget the peaks, study the valleys.

Just because a stock is 50% off its high doesn’t mean it’s a bargain. Don’t believe the newspaper headlines. As investors we learn more from mistakes sometimes than success. Study a company’s ups and downs and economic cycles - and study its P/E, not how far has it fallen from its 52-week high. How far is it off a low and is the low in line with a ‘reasonable’ valuation? Reasonable being 10x to 30x earnings depending on the growth rate, or versus historical average P/E.

4. Listen to what the executives say, but more importantly, listen to what customers say.

Look at inventory pile up or order backlog. Are customers still buying its leading product or has another company moved in for competition? For example, in the ISP industry ask your local ISP what servers, routers and switches they use and why. Ask about pricing and performance.

5. Learn the difference between ‘betting’ and ‘investing’.

A large part of what tanked the market in 2000 was that most people seemed to be speculating. Federal Reserve chairman Alan Greenspan and the Federal Reserve with its interest rate hikes were not speculating.

Research every company you want to invest in from a wide variety of sources, as well as the sector each is part of. I use several great resources including EDGAR, Zacks, First Call, Multex, Market Guide, Hoovers, a number of finance web sites, S1 filings, 10Ks, 10Qs, S&P, Media General, CSI, Bloomberg and more.

6. Diversify investments.

Stocks. Bonds. T-Bills. Real estate. With stocks, examine low, medium and high risk stocks and know why you own any one of them. Know what the company does and how economic cycles help or hurt the company. Limit your exposure to high risk stocks. If you cannot afford to lose your investment don’t invest in high risk stocks.

7. Cash - how much does the tech company have?

Can it pay the bills for several years without selling equity or debt? Does it have a cash-flow positive business? Earnings to sustain itself? How much cash is on hand? Working capital? Thousands of companies don’t have enough cash because they were funded by external financing - rather than sales and earnings - and investors are no longer interested in footing the bill.

8. Stock options.

Many tech companies issue stock options and it may dilute the shares outstanding (and earnings) dramatically. Typically 25% to 30% of tech companies are owned by employees. They all want to convert their options to cash some day. This option overhang is seldom computed by most analysts or investors. Look in the company filings and IPO documents to see what the total fully-diluted shares outstanding are.

9. Establish buying and selling discipline.

Always employ a stop-loss to limit your downside. Typical is making it 20% from the cost of the shares or the closing price if the stock climbs. On selling, if the stock has risen a set percentage - whatever you’re comfortable with - sell some or all. Consider selling enough to cover your cost basis at the very least. Take profits. You may miss more climb but at least you have limited downside. Or if management shuffles happen quick or earnings fall short, consider selling.

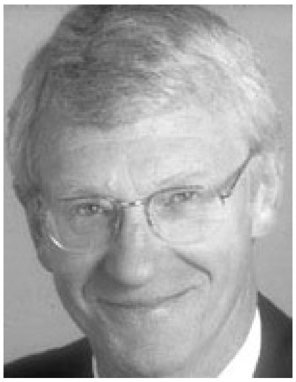
10. Never get emotionally attached to a stock.

Love the company’s cash flow or earnings but not the stock. Just because your father owned AT&T doesn’t make it a great investment. Or a stock that did well before may not be a perpetual winner. In technology the industry changes rapidly and you must keep up with those changes.

> *‘A common investment paradigm is “don’t try to hit home runs - you make the most money by hitting a lot of singles”. I couldn’t disagree more.’*

Richard Driehaus

John Hathaway



John C. Hathaway is a partner and managing director of Tocqueville Asset Management, a registered advisor. He manages the Tocqueville Gold Fund as well as separate portfolios for individual and institutional clients.

Investing in gold

1. An investment in gold should be based on macroeconomic considerations.

If one expects or fears rising inflation, destabilizing deflation, a bear market in stocks or bonds, or financial turmoil, gold should do well and exposure is warranted.

2. Understanding the internal dynamics of the gold market can be helpful as to investment timing issues.

For example, the weekly position reports of commodity trading funds or sentiment indicators offer useful clues as to entry or exit points for active trading strategies. Reports on physical demand for jewelry, industrial, and other uses compiled by various sources also provide some perspective. However, none of these considerations, non-monetary in nature, yield any insight as to the broad market trend. Reports of central bank selling or lending may influence the market in the short term but cannot counteract macro economic factors.

3. Excessive reliance on trading strategies to generate returns can be dangerous and counterproductive.

Returns from a ‘buy and hold’ strategy should be more than sufficient to compensate for the inherent volatility. Many who have tried to outsmart this market by hyperactive trading have underperformed. Success is dependent in large part on the occurrence of ‘fat tail’ events that lie outside the parameters of trading models.

4. Every investor should have some gold.

A reasonable allocation in a conservative, diversified portfolio is 0% to 3% during a gold bear market and 5%-10% during a bull market.

5. Equities of gold mining companies offer greater leverage than direct ownership of the metal itself.

Gold equities tend to appear expensive in comparison to those of conventional companies because they contain an embedded option component for a possible rise in the gold price. The share price sensitivity to a hypothetical rise in metal price is related to the cash flow from current production as well as the valuation impact on proven and probable reserves.

6. Watch out for companies that have hedged their gold exposure.

Although a rising tide may lift most boats, financial statements should be reviewed with special attention to hedging arrangements that could undermine participation in higher gold prices or even jeopardize financial stability. The carnage of the last twenty years has simplified the task of individual stock selection because so few have survived the gold bear market. But individual stock selection is less important than identification of the primary trend.

7. Don’t get caught up in gold fever.

Even though gold itself is a conservative investment, ‘gold fever’ attracts a crowd of speculators, promoters, and charlatans who only want to separate investors from their money. Avoid offbeat ‘exploration’ companies with little or no current production and gargantuan appetites for new money.

8. Bullion or coins are a more conservative way to invest in gold than through the equities.

There is also greater liquidity with bullion for large pools of capital. Investing in the physical metal requires scrutinizing the custodial arrangements and the creditworthiness of the financial institution. Do not mistake the promise of a financial institution to settle based on the gold price, for example, a ‘gold certificate’ or a ‘structured note’ (i.e. derivative), for the actual physical possession of the metal. Insist on possession in a segregated vault, subject to unscheduled audits, and inaccessible to the trading arrangements or financial interest of the financial institution.

9. Gold is a controversial, anti-establishment investment.

Therefore, do not rely on conventional financial media and brokerage house commentary. In this area, such commentary is even more misleading and ill-informed than usual.

10. Don’t settle for too little.

Should outlier events now deemed unimaginable by consensus thinking actually occur, the price target for gold would be several multiples of its current depressed price. Gold represents insurance against some sort of financial catastrophe. The magnitude of the upside is a function of the amount of paper assets that would be converted to gold irrespective of price.

> *‘In a world where annual births are static, you won’t make your fortune investing in baby clothes companies. Follow the growth age groups; they’re buying holidays, hollyhocks, healthcare and hearing aids.’*

Richard Cragg

John Husselbee

John Husselbee is a Director at Henderson Global Investors, where he is responsible for portfolio construction and fund selection for a complete range of multi manager, mutual fund portfolios. John has over 10 years experience, both at Henderson Global Investors and Rothschild Asset Management, researching and selecting fund managers to include in his retail portfolios. He sits on the AUTIF Performance Committee as well as the advisory panel for the Investment Week Mutual Fund Awards. John writes a regular monthly column for Bloomberg Money and is a regular guest on Bloomberg TV.

Selecting a mutual fund manager1. Never use an old map to find new countries.

One thing I firmly believe is that consistent performance doesn’t exist. The past is only a guide. I prefer to use it as such and then look a little deeper. I want to find out how and why a fund has achieved a top ranking and then establish whether those reasons can be imposed upon current market conditions and future market prospects.

2. It’s not all about returns.

It may be a simple observation but a fund’s objective is a key issue for me. And the objective is not simply to make lots of money. Each fund has a stated objective, quoted in their scheme particulars, and guidelines on how it aims to achieve it. Does the objective match your own? Is the manager’s style, which can be gleaned from the types of company he holds (larger companies or smaller companies, for example), appropriate? A clear understanding of the objectives and management style and consistency of approach will assist in predicting how the fund will behave in the prevailing market conditions.

3. Experience brings its own rewards - let the apprentices practice with someone else's money.

The fund manager's experience is extremely important. And that means experience relevant to the fund he is managing. Look at the manager's track record for both his current fund and any previously managed funds. This information can be easily obtained. I'm happier investing in managers who have mastered their craft in varying types of market conditions. This is particularly relevant given the extended bull run we've seen recently. There are many managers out there who have no experience of managing money in bear markets.

Loyalty and length of tenure are also attractive qualities in a fund manager. As well as providing a clear track record, they can also highlight whether a manager's own objectives are in line with the fund's.

4. You can get a better view from the big house on the hill.

The larger investment houses can bring a great deal to the party. In many instances the investment house dictates asset allocation and has particular views which the fund manager is bound to follow. This will naturally have a big effect on how the fund is managed and how it performs. So remember you're buying the house as well as the manager.

The larger houses can also provide a great deal of resources to the fund manager, particularly in the form of global economic and company information. The manager of a large house will gain greater access to the companies he invests in. Such first hand information will certainly benefit you as an investor. These houses can also provide an element of security and inspire confidence.

5. Elephants can’t gallop.

The size of a fund matters and can bring with it problems for the manager. Good managers very often become victims of their own success. Cash pours in from investors hoping to share in the success of the top performing funds. Trying to invest large amounts of money can dilute a manager’s ideas.

Make sure the size of the fund sits well with the fund’s objectives. A smaller companies fund, for example, is going to have difficulty investing £1 billion. A word of warning though: small funds can flatter an average fund manager so don’t go small for the sake of it.

6. Show me what’s up your sleeve!

Investing money isn’t a magic show. You should expect complete transparency. There should be a clear flow of information, revealing exactly what a manager is up to. The companies he invests in, the transactions that take place and the reasons why decisions have been made. You can only make an informed decision if you have all the information to hand. The manager should have no secrets. If he’s hiding something then he’s got something to hide.

7. Beware the siren’s call.

Don’t let the clamour of sales and promotions distract you from the core essentials of investing. Be confident in the reasons why you are investing. Everyone’s looking to promote Number One figures and you’d be amazed how many Number One funds there are out there. Look behind the figures and check the timescales and the management. A Number One fund is no good to you if the manager has since left. And watch out for the press-fuelled thematic bandwagon. It could entice you onto the rocks of an investment you’re simply not suited to.

8. Be sure you understand what you’re letting yourself in for.

Investing is a risky business. In fact it is the business of managing risk. Always understand that if you’re chasing big returns they come at a price. Risk and return is a clear trade-off so make sure you’re comfortable with the ratio.

9. A little knowledge is a dangerous thing.

You can’t beat in depth research. Quality information makes the decision process less emotive. Look deeper - it’s worth it.

10. Knowing when to sell.

You should review your circumstances and expectations regularly and see if your current portfolio still sits comfortably within them. If it doesn’t, make changes.

Remember, poor performance may be temporary so understand why before making a decision. If a manager has left - what’s the new one like? If the manager isn’t doing what he said he would - what is the impact on you?

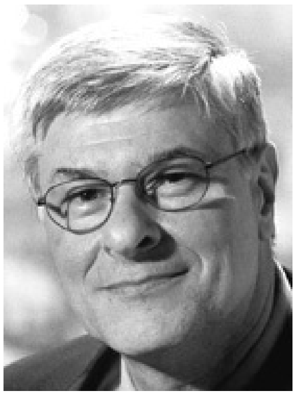
Most of all, take control. Ensure that you are getting what you want from your investments. They are yours, after all.

‘Each day, millions of managers the world over systematically destroy shareholder wealth, sometimes in huge amounts. Why? It is not because they are incompetent. Nor because they are dishonest.

It is because they are responding rationally to the compensation systems used by the vast majority of corporations which reward them for over-investing in mature industries, over-spending on labor-saving automation, and over-paying for acquisitions.’

Joel Stern

Roger Ibbotson



Roger Ibbotson is chairman and founder of Ibbotson Associates, a leading authority on asset allocation, providing products and services to help investment professionals obtain, manage and retain assets. The company's business lines include asset allocation, investment consulting and planning, analytical and wealth forecasting software, educational services and a widely used line of NASD-reviewed presentation materials. Mr. Ibbotson is also a professor in the practice of finance at the Yale School of Management.

How to manage your asset allocation

1. Invest in stocks for the long run.

Several studies suggest that future stock returns will be much lower than past returns. In fact, one study even suggests that the future equity risk premium is negative, meaning that stocks will not beat bonds in the future.

Our research shows, however, that of the 11 percent that the market returned each year over the past 75 years, only 1.25 percent was from an increase in the P/E ratio - the rest was from actual earnings growth. While changes in P/E ratios are largely responsible for returns in the short term, they are highly volatile and unpredictable. In contrast, growth from corporate earnings accounts for returns in the long run and is relatively stable. There is good reason to believe that stocks will continue to provide significant returns over the long run.

2. Asset allocation is the most important of all investment decisions.

On average, investors don't beat the market, which means that the asset allocation mix accounts for 100 percent of the return on an average portfolio. Of all the decisions investors make, therefore, the asset allocation decision is the most important. Typically, 40 percent of the return difference between one fund and another is explained by asset allocation differences, while the remaining 60 percent difference is explained by security selection, timing and fee differences between the funds.

3. Diversify across and within asset classes.

The extended superior performance of large cap growth and technology stocks through the last half of the 1990s lulled investors into a false sense of security. If 2000 taught us anything, it's that hot stocks and asset classes are difficult to predict and equally hard to time. Returns, historically, tend to come in spurts that make momentum investing and market timing unreliable investment strategies. Investors should heed the old adage, 'Don't put all of your eggs in one basket.'

4. Invest globally.

Although the correlation between the U.S. and international markets is rising, that’s no reason to reduce international exposure. The United States only accounts for approximately half of the world’s market. Americans traditionally allocate far too little to international markets, cutting off a huge portion of the investment universe. The correlation is still relatively low and continues to provide substantive diversification to investors’ portfolios.

5. Minimize costs.

The costs associated with purchasing investments are certain, but the returns of those investments are not. And, over time, high returns in one year tend to cancel out low returns in another, but costs just compound. Differences in fee structures explain much of the performance difference between two funds over the long run. Paying close attention to the cost structure of an investment will increase total return.

6. Limit the impact of taxes.

Know how different types of gains are taxed and hold them in the appropriate accounts. To capitalize on the full benefits of tax-deferred or exempt accounts, make the maximum contributions and hold highly taxed assets (such as taxable bonds, dividend-producing equities or mutual funds with high trading activity) in these accounts to defer realization of capital gains as long as possible. Hold long-term investments in taxable accounts.

7. Keep a composite record of your total wealth and accounts.

It’s easy to fixate on the big winners and the big losers in one’s portfolio rather than the portfolio as a whole. Every portfolio should have winners and losers - that’s the sign of a well-diversified portfolio. If you concentrate on the total performance, you will stay focused on your long-term goals.

8. Evaluate and rebalance your portfolio regularly.

Investors should evaluate their portfolios each year to determine if their asset allocation has significantly changed due to the price appreciation or depreciation of their investments. Rebalancing will help keep an investor on track to achieve his or her long-term goal and can help reduce risk. Investors with an allocation in technology stocks, for example, who did not rebalance annually during the tech runup took a much bigger hit during the decline than those who rebalanced.

9. Plan your investments to cover your liabilities.

We sometimes lose sight of the goal of investing, which is to accumulate wealth to finance various consumption needs. Whether it's retirement or college tuition, investors must consider how far away the liability is in time, the rate at which it is increasing and the likelihood that the chosen investment vehicle will be able to meet the liability when it's due.

10. Invest over your life cycle.

Reduce your allocation to equities as your investment horizon decreases. However, don't get out completely. People are living longer and facing many costs, like healthcare, that are rising faster than inflation. Even retirees need to have a portion of their portfolios allocated to stocks in order to finance retirement.

> *'As attractive as the concept might sound - generally something like buy global winners to capture the benefit of international markets without the risk -- the reality is that one does not get the diversification advantage of foreign stocks with multinationals.*
>
> *Domestic MNCs tend to have a beta close to 1.0 with their home market, and large-cap global MNCs are usually the most highly correlated both with each other and with large developed markets.'*

Steven Schoenfeld

Mark Ingebretsen

Mark Ingebretsen writes a weekly column on trends in online investing for TheStreet.com. He is working on his second book recounting the rivalry between the New York Stock Exchange and the Nasdaq. It will be published by Random House in January 2002.

The Guts and Glory of Day Trading, Harriman House, 2010

Using the web to perform due diligence on a stock

1. Create a watch list.

With a watch list you can monitor a stock’s daily performance before buying. Also, you can use that watch list as a base for doing fundamental research on the stock. Yahoo Finance! (http://finance.yahoo.com) allows you to do both. Many other financial web sites give you the same kind of fundamental information you’ll find at Yahoo! Finance but Yahoo’s pages load the fastest. And they let you explore SEC filings, options prices, recent analyst upgrades and downgrades.

2. Find out what people are saying about the stock.

A web site called Validea.com (www.validea.com) tracks what financial reporters and analysts have had to say about your stock recently. Not only that, the site details the track record of each pundit. You can also ferret out opinions on a stock by searching the archives at the financial news site TheStreet.com (www.thestreet.com). The search window appears on the site's home page. For technology stocks, CNet (www.news.com) is especially helpful, since it leads to reviews of a company's products from a wide-ranging group of magazines, both general interest and technical.

3. Get a second opinion.

Quicken.com (www.quicken.com), VectorVest (www.vectorvest.com) and ValuEngine (www.valuengine.com) all have free stock analysis software on their sites. Simply enter a ticker symbol and the number crunching software will give you an opinion on, for example, what the stock's fair value might be, or what its growth prospects are. Compare this information with what analysts have said about the stock.

4. Analyze the stock's sector.

As much as 80 percent of a stock's movement can stem from movements by the sector as a whole. The web site ClearStation (www.clearstation.com/cgi-bin/Itechnicals) shows you how the stock's sector has been performing. Using a list of fundamental and technical indicators it compares the sector performance to its component stocks.

5. Determine the trend.

Will the stock likely rise or fall in the near term? Using technical indicators the web site BuySellorHold (www.buysellorhold.com), gives you a quick read on the trend and points to short-term support and resistance levels.

6. Know the risk of ownership.

At RiskGrades (www.riskgrades.com) you can simply enter a ticker symbol, specify a period - say, six months - and then view a graph of the stock's volatility as compared to the market. Another useful site called BigCharts (www.bigcharts.com) again lets you specify a period, and then see a chart detailing how the stock traded that week.

7. Develop a plan.

At what point should you buy the stock? When would it be most advantageous to sell when factoring in such things as dividends, and tax consequences? The free calculators at FinanCenter.com (www.financenter.com) let you quickly perform calculations like these.

8. Monitor your performance.

A web site called Gainskeeper.com (www.gainskeeper.com) will automatically track your cost basis in a stock, calculating the effect of dividends, splits, spin offs, *etc*. The site will also automatically generate a Schedule D used for reporting capital gains on a U.S. tax return. Fees for this service start at US$49 per year.

Philippe Jorion

Phillippe Jorion is a Professor of Finance at the University of California at Irvine. His recent work addresses the issue of forecasting risk and return in global financial markets, as well as managing exchange risk with derivative instruments.

Value at Risk Fieldbook, McGraw-Hill, 2000

Value at Risk, Irwin, 2000 (2nd ed.)

Big Bets Gone Bad, Harcourt Brace, 1995

Financial Risk Manager Handbook, John Wiley & Sons Inc, 2005

Value at Risk

1. Balance returns against risk.

If you want no risk, invest in cash. You sure cannot get greater returns without assuming some risk. Your goal should be to get the just reward for the risks you elect to take. But you need to measure your risks.

2. Use Value at Risk (VAR) for an intuitive sense of risk.

VAR is a first-order measure of downside risk. It is the maximum loss over a target horizon that will not be exceeded at some confidence level. Say you have $1 million invested in a diversified stock portfolio. You would then say: “Over the next year, the VAR at the 95% confidence level is approximately $330,000.” You would expect this loss not to be exceeded in 95% of cases, or 19 years out of 20. But in one year out of 20, there will be a larger loss. If you are uncomfortable with this risk profile, you should alter the asset allocation. But at least this will be an informed decision.

3. Risk should be measured in a portfolio context.

What looks like a volatile investment, say in an emerging market, may have little effect on the total portfolio risk. Actually, if foreign equities move in opposite cycles to domestic stocks, portfolio risk is reduced. Limiting the amount invested in more speculative assets can also control risk. Portfolio risk is best measured with VAR.

4. Beware of chasing winners.

Picking losers among mutual funds is a bad idea, but picking winners can be dangerous too. Winning portfolios may be heavily exposed to the same risk factor, say the high-tech industry. If so, loading the portfolio with winners will create undue risk concentration. A downturn in this industry will hurt badly.

5. Risk is a double-edged sword.

Beware of traders that enjoy sizzling returns. Risk is the dispersion in unexpected outcomes, and not only the occurrences of losses. Countless investors have missed this point, as they failed to realize that the performance of traders, such as Nick Leeson or Robert Citron, really reflected greater risks. Extraordinary performance, both good and bad, should raise red flags. Ask questions, if only to imitate them.

6. There is no such thing as 10% or more excess return with no risk.

Anybody making such a statement either has not measured risk or did not measure it well. Robert Citron maintained that his fund was "safe". He managed to lose $1.6 billion out of $7.5 billion invested. He did not measure his risk. The partners at LTCM maintained that the fund had a daily volatility of $45 million only. They managed to lose $4.4 billion out of $4.7 billion. The real risks were misunderstood.

7. Watch for large short positions in options.

These created most financial blowups. Short options positions collect regular premiums but take a large hit once in a while. Victor Niederhoffer was a legend in the hedge fund business, returning an average of 32% annually from 1982 to 1997. In 1997, he sold naked out-of-the-money puts on the S&P and was wiped out as the market dived. LTCM's positions amounted to a huge short option position, a bet on volatility and liquidity risk. Similarly, selling earthquake insurance is profitable until the big one hits.

Ajay Kapur

Ajay Kapur is a Managing Director at Morgan Stanley in Hong Kong and the firm’s Asia/Pacific equity strategist. He is ranked as #1 equity strategist in 2001 by Institutional Investor and the Greenwich (US) survey.

Prior to working at Morgan Stanley, he was the Asia equity strategist at UBS Securities, the Chief Economist at Peregrine Securities in Hong Kong, and an economist for WEFA Group in the USA.

Investing in Asian equities

1. Ride the cycle - don’t freewheel.

Asian equities are trading, not trending markets. Buy and hold, and you will fold. Corporate profitability in Asia is extremely cyclical, being linked with the global business cycle. Margins are compressed by replicated capacity, more assertive labor and a lack of franchises - hence, the need for the cycle to be positive.

2. When global growth is low, let the Asia money flow.

Asia’s cyclical equities bottom with global growth (time to buy), and peak when global activity is strongest (time to bye-bye). Follow the US yield curve, the NAPM new orders index, the Australian dollar, and the stock/bond relative performance to track expected moves in global activity, in addition to global monetary growth and interest rates.

3. Country beats sector. Don’t go out without your passport.

In Asia, unlike Europe, country prevails over sector in stock-picking. The region is a patchwork of different monetary and fiscal policies, political cycles, development levels and regulatory risks. Lesson: know the country.

4. Know the price of everything. Don’t pay $1.50 for $1.

With the exception of technology, value triumphs over growth in secular fashion in Asia. There is no value-growth cycle, unlike in the US. Why? Investors overpay for the latest growth concept, or fashion, that emerges. Competition and capital raising attracted by the latest fashion crush excessive enthusiasm and multiples for growth stocks in Asia.

5. If the barn-door is open, don’t scramble through the skylight.

In other words, don’t ignore the big and obvious. Larger companies have higher returns on equity, a lower cost of capital, longer histories, greater survival skills, stronger political connections, rent-seeking abilities, and also attract the best talent. Small gems can be mined, but are only for those with time and a tolerance for pain.

6. Crises don’t just happen. Be a macro maven.

You wouldn’t check into a luxury hotel that violated fire safety regulations and construction codes and was located in an earthquake-prone zone. Likewise, you’ll want to avoid the financial crises that convulse Asia about once a decade. Monitor lending booms, the ratio of short-term external debt to international reserves, the current account balance, and the (generally) under-regulated non-bank financial sector where the mischief usually begins.

7. Don’t follow the herd - it may be heading to the slaughterhouse.

The herd instinct is extremely powerful in Asia. Both local retail and foreign institutional investors fall prey to it. Tracking investor sentiment is extremely profitable, if you remember that happy masses precede crashes. Bubbles come and go in Asia with regularity. Know when to get off by monitoring volatility, small cap relative performance, the ratio of market capitalization to money supply and inflows to equity mutual funds.

8. Cool today is cruel tomorrow. Leave the fads to the amnesiacs.

Restructuring, mega-growth, and unbounded prosperity from the latest fad/theme resonate at market peaks, are conveniently forgotten at troughs, and are shamelessly repeated in the next upswing. The plot lines are similar, a few characters change. Stories based on large populations hungry for the next cool product should be treated with suspicion.

9. When the political wind changes, expect the windfalls to stop.

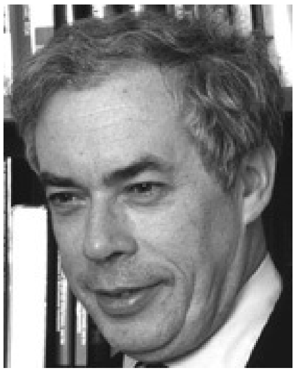
Do not underestimate the impact of politics, corruption and malpractice on stock performance. Many Asian democracies are young, the rule of law is tender, and political transitions are tricky. Cronyism and sharp practices often lead to excess returns in the short term, but can inflict large losses when political winds shift. Diversify across political factions.

10. Follow the central banks. That’s where the money is.

Track the central bank balance sheet, not just company balance sheets. Asian equity markets move closely with the liquidity cycle. Track the gap between narrow money growth and nominal activity - when rising, it is positive for Asian equities, when contracting it is negative.

> *‘The IPO market is never in equilibrium. It’s either too hot or too cold. Buy in the cold periods.’*
>
> Jay Ritter

John Kay



John Kay has been described as "the most important business analyst in Britain, bar none". He is well known for his incisive and entertaining columns in the *Financial Times,* his regular audio and TV broadcasts, and is much in demand as a speaker and consultant.

The Business of Economics, Oxford University Press, 1996

Foundations of Corporate Success, Oxford University Press, 1993

Everlasting Light Bulbs: How Economics Illuminates the World, The Erasmus Press Ltd, 2004

The Hare and the Tortoise: An Informal Guide to Business Strategy, The Erasmus Press Ltd, 2006

Business economics

1. Myth - ‘Profits are higher in fast growing industries.’

They’re not, because everyone else knows they are fast growing. Returns are often higher in unfashionable activities, like tobacco. Best are industries that grow faster than expected - whether expectations are high or low.

2. Myth - ‘Most industries are concentrating around a few global companies.’

Some are, some aren’t. The overall trend of concentration has been down over the last twenty years - even in automobiles.

3. Myth - ‘A company can get the middleman’s profit by vertical integration.’

But it will have to pay for it - you don’t save the highwayman’s toll by buying his business. Vertical integration pays only when a company can use it to extend its market power, or take control of assets that are specific to its business.

4. Myth - ‘Diversification increases the quality of business earnings.’

Sorry, but a company’s shareholders can diversify more cheaply than it can. Brokerage commissions are a lot less than takeover premiums.

5. Myth - ‘New technologies increase profits.’

If new technologies are generally applicable, then competition means that the benefits will go to consumers. Not just most of them, all of them. New technology has always been better news for customers than shareholders.

6. Look at industry specifics, not assertions about trends.

Few generalisations about industry structure stand up. You need to understand the specific nature of competitive advantage in each industry.

7. Competitive advantages come from distinctive capabilities.

The only way to make profits above the cost of capital in the long run is to do something others can’t - and *still can’t* after they see the benefits to the company that can.

8. Myth - 'First mover advantages are key - the early bird catches the worm.'

Not often, in business. There are very few industries in which being first is the basis of a sustained distinctive capability. How many of us have Ampex video recorders?

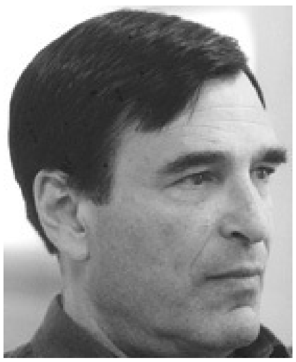
9. Myth - ‘Market share is key to profitability.’

High market share is associated with higher profitability. But that doesn’t mean higher market share causes higher profitability. Sustainable competitive advantage is the source - the only source - of both higher market share and higher profitability.

10. Beware financial engineering.

Over the long run, the only place shareholder value can come from us cash generated by operating businesses.

Mike Kwatinetz



Mike Kwatinetz is a founding partner of Azure Capital Partners, an investment advisory firm focused on technology.

He was formerly the global head of Credit Suisse Boston’s Equity Technology Research Group. Kwatinetz has been named No. 1 PC Hardware Analyst by *The Wall Street Journal* and by *Institutional Investor* for four of the past five years and No. 2 Software Analyst for the past two years.

BOOKS

The Big Tech Score, John Wiley, 2000

Investing in technology companies

1. Look for a CEO under fifty.

Technology is a very fast-paced business. While age shows a certain amount of maturity and experience, I’ve found that a lot of CEOs begin to falter once they hit a certain benchmark. Take Digital Equipment. The company’s founder, Ken Olsen, was one of the smartest people in the entire industry - but at a certain point, he lost track of where the market was heading. The PC revolution swept in and Olsen ignored it.

2. Look for a ‘virtual enterprise’.

With new technologies it’s often crucial to get up to critical mass as quickly as possible, because getting the numbers up creates an advantage both for customers and for the product. By licensing its operating system to every PC manufacturer, Microsoft made its operating system pervasive, which in turn encouraged software developers to write programs for it, which in turn attracted more users - a ‘virtual enterprise’ of partners. Apple, by contrast, refused to let its system run anywhere but on its own products, and has always remained an ‘exclusive’ product.

3. Look for an ‘increasing feedback loop’.

> Put another way, is it a product where the more people use it, the more valuable it becomes to *all* users, and the more valuable it becomes to all users, the more people get involved with it?

AOL’s buddy list allows users to type in the email addresses of a list of friends, and AOL then notifies them whenever any of those friends are online. In the first year it was offered, the service grew so popular that many people signed up with AOL just so they could use it. As more people signed up, the value of the Buddy List increased further. This became a huge competitive advantage for AOL.

4. Make sure the product cannot easily be replicated.

Meaning either that it would be so costly or time-consuming for a competitor to replicate it that it doesn't make sense to try, or that the product is protected by copyright, patent or trademark legislation.

Texas Instruments holds many of the original patents on computer memory chips, and gets a royalty for almost every memory chip that hits the market. Xerox, on the other hand, developed the graphical user interface (GUI), Ethernet and the laser printer but didn't patent anything. As an investor, it's important to determine not only how good a technology is, but also how easily it can be copied.

5. Favour strong brand names.

Few competitive advantages are as difficult to fight as a brand name. An economic advantage can be overtaken eventually, a patent may be lifted, but a great brand can be sustained for years. Note that a brand can do more than retain market share. It also allows the company to launch new markets. Amazon started as an online bookseller. A few years later, it branched into CDs, DVDs, videos *etc*. Because it had such a strong brand, it has a sea of loyal customers, already comfortable with its site.

6. Use forward earnings estimates, not historical ones.

A company’s value should be judged on its future prospects, not on its performance last year. Let’s say you’re thinking of investing in a company whose earnings per share were $5 last year, putting it on a P/E of 15. That may sound fine, until you learn that a competitor is about to release a product that is likely to bankrupt the product within a year. Basing your evaluations on historical earnings is ludicrous, especially for companies in the fast-changing technology industry, yet that is precisely what most investors do.

7. Use the P/R ratio where the P/E ratio is impossible.

If a company has no earnings, you cannot value it using the P/E (Price/Earnings) ratio. Such companies are obviously higher risk, and you shouldn’t have more than two of them in your high-growth portfolio. But you can still value them using the P/R ratio: market capitalisation divided by consensus forecast revenue.

You may be invited to invest in public companies which not only have no earnings, but have no revenue. My advice: stay away.

8. Check for all three growth drivers.

For real long-term growth opportunity, a company needs three factors in its favour: it has to be in a market that is growing rapidly; it has to growing its market share rapidly. And it has to be creating products or services which propel it into new markets. Be wary of the company that already has a large market share in a static market and which cannot branch out, because however good it is, the potential for growth is limited.

9. Put your companies through the stock screener test.

Apart from rookie companies with the potential to be superstars, any stock you hold should have revenue of at least $100 million, and have grown revenues at least 25 per cent each year for the past three years. Its rate of growth decline should not be unreasonable. On this last point, growth rates invariably slow as companies get bigger, so a slowing growth rate is not necessarily a reason not to invest. But the rate of slowing should be within certain parameters. The formula for deciding what rate is acceptable is described in detail in *The Big Tech Score*.

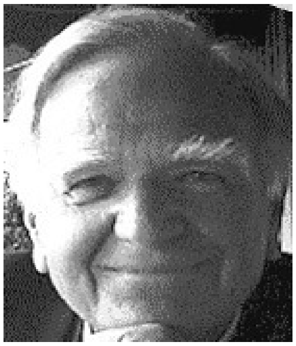
10. Check whether the company has met brokers' consensus earnings forecasts in the past.

Some companies are conservative in the guidance they give analysts, beating the quarterly estimates time after time. Others give optimistic guidance, then consistently come up short. Others have no bias at all. Try to incorporate this factor into your stockpicking: a company that has a history of doing better than estimates is likely to be cheaper in reality than its P/E suggests. And a company that routinely does worse, more expensive.

> *'Timing is everything. It didn't take a genius to figure out that tech stocks were overvalued long before the peak of the boom. But you could have lost a lot of money going short on the way up, and several fund managers lost their jobs because they kept out of the market bonanza.'*

Laurence Copeland

Dean LeBaron



Dean LeBaron, founder of Batterymarch Financial Management in 1969, pioneered the application of computer technology and modelling techniques, first in the US market and then in international and emerging markets. Batterymarch is recognized as one of the first foreign entrants in the nascent securities markets of Brazil, India, Russia and China.

BOOKS

Dean LeBaron's Treasury of Investment Wisdom: 30 Great Investing Minds, John Wiley & Sons Inc, 2002

Mao, Marx and the Market, Wiley, 2001

Dean LeBaron's Treasury of Investment Wisdom, Wiley, 2001

Dean LeBaron's Book of Investment Quotations, Wiley, 2001

The Ultimate Book of Investment Quotations, Capstone, 1999

The Ultimate Investor, Capstone, 1999

Habits

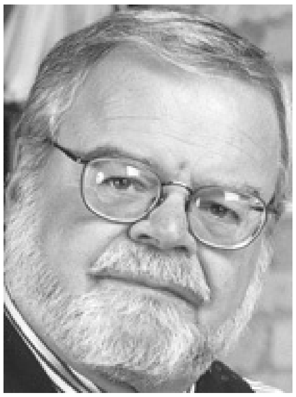
Sole Rule: Don't have rules - it's too hard to break them. My guiding precepts are habits, which others might call rules or addictions, but, like all addictions, I might try to break them when circumstances warrant . . . with varying success.

1. Observe the views of others, especially the most prestigious and widely recognized, but do not follow their prescriptions.
2. Ignore earnings and follow the cash.
3. Recognize that corporate control is worth everything or nothing; there is no point in between.
4. Learn more about enterprises from competitors than from the enterprises themselves.
5. Avoid company visits, since they are usually successful promotions.
6. Observe commercial bankers, who usually know the inside story and are a source of hints.
7. Ignore investment bankers and their advice.
8. Recognize that prestige is inversely related to future investment success.

   'Investors frequently expose themselves to great risk by seeking superior cash returns in emerging markets debt and distressed sectors. Often the risk-return trade off for these sectors is pitifully inadequate.'

David DeRosa

Steve Leuthold



Steve Leuthold is the founder and Chairman of Leuthold Weeden Capital Management and a portfolio manager for three of its funds. He has been an investment strategist, manager and researcher for more than thirty years. He is also Chairman of The Leuthold Group, an investment research organization, where he leads a team that uses quantitative historical research to develop sophisticated investment models.

BOOKS

The Myths of Inflation and Investing, Crain Books, 1980

Index Funds, The Risks And Pitfalls, 1977

Managing your mother lode . . . your serious money

1. Know thy self.

When investing, everyone has strengths and weaknesses. It is particularly important to recognize the weaknesses and continue to be aware of them. Then you can defense against them. Examples: ‘I hate to admit I’m wrong’, ‘I’m a sucker for sexy tech stocks’, ‘I’m inherently pessimistic’.

2. Discipline is essential.

Establish your own personal set of investment disciplines, carefully considering your own investment shortcomings. Write them down. Carry them with you. Follow them. Revise your disciplines only after considering the revisions for a period of time (in a de-emotionalized state).

3. Manage risk as well as return.

When deciding on an investment, always consider how much you might lose, as well as how much you might make. Compare the potential risk with the potential reward. Does it make sense if the potential gain is 25%, but if things go wrong the risk is 50%? Apply this kind of analysis to an entire market (bonds, stocks, real estate), as well as to individual issues.

4. Cash is not trash.

Cash reserves reduce overall portfolio risk in declining markets. But more importantly, cash reserves provide the investor with the ammunition to take advantage of the unexpected opportunities that develop in markets - see the next rule.

5. Market crisis is market opportunity.

Your emotions say sell, sell, sell. But your personal disciplines previously established say BUY! However, if you have no cash reserves, the opportunity is lost.

6. Bonds can be best.

Over the next year, if yields fall to 6%, a 20-year bond now priced to yield 7% will provide a total return of over 20%, twice the historical return achieved by the stock market. What of the risk? If yields rise to 8% instead of falling to 6%, the total return loss from the bond is less than 2%. And, with bond yields rising, the stock market could be down much more.

7. Stock market new valuation eras have always been temporary.

When Wall Street starts using the term ‘new era’, saying it’s really different this time for the stock market . . . well, that’s the signal to consider asset class options like cash and bonds. While bubbles can inflate beyond most all expectations, they always ultimately burst.

8. Not even Microsoft is forever.

Virtually every blue chip growth company ultimately has matured and become a no-growth company. No company's earnings growth will ever be permanent. Of America's 100 leading companies in 1920, only 1 is on the list today (GE). Thus, you can't just buy today's leaders, put them away, and expect them to still be leaders 20, or even 10 years from now.

9. Short term trading is a loser's game.

Over 90% of non-professional short term traders will end up losers, if they stay in the game. Even those with winning trades two-thirds of the time will mostly end up losers since losses on losing trades are usually at least twice as large as the average gains realized. The few that are successful, professional or not, typically will ultimately 'burn out'. So, even if successful, the ultimate price can be high. Many of those who do win still end up as life's losers.

10. History is experience ... learn from it.

History is not a Xerox machine, and does not repeat itself exactly. Simply put, history is mankind's past experience. It is said, experience is the best teacher, but it is much less painful to learn the hard lessons from the experience of others. In terms of human nature, investor psychology in the horse and buggy days is little different than today. Society may have changed, but human nature has not. Fear and greed continue to be the dominant market forces.

Burton Malkiel

Dr. Burton G. Malkiel is the Chemical Bank Chairman's Professor of Economics at Princeton University. He is a past president of the American Finance Association and is a member of the American Economic Association.

One of his books, *A Random Walk Down Wall Street,* is in its seventh edition, and he has written or co-edited eight other titles, the most recent of which are *Global Bargain Hunting: An Investor's Guide to Profits in Emerging Markets*, with J. P. Mei, and *The Index Fund Solution*, with R. Evans.

BOOKS

A Random Walk Down Wall Street, W.W. Norton, 7th edition, 2000

Global Bargain Hunting, Simon & Schuster, 1998

Essential truths of risk and reward

1. Investment rewards can only be increased by the assumption of greater risk.

This fundamental law of finance is supported by centuries of historical data. Stocks have provided a compounded rate of return of 11 per cent per year since 1926, but this return came only at substantial risk to investors: total returns were negative in three out of ten years. Higher risk is the price one pays for more generous returns.

2. Your actual risk in stock and bond investing depends on the length of time you hold your investment.

Holders of a diversified stock portfolio in the years 1950 to 2000 were treated to a range of annual total returns which varied from +52% to -26%. There was no dependability of earning an adequate return in any single year. But if you held your portfolio for 25 years in the same period, your overall return would have been close to 11% whichever 25 years you were invested. In other words, by holding stocks for relatively long periods of time, you can be reasonably sure of earning the generous rates of return available from common stocks.

3. Decide how much risk you are willing to take to get high returns.

J.P. Morgan once had a friend who was so worried about his stock holdings that he could not sleep at night. Morgan advised him to “sell down to his sleeping point”. He wasn’t kidding. Every investor must decide the trade-off he or she is willing to make between eating well and sleeping well. Your tolerance for risk informs the types of investment - stocks, bonds, money-market accounts, property - that you make. So what’s your sleeping point?

4. Dollar-Cost Averaging can reduce the risk of investing in stocks and bonds.

Dollar-cost averaging simply means investing the same fixed amount of money in, for example, the shares of a mutual fund at regular intervals - say, every month or quarter - over a long period. It can reduce (but not avoid) the risks of equity investment by ensuring that the entire portfolio of stocks will not be purchased at temporarily inflated prices.

5. Stock prices are anchored to ‘fundamentals’ but the anchor is easily pulled up and then dropped in another place.

The most important fundamental influence on prices is the level and duration of the future growth of corporate earnings and dividends. But earnings growth is not easily estimated, even by market professionals. In times of optimism, it is easy to convince yourself that your favourite corporation will enjoy substantial and persistent growth over an extended period. In times of pessimism, many security analysts will not project any growth that is not ‘visible’ and hence will estimate only modest growth rates for the corporations they follow. Given that expected growth rates and the price the market is willing to pay for growth can both change rapidly on the basis of market psychology, the concept of a firm intrinsic value for shares must be an elusive will-o-the-wisp.

6. If you buy stocks directly, confine your purchases to companies that appear able to sustain above-average earnings growth for at least five years and which can be bought at reasonable price-earnings multiples.

As difficult as it may be, picking stocks whose earnings grow is the name of the game. Consistent growth not only increases the earnings and dividends of the company but may also increase the multiple (P/E) that the market is willing to pay for those earnings. The purchaser of a stock whose earnings begin to grow rapidly has a potential double benefit: both the earnings and the multiple may increase.

7. Never pay more for a stock than can reasonably be justified by a firm foundation of value.

Although I am convinced that you can never judge the exact intrinsic value of a stock, I do feel that you can roughly gauge when a stock seems to be reasonably priced. The market price earnings multiple (P/E) is a good place to start: you should buy stocks selling at multiples in line with, or not very much above, this ratio. Note that, although similar, this is not simply another endorsement of the ‘buy low P/E stocks’ strategy. Under my rule it is perfectly alright to buy a stock with a P/E multiple slightly above the market average - as long as the company’s growth prospects are substantially above average.

8. Buy stocks with the kinds of stories of anticipated growth on which investors can build castle in the air.

Stocks are like people - some have more attractive personalities than others, and the improvement in a stock’s P/E multiple may be smaller and slower to be realized if its story never catches on. The key to success is being where other investors will be, several months before they get there. Ask yourself whether the story about your stock is one that is likely to catch the fancy of the crowd.

9. Trade as little as possible.

Frequent switching between stocks accomplishes nothing but subsidizing your broker and increasing your tax burden when you do realize gains. My own philosophy leads me to minimize trading as much as possible. I am merciless with the losers, however. With few exceptions, I sell before the end of each calendar year any stocks on which I have a loss. The reason for this is that losses are deductible (up to certain amounts) for tax purposes, or can offset gains you may already have taken. Thus, taking losses can actually reduce the amount of loss by lowering your tax bill.

10. Give serious thought to index funds.

Most investors will be better off buying index funds (funds that buy and hold all the stocks in a broad stock market index) rather than buying individual stocks. Index funds provide broad diversification, low expenses and are tax efficient. Index funds regularly beat two-thirds of the actively managed funds with which they compete.

> *‘A good rule-of-thumb is: the larger the investment bank or stockbroking firm that employs the analyst making the recommendation, the less likely it is to reflect what the analyst really thinks.’*
>
> Tony Golding

Joe Mansueto

Joe Mansueto founded Morningstar, Inc., a leading provider of investment information and analytical tools, in 1984.

Morningstar.com is listed among the top investing sites by *The Wall Street Journal*, *Barron's*, *SmartMoney*, *Money*, *Worth* and *Kiplinger's Personal Finance*, and is also named among the top 50 Web sites by CIO magazine.

Mansueto received the Distinguished Entrepreneurial Alumnus Award from University of Chicago Graduate School of Business in 2000.

Value investing and funds

1. Apply a private company mentality to public company investing.

Private company owners rarely buy or sell equity and, when they do, they know the value of their equity. A similar approach works well with public company investing: know the value of what you’re buying and treat your holding as you would a family business by rarely trading it. Also, private company owners think about the worth of their shares at most once or twice a year. You’ll do better with your public company investing if you adopt a similar mindset and don’t obsess with daily fluctuations in value.

2. If it’s overly complicated and you don’t fully understand it, avoid it.

Only invest in things you understand and feel strongly about. If you don’t have conviction when you buy it, there’s a greater likelihood you’ll sell at the first sign of bad news. As with most things, simplicity is a virtue in investing.

3. Invest for the long term.

Most real wealth is built from owning excellent companies for long periods of time. Frequent trading leads to frequent tax bills and frequent transactions costs, both of which can reduce long-term returns significantly. Give the exponential effects of compounding time to work for you. Take a look at your portfolio: how many holdings have you owned for five years or more?

4. As long as you don’t lose money, you won’t have to worry much about making money.

If your portfolio earns 50% one year and then loses 50% the next year, you’re even, right? Wrong. Your two year return is still a negative 25%. To achieve a high return over a long period of time, focus more on minimizing mistakes. Ask yourself “what is the downside risk on this investment?” and leave a comfortable margin of safety. You needn’t hit a homerun on every investment, but avoiding large losses will do wonders for your overall return.

5. Buy great companies at reasonable prices.

Look for companies that have high returns on capital, strong balance sheets, sustainable competitive advantages and shareholder-oriented management. Be patient and try to buy them when they are selling at a discount to their real worth. These opportunities don’t come often, so buy meaningful amounts when they do.

6. Don’t worry about forecasting the market.

Focus on a company’s prospects and its valuation, not the overall market. No one knows where the market is headed over the next year, so don’t concern yourself with it. And tune out the noise from those who claim - rather loudly, sometimes - that they do. If you’re right in your company selection, you’ll be fine in the long run.

7. Think different.

To do well as an investor, you need to have the insight and courage to invest differently than the crowd. It’s easy and comforting to invest in what’s currently popular and doing well - like technology stocks in 1999 and 2000. Being contrarian and following the less traveled path will lower your risk and give you the opportunity to outperform.

8. Search for a few great managers and stick with them.

On average, fund managers approximate the market because they *are* the market (or at least a significant part of it). Still, there are a few brilliant managers who consistently do far better than average. Search them out and invest with them for long periods of time.

9. Don’t pay active management fees for passive management by buying closet index funds.

Many funds don’t stray far from the component make-up of their passive benchmarks. This guarantees they’ll never have terrible relative performance and hence increase the odds of holding onto their investors. In these cases, you’re better off investing in index funds and lowering your expenses.

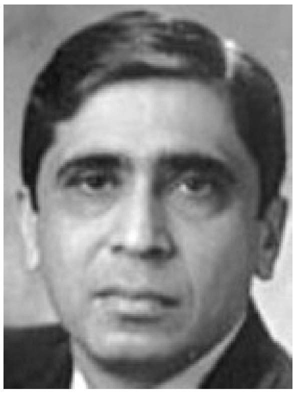
10. Consider index funds for all or part of your portfolio.

You'll certainly do better than the average fund by owning an index fund. The Vanguard 500 Index Fund, for example, has outperformed 80% of its peers over the last fifteen years. The compounding effect of your management fee savings translates into meaningful sums over the years. And you'll pay less to the tax man as well, since index funds have very low turnover.

> *'Don't be fooled by companies that boast investments by well-known companies like Intel and Microsoft. Both held big stakes in Lernout & Hauspie.'*

Herb Greenberg

Rajnish Mehra



Rajnish Mehra is Professor of Finance and Chair of the Department of Economics at the University of California. He is a visiting professor at the Graduate School of Business, Chicago, and is an associate editor of The Journal of Economic Dynamics and Control.

The equity premium

1. The equity premium - what is it?

For over a century, stock returns have been considerably higher than those for T-bills. The average annual real return (that is to say, the inflation adjusted return) on the U.S. stock market over the last hundred and ten years has been about 7.9%. Over the same period, the return on a relatively riskless security, like a government bond was a paltry 1%. The difference between these two returns, 6.9 percent, is termed the ‘equity premium’. This statistical difference is even more pronounced over the post war period, with the premium of stock returns over bonds being almost 8%.

2. What is the equity premium puzzle?

Since stocks are ‘riskier’ than bonds, investors require a larger premium for bearing this additional risk; and indeed, the standard deviation of the returns to stocks (about 20% per annum historically) is larger than that of the returns to T-bills (about 4% per annum), so, obviously they are considerably more risky than bills! But are they?

Stocks and bonds pay off in approximately the same states of nature or economic scenarios and hence according to standard asset pricing theory they should command approximately the same rate of return, or at most, a 1% return premium over bills! Since the observed mean premium on stocks over bills is considerably and consistently higher, we have a puzzle on our hands.

The equity premium puzzle is a quantitative puzzle in that standard theory is consistent with our notion of risk that, on average, stocks should return more than bonds. The puzzle arises from the fact that the quantitative predictions of the theory are an order of magnitude different from what has been historically documented.

3. Statistics, damn statistics . . .

The observed premium is not just a statistical artifact. Given that we have over a hundred years worth of good data, it is highly unlikely that the ‘true’ premium is small or zero when the observed premium is 7%.

4. The US and other markets.

The pattern of excess returns to equity holdings is not unique to U.S. capital markets. Equity returns compared to the return to debt holdings in other countries also exhibit this historical regularity. The annual return on the British stock market was 5.7% over the post war period, an impressive 4.6% premium over the average bond return of 1.1%. Similar statistical differentials are documented for France, Germany, Italy and Spain.

5. Great fluctuations of the equity premium year-by-year.

The ‘ex-post’, or ‘realized’, equity premium is the actual, historically observed difference between the return on the market, as captured by a stock index, and the risk free rate, as proxied by the return on government bills. This premium has varied considerably over time, being positive in some years and negative in others.

6. Investment planning with the equity premium.

The related concept, the ‘ex-ante’ equity premium, is a forward-looking measure of the premium - that is, the equity premium that is expected to prevail in the future or the conditional equity premium given the current state of the economy.

To elaborate, after a bull market, when stock valuations are high relative to fundamentals, the ex-ante equity premium is likely to be low. However, it is precisely in these times, when the market has risen sharply, that the ex-post, or the realized premium is high. Conversely, after a major downward correction, the ex-ante (expected) premium is likely to be high while the realized premium will be low.

The ex-post premium (i.e. the realized) premium can be negative. However, the forward-looking premium MUST be positive. If it were negative investors would not hold stocks and perhaps even short them. Can the whole market do that? No. What will happen is that the price would go down so that, looking ahead, the premium is positive.

7. Investment planning horizons are key!

The documented equity premium is for very long investment horizons. It has very little to say about what the premium is going to be over the next couple of years. Market watchers and other professionals who are interested in short term investment planning, will wish to project the conditional equity premium over their planning horizon. This is by no means a simple task.

8. Time and tide . . .

The ex-post equity premium is the realization of a stochastic process over a certain period and it has varied considerably over time. Furthermore the variation depends on the time horizon over which it is measured. There have been periods when it has even been negative. It is important to remember that not only is the mean 7% but it comes with a standard deviation of almost 20%!

9. The equity premium is dead! Long live the equity premium!

There is the point of view, held by a group of academicians and professionals who claim that at present there is no equity premium and by implication no puzzle. Before we dismiss the premium we need to examine the evidence. The data used to document the equity premium over the past hundred years is probably as good as any economic data we have - and a hundred years is long series when it comes to economic data. Even if the conditional equity premium, given the current market conditions is small, this in itself does not imply that either the historical premium was too high or that the equity premium has diminished.

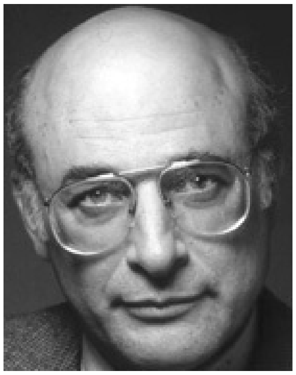
10. Stocks payoff in the long run.

Based on what we know, we can make the following claim: over the long investment horizon the equity premium is likely to be similar to what it has been in the past and the returns to investment in a diversified equity portfolio will continue to substantially dominate that in bills for investors with a long planning horizon.

> *'If you are wondering when to bank a profit, wait until all the brokers say buy and the stock is tipped in the Sunday Newspapers. It can be promoted no more and it is then time to get out.'*

Tom Winnifrith

Paul Melton



Paul Melton edits *The Outside Analyst*, the only monthly newsletter that actually compares stocks globally. Since its inception in 1986, this wholly independent publication has earned a reputation for sound research.

Melton specialises in sourcing the world's bargain equities, screening earnings estimates each month for more than 15,000 companies in over 40 countries.

BOOKS

Investor's Guide to Going Global with Equities, FT Prentice Hall, 1996

Navigating the world’s markets

1. Chart a course.

Lucius Annaeus Seneca (4BC-AD65) left you this warning: “When a man does not know what harbor he is making for, no wind is the right wind.” There are investment strategies to suit all tastes and pocketbooks. The key is to decide which approach best suits your circumstances, special skills, unique sources and, above all, your character. Then stick to your plan.

2. Leave your home port.

Antoine Marin Lemierre (1723-1793) wrote: “It is a profound mistake to think the horizon the boundary of the world.” Not everyone can beat the averages. But sailing out of your home port decidedly improves your odds.

First of all, going global gives you more opportunity to find bargains. If no equities meet your criteria in a particular market, move on to another. There’s always a bull market somewhere. Secondly, going global makes your portfolio more stable. The risk of your home market remains the same, whether you own two stocks or twenty. That’s because stocks in a single market tend to move up or down together. However, just as you can diversify away the specific individual risk of each stock, you can reduce the market risk of your total portfolio by going into uncorrelated markets.

For optimal global equity diversification, select some twenty-five stocks, or their equivalents, from different countries and industries, placing more emphasis on country diversification than on industry diversification. Diversify to hedge your ignorance. (John Maynard Keynes, Warren Buffett, and William J. O’Neil would all disagree, saying it’s better to own few stocks about which you know a great deal. If you’re a full-time investor and truly in their league, you can afford to ignore diversification.)

3. Remember that one port can be as good as another.

To the global navigator, all countries are equal. Yet, to paraphrase Orwell, some countries are more equal than others. So weight countries as equally as possible. Though equal weighting, as typified by the MEGA benchmark in Going Global with Equities, is clearly the best point of departure, it by no means rules out further adjustments. Quite the contrary. Each country's part of the total score should be further attuned to risk and reward. The two steps to doing this: first, adjust your weightings to minimize the chance of correlated market movements, then tilt that mix towards the most promising markets and shares.

4. Fish where they’re biting.

The bumblebee’s philosophy was neatly expressed by Publilius Syrus in the 1st century BC: “It is better to have a little than nothing.” Bees ignore rare events and pay attention to common events. A U.S. researcher set out an artificial meadow of reliable blue flowers, each containing a small amount of nectar, and chancy yellow flowers, some containing nothing, some a jackpot of nectar. The bees - in this universe of specific risk - quickly learned to avoid the chancy flower and home in on the known quantity. They clearly preferred steady small rewards to the chance of hitting it big.

Humans, on the other hand, are optimists who believe rare events will happen more frequently than they actually do. So don’t chase the giant marlin by paying too much for the prospects of huge profits from a new industry, the potential of a big minerals find, or the current fast growth of a technology firm. Go for earnings stability and settle for smaller fish that are easier to catch.

5. Tack into the wind.

As Henry Wadsworth Longfellow noted: “Things are not what they seem.” Perceived risk and actual risk do not coincide. If markets were perfectly rational and efficient, returns would relate to market risk: the risk you cannot diversify away within a single market. But markets are people, and people are not perfectly rational. People expect greater return for greater perceived risk, and price an equity accordingly. Share prices fluctuate much more widely than values. Popular equities are often overvalued and unpopular ones undervalued Hence, one way to create steady profits is to follow strategies that exploit these recurring discrepancies between the risk the crowd sees in an equity and its expected market risk. So buy shares perceived as risky.

Market cycles are like the seasons. When the winter winds blow, blue and yellow flowers wilt alike. But if you’ve gone global, you have a portfolio for all seasons. In choosing your holdings, this diversity gives you the opportunity to seek market risk for more potential reward. For individual stocks, the best proxy for market risk is the dispersion of analyst estimates. The wider such estimates are scattered, the higher the return you can expect. Typically the strategy will produce some spectacular flops more than offset by spectacular gains. Though this may seem the antithesis of the bumblebee’s approach, your global portfolio of apparently ‘risky’ wallflowers will have a much higher probability of success. The bumblebee would envy you.

6. Limit ballast.

William Wordsworth put his finger on the problem of information overload back in 1807: “The world is too much with us.” We react consciously to only a fragment of the data being thrown at us. Research suggests we tend to become more confident and less accurate as we process increasing amounts of information. So avoid information overload.

As most people can handle no more than seven pieces of information at once, it is wise to employ no more than seven criteria for choosing each stock. (Barry Ziskin uses only seven criteria to pick stocks for his Z-7 Fund. These include: earnings stability, good working capital ratios, acceptable cover of long-term debt obligations, a share price of less than 10 times estimated current earnings, and institutional ownership of less than 10%.)

7. Check regularly for leaks

"Beware of small expenses," said Benjamin Franklin: "A little leak will sink a great ship." For every euro, dollar, or yen, skimmed from your investment capital today, you lose far more as you sail on. Those funds are gone forever. They can no longer help increase your assets. Money spent on commissions and expenses is money that fails to grow. The key to evaluating investment fees is to perceive that such expenses represent capital that would otherwise have been invested. The hidden cost of investment fees is their future cost: cumulative curtailment of your return. So hold down turnover and fees.

Expert tennis is a winners game because the ultimate outcome is determined by the actions of the winner. Conversely, amateur tennis is determined by the actions of the loser, making it a loser's game. The amateur seldom beats his opponent, but he beats himself all the time. The victor gets a higher score because his opponent loses even more points. Most investment managers fail to beat the market because due to the rising costs of trading they are playing a loser's game. The average spread on the Nasdaq rose from less than 3% in 1984 to almost 6% in 1992. Suppose we estimate that in most markets institutional investors incur spreads and commissions some 60% lower than those on Nasdaq, say 3.5% Now here's a key question: If equities return an average annual 9% return, turnover averages 30% a year, and dealer spreads and commissions on institutional transactions (one way) average 3.5% of the assets involved, how much does a professional manager have to outperform a market to deliver net returns 20% above its index? The answer boggles the mind: over 43%. And that ignores management and custody fees! Using the same estimates, the active manager must beat a market gross by 23% just to equal the market net.

The moral? Think twice before doing anything, because chances are it is a mistake.

8. Maintain the lifeboats.

When asked what he had done during the Terror of the French Revolution, the Abbé Sieyes replied, “I survived.” Rule 8 will help you to do likewise: Limit your downside. Use stops, which, in the long run, limit losses to reasonable size and let profits run. A stop can be used not only to protect against loss, but also to lock in a profit. The idea is to place a “trailing stop” under a stock that’s on the rise. You can think about raising that stop when your paper profit nears 20%. Your aim is to separate random and normal short-term sell-offs from really bad news. Bear markets are a fact of life, so ultimately a local index will turn down and trigger your trailing stop, often letting you realize substantial profits. When several stops are triggered in a single market, implying a major downturn, buying puts in that market is likely to produce gains.

9. Sell your catch before it spoils.

“Experience,” wrote Oscar Wilde, “is the name everyone gives to their mistakes.” So set strict rules on when to sell. You can ignore the history of any equity in your portfolio. Just ask yourself the simple question: “Would I be willing to buy it now at today’s price?” If not, you should sell. Sell after a stock has gone up 50%, or after the first two years, whichever comes first. Sell if the dividend is omitted, or if earnings decline so sharply that the stock sells 50% above your target purchase price. Don’t be afraid to take a loss; mistakes are part of the game.

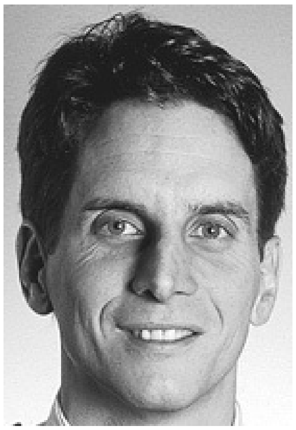
10. Don’t give up the ship too soon.

A song of the thirties embodies this investment axiom: “The fundamental things apply, as time goes by.” Trust time rather than timing. Time is on your side. Currency-cost averaging, regularly investing the same amount of euros, yen or dollars, is a system that makes anyone an expert market timer. You may not get all your money in at the cheapest point, but you won’t be committing your whole wad at the top either. By investing a fixed sum each month, the number of shares you acquire depends on the level of a market from month to month. If the market rises, the price of shares goes up and each investment buys fewer. But if the market falls, the price of shares goes down and each investment buys more of them. If you regularly invest a fixed amount over a number of market cycles, the larger number of low-cost shares in your portfolio will lower the average cost. This system is especially useful in purchasing volatile country funds, such as those in emerging markets.

Time is your friend in another way. The wise investor diversifies not merely in space (geographically), but also in time. Patience is the key. You get the chicken by hatching an egg - not by smashing it. Long-term investors almost invariably come out winners. Obviously, many individual shares lose money in the long run. But a diversified equity portfolio, especially one mirroring various markets, will rise on the back of the long-term upward trend. You get most of the benefits of time diversification within ten years. Global and time diversification make an unbeatable combination for minimizing your chances of loss and meeting your long-term expectations of gain.

> *‘Never put yourself in a position where you were absolutely correct but didn’t take enough of a bet to make a difference in your life.’*
>
> Thom Calandra

Michael Molinski



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BOOKS

Investing in Latin America, Bloomberg Press, 2000

Global investing and the small investor advantage

1. Diversify.

This is the golden rule of global investing. Diversification is why you're going global in the first place. But it doesn't stop there. Putting half your portfolio outside your home country doesn't necessarily mean you're sufficiently diversified. It's important to split up your investments between different regions of the world, between developed countries and emerging markets, between different asset types, industries and investment styles.

2. Pay attention to correlation.

This follows from Rule #1, but it’s important enough to emphasize. Avoid investing in countries whose stock markets are closely correlated with each other. Look for stocks in countries that have low correlation coefficients (R-squared) relative to the market of your home country (assuming most of your portfolio is invested in your home country).

3. Don’t ignore risk.

Risk can be measured and quantified, either by looking at volatility (standard deviation), relative volatility (beta) or risk-return measures such as the Sharpe Ratio. Get to know these terms. Even if you don’t fully understand them, you can use them to compare potential investments. Understanding risk is especially important when investing outside your home country. Find out what risks your investments are subject to such as currency risk, political risk, or regulatory risk, and weigh them against the stock’s potential returns.

4. Never forget why you picked a stock.

In today’s volatile investing world, it’s easy to get caught up in rallies or get spooked in bear markets. But when you’re faced with the decision of whether or not to sell a stock, the most important question to ask yourself is, ‘Why did I pick it in the first place?’ Do the reasons still hold water? If not, dump it!

5. Don’t use currency hedges.

It’s a natural assumption that when one invests in a country whose currency is prone to devaluation, you should consider buying currency futures or hedging your investments in similar ways. In most cases, though, that assumption is wrong. Your global investments are, in and of themselves, hedges against a downturn in your home country’s stock market and against the stability of your home-country currency. Besides, currency hedges are expensive and require constant monitoring and frequent transactions. Your time and money are better spent elsewhere.

6. Look under rocks.

One of the principal reasons for investing abroad is that markets in less-developed countries are less efficient. It’s easier to find stocks whose prices may not reflect all the information that is out there about that company. Perhaps the investor who most personifies this rule is Templeton’s Mark Mobius, who has spent his life digging up bargains in the far corners of the globe. We don’t all have his travel budget, but we can spend time combing the web for bargains.

7. Do your homework.

The internet has made it possible for an investor in Des Moines, Iowa or Toledo, Spain to research and invest in companies from Kuala Lumpur to Sao Paulo. You wouldn’t buy stock in a company down the street if you didn’t know something about what the company does, would you? The same goes for global investing. What does the company make? What are its financial fundamentals? Who manages it? Who are its major shareholders? What are its strategic advantages? Who is its competition?

8. Exploit the small-investor advantage.

It's a myth that large investors have an advantage over small investors. Especially when investing in far-off places, small investors can have several benefits, many of them having to do with liquidity. Emerging market stocks, for example, are often so lightly traded that big pension funds and mutual funds won't spend the time researching and investing in them. Institutional investors also tend to put limits on the 'high-risk' portion of their portfolios. And in times of crisis, it's much more difficult for a big pension fund to sell off its $10 million stake in that Chinese cement company than it is for Joe Smith to sell off his $10,000 stake.

9. Buy bonds.

Don’t limit yourself to equities when investing abroad. Global bonds can diversify your fixed-income portfolio, and can bring much higher yields than the bonds of U.S. or major European countries - sometimes without a significant amount of added risk. Price inefficiencies also exist in the bond market, and investors willing to do their homework can find bargains in emerging market bonds.

10. Buy mutual funds.

I'm a big believer in mutual funds, both in indexed products and in professionally managed portfolios. If you don't have the time and energy to spend researching global stocks, let someone else pick them for you. Your costs will almost invariably be lower than if you tried to build your own portfolio of global stocks. In picking funds, though, be sure to pay attention to costs, tax implications, risk and the track record of both the fund and its managers. Spread the foreign portion of your portfolio across more than one fund. For example, you might buy three funds: a broad-based international fund, a regional fund in an area of the world that you believe will outperform, and an emerging markets fund.

> *'Myth # 6: First mover advantages are key - the early bird catches the worm. Not often, in business. There are very few industries in which being first is the basis of a sustained distinctive capability.'*
>
> John Kay

Robert A.G. Monks

Robert Monks is the world's highest profile shareholder activist. He founded Lens, the institutional activist investment fund which since 1992 has achieved returns in excess of the S&P 500 average throughout its life and has exceeded them by over 100% during the last three year period.

BOOKS

Corporate Governance, Blackwell Publishers, 2003

The New Global Investors, Capstone, 2001

The Emperor's Nightingale, Capstone, 1998

General principles and Senators from Tennessee

1. Sometimes it snows in July.

We should never forget how little we know. Barraged by data, extrapolations and seeming numeric certitude, the reality is that no one on earth will ever possess more than .01% of the facts necessary for a genuinely rational decision. The only constant is change. We cannot over invest in the past; the past is not always prologue for the future; the unexpected is to be expected.

2. If you don’t understand the concept, it is not understandable.

Particularly in a time when huge value is created through technological innovation, the temptation is strong just to ‘go along’ when everyone else nods in agreement about the brilliance and financial promise of a particular breakthrough. This is a mistake. If you do not understand the concept, either it is poorly articulated, or - even worse - it is imperfectly understood. In either case, do not part with your money.

3. The children (or designated heirs) of a great CEO are about as likely to excel as are any of Beethoven’s children to write great symphonies.

Upper middle class values favor artistic genius, but will settle for professional success. There is no place on the scorecard for mere businessmen. The fact is that business is an ‘art’ and there are geniuses in this category. No one expects that the child or the protegee of a master will themselves be a master, but hubristically, there is a tendency to forget this in business. Beware of investing in a company run by ‘son’ (or ‘daughter’) of ‘great man’.

4. Sell short the stock of any company with a former or future Senator from Tennessee on its board.

In light of the service of the following Tennessee Senators on the following boards: Howard Baker - Waste Management, Fred Thompson - Stone & Webster, Albert Gore, Sr. - Occidental Petroleum. This rather rude aphorism is a reminder that distinction in one walk of life cannot be taken as an automatic qualification in another. Celebrities can be good directors - even former Senators - but the question must be posed as to what their appointment to a board says about the board's view of itself. If you need Henry Kissinger's wisdom, engage him as a consultant.

5. Before you utterly repudiate ‘short termism’ beware lest ‘long termism’ turns out to be a euphemism for forever.

Many of the best managers make decisions that tend to under stress profits in the short term in the interest of long-term value maximization. The trick is to differentiate between them and the preponderance of managers failing to hit the numbers who use this nomenclature as an excuse. An investor must insist on the achievement of intermediate benchmark objectives.

6. Invest in companies where outside directors have large personal stakes.

Nobody likes to lose money. No matter how smart, how principled, how otherwise successful an outside director is, nothing will assure the application of their ability to ‘your’ company more than a substantial personal investment. This is to be distinguished from granting themselves options - if there is any justification for that one-way street, it should be restricted to full time officials.

7. Only invest in conglomerates which have ‘genius’ CEOs.

This is a short list. Litton Industries with Thornton and Ash, ITT with Harold Sidney Geneen, Berkshire Hathaway and Warren Buffett, Jack Welch and GE, Dennis Kozlowski and Tyco International. The market values enterprises under their stewardship at a premium, thus enabling the continuing acquisitions that assure growth. Without the market perception of genius, the premium disappears and the discount is almost a self-fulfilling prophecy for the decline and eventual liquidation of these once beautiful creatures.

8. Do not buy personal service businesses.

There is endless evidence that the key employees who create and maintain the relationships on the basis of which huge revenues are produced appropriate the ‘surplus’ in personal service businesses. How many times have we witnessed the sale of a boutique money manager or investment banker to a large institution only to be followed within five years by the sale back of the same property for 10 cents on the dollar? There is no ‘there’ there.

9. Wall Street sells better than Main Street buys.

The most highly paid people in the country work on Wall Street. They become highly paid because they persuade people to buy and sell securities. It would be hyperbole to say that they had no interest in the fate of the transaction - but only a little bit. The huge Wall Street fortunes of the last decade were in substantial part gleaned as commissions from unloading on a credible public the mangiest bunch of IPOs since the Dutch Tulip Bulbs.

10. Affronting the public is bad business.

No matter how much money Exxon, Mobil or Philip Morris spend and give to persuade the public of their attentiveness to public concerns, the perception that they have inadequate concern for the environment and make products hostile to human welfare will in the long run depress the value of their stock. P/E multiples are an implicit calculation of the risk that current earnings and cash flows can be maintained and enhanced for an indefinite number of years. Discounts are applied - or will be applied - to industry P/Es for companies and managements that are perceived as being contumacious.

> *'You can check in but you can't check out neatly summarises the issue of liquidity for biotechnology stocks. Be careful not to check in to the Roach Motel.'*

Karl Keegan

David Morgan

Mr. Morgan has been a private silver analyst for over twenty years and adheres to the Austrian School of Economics. He hosts www.silver-investor.com, and issues a private email newsletter for serious investors on a monthly basis.

BOOKS

Get The Skinny On Silver Investing, Morgan James Publishing llc, 2006

Investing in silver

1. When all else fails, there's silver.

No one likes to be labeled a prophet of doom, but the simple truth is that silver is the world's money of last resort. Should a severe economic collapse occur, leaving paper assets worthless, silver will be the primary currency for purchase of goods and services. (Gold will be a store of major wealth, but will be priced too high for day-to-day use.) Thus, every investor should own some physical silver - and store a portion of it where it's accessible in an emergency.

2. Start small - and keep it simple.

Too many investors, upon deciding to beef up the metals portion of their portfolio, buy too much physical silver at once - and in the wrong forms. Beginning metals investors should concentrate on pure bullion bars or coins, in smaller sizes, looking to pay a minimum premium over the actual metal value. Avoid commemorative coins, decorative items, jewelry and other collectibles, all of which carry large premiums and have limited resale markets.

3. Boost the buying power of your dollars with mining shares.

If you’re a typical investor, you can’t expect to be an expert on silver and the silver market - but you can invest in the people who are. Once you’ve established a core holding of physical silver, leverage both your knowledge and your buying power by purchasing the stocks of silver mining companies. These shares are highly responsive to changes in silver prices, frequently producing much higher percentage returns than the metal itself.

4. Dollar-cost average to lower your costs - and increase your discipline.

Dollar-cost averaging is an ideal way to implement Rule 2. By making same-dollar purchases at regular time intervals, you wind up buying more metal when prices are low and less when they’re high. This approach helps you develop discipline, erasing the ‘trader’ mentality that infects many market participants and instead fostering an ‘investment’ philosophy. Dollar-cost averaging also eases some of the sting when prices move against you, allowing you to view the downturn as an improved buying opportunity rather than a disappointing loss.

5. Don’t get a raw deal from your dealer.

Because of the specialized nature of the physical metals markets, selection of a well-established dealer with a quality reputation is essential. A good dealer will provide timely execution of your trades at fair prices with reasonable fees. Note, as well, that the lowest price is not necessarily the best price. In the past, some dealers who squeezed their price margins too low in order to attract clients were unable to make delivery, leaving those clients holding the bag.

6. What’s yours is yours - so keep it that way.

While it’s wise to keep some of your silver where you can get to it easily, it’s also important to keep the bulk of your metal in a safe place - especially as your holdings increase. However, if you establish an account with a brokerage warehouse or other public storage facility, you should make sure your holdings are kept segregated and that you can inspect them when you wish.

7. Silver speculation's like cough syrup - good in small doses, but too much can make your portfolio sick.

Depending on your individual goals and your personal tolerance for risk, a small portion of the assets you commit to silver can be used for speculation, perhaps in futures contracts or options on futures. Never forget, however, that this type of trading is speculation, *not* investment.

8. A little information can mean a lot more dollars.

You do not need to be a student of the silver market to profit from your metals investments. However, you will greatly increase your chances of success - and the size of your potential profits - if you understand the fundamental factors that drive silver prices and pay regular attention to current supply and demand considerations.

9. Collecting silver is an art - but not really an investment.

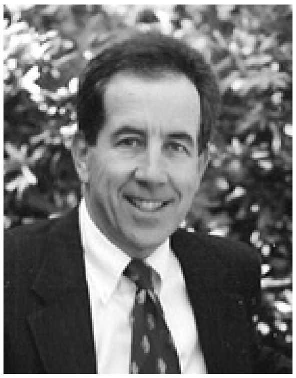
Owning fine silver items - including rare coins - can provide great enjoyment and personal satisfaction. Like paintings and other artworks, they are beautiful and often quite valuable - and, if you are astute at buying and selling, they can generate large profits. In spite of this, however, always view such holdings as collectibles, *not* as investments. When you need your silver - or simply want to cash in - you don’t want to have difficulty selling or be forced to forfeit a large aesthetic premium, both of which are likely with silver rarities.

10. More than 10 percent is too much of a good thing.

No matter how good the market looks, or how worried you are about the future of civilized society, you must always remember that silver should make up only a small portion of a well-diversified portfolio. I recommend committing no more than 10 percent of the average portfolio to silver, regardless of how strong you feel about the potential of the metals markets.

> *‘Investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, much of it meaningless.’*
>
> Gary Belsky

John M. Mulvey



John Mulvey is a Professor of Operations Research and Financial Engineering at Princeton University. His specialty is strategic financial planning and dynamic optimization. He has implemented financial risk management systems for many companies, including Pacific Mutual, American Express, Towers Perrin, Merrill Lynch, American Re-Insurance, Siemens, and Lattice Financial.

BOOKS

Worldwide Asset and Liability Modeling, Cambridge Univ. Press, 1998

Financial Engineering, AOR, co-editor, 1994

Portfolio optimization

Note: Thanks are in order to Ron Madey at Towers Perrin for initial discussions regarding the investment rules

1. Invest for a purpose.

Investors should link their assets, liabilities and goals in an integrated fashion. For example, a couple saving for retirement should put together a savings and investment plan with a view of their consumption requirements. Uncertainties should be addressed in the planning process.

2. Risk is not achieving one’s goals.

Traditional portfolio theory suggests that risk is equated with volatility or standard deviation of investment returns. However, a young investor with a long horizon will take on less risk by investing in equities, as compared with an elderly person (also investing in equities) who needs liquidity this year. Measuring risk requires an understanding of the investor’s goals.

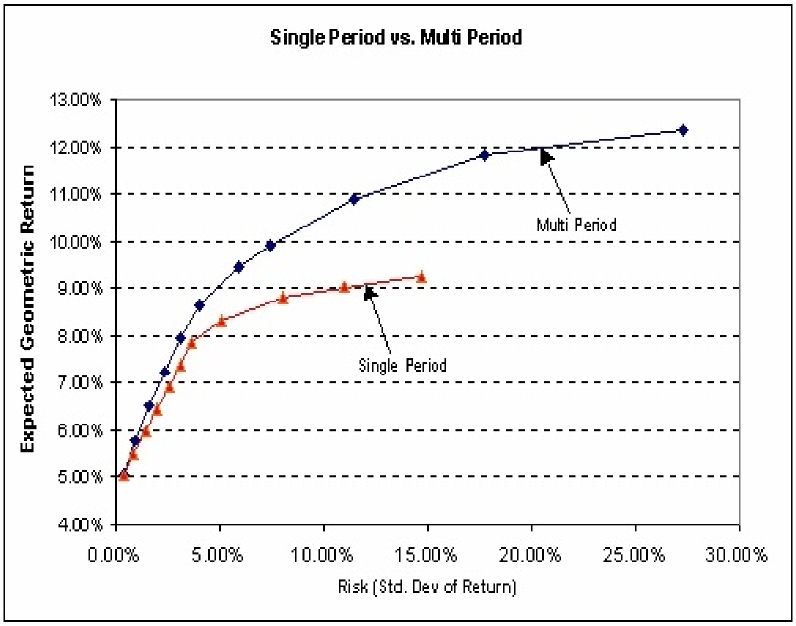
3. Long-term investors should employ multi-period portfolio models.

The Markowitz mean variance model is generally posed as a single period model. This approach, while simple, misses an important dimension since it is a static approach to investing. It is better to conduct a dynamic analysis in which the investor re-balances his portfolio at the beginning of each period. Dynamic analysis will give difference recommendations than a static model.

4. Take advantage of volatility pumping.

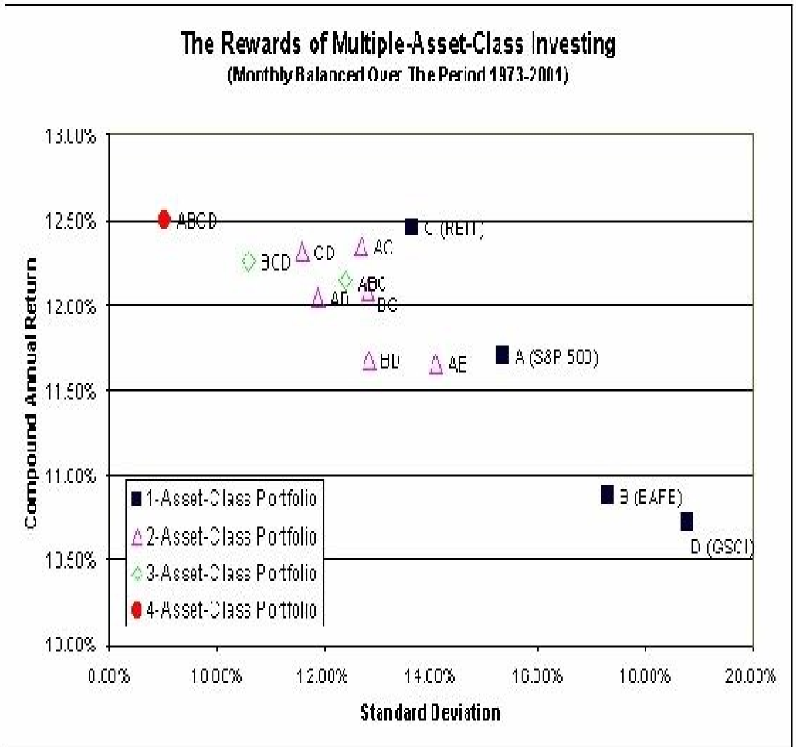
Within a dynamic investment model, the most aggressive side of the efficient frontier consists of a set of high returning assets (see Figure M1).

Figure M1



The investor must re-balance his portfolio to the target mix at the beginning of each period. This fixed-mix approach can provide higher returns than any single asset category by taking advantage of the market's natural volatility. In fact, highly volatile assets with high growth are sought after. Historical returns show a similar result (see Figure M2).

Figure M2



The Rewards of Multiple-Asset-Class Investing
(Monthly Balanced Over The Period 1973-2001)
Compound Annual Return
12.50%
12.00%
11.50%
11.00%
ABCD
C (REIT)
BCD
CD
AC
ABC
AD
BC
BD
AE
A (S&P 500)
B (EAFE)
D (GSCI)
1-Asset-Class Portfolio
2-Asset-Class Portfolio
3-Asset-Class Portfolio
4-Asset-Class Portfolio
12.00%
14.00%
Standard Deviation

5. Asset allocation is critical for long-term performance.

High net worth and institutional investors focus on asset allocation as a critical aspect of investment planning. Any investor can readily employ a passive index approach to investing within an asset allocation framework. The passive portfolio provides a benchmark for active management. Active managers are paid to beat their benchmark. In many cases, the active managers do not beat their benchmarks due to high fees and other causes.

6. Find robust recommendations.

A portfolio model is dependent upon a set of parameters, such as the equity risk premium. These parameters are determined by analyzing historical returns in conjunction with current market conditions and expert opinion. Blending these aspects together can be difficult. Recommendations of a portfolio model should be stress tested. The final recommendations should be robust with regard to the assumptions.

7. Optimal portfolios should make sense.

The recommendations of an investment model should be explainable in common sense terms. How does the model react to changing market conditions? What are the projected ranges on the upside and the downside? Any model suggesting an outcome that is too good to be true is likely to be flawed. Optimization will attempt to exploit any advantage, without regard to the practicality of the strategy. Care must be given to the output of an investment model.

8. Protect the investor’s surplus.

Investors should diversify their assets in concert with their liabilities and goals. For instance, a pension plan must make contributions when their assets fall below the market value of their liabilities. These contributions can be difficult to make when the economy is experiencing a recession. Similarly, an individual investor should protect their own surplus by finding assets that are correlated to their long-term goals.

9. Avoid computer black boxes.

Periodically, there are proposals to develop deep ‘mathematical’ methods for forecasting the returns on financial assets, such as stocks, bonds, and currencies. These computer systems depend upon a complex set of equations that involve feedback, highly nonlinear functions and other exotic techniques. The investor is told that model is too complex for understanding the underlying approach. Beware of these black box systems. Investors should be able to understand the underlying methodologies.

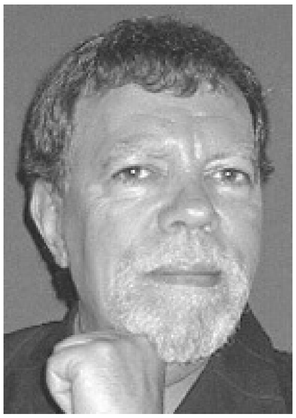
10. Implementing a strategic plan requires persistence.

The goal of a planning system is to develop insights towards a plan of action. The investor must implement their financial plan and stick with it during both good and bad periods. Changing strategies during strong market moves generally leads to poor performance.

> *'As difficult as it may be, picking stocks whose earnings grow is the name of the game. Consistent growth not only increases the earnings and dividends of the company but may also increase the multiple (P/E) that the market is willing to pay for those earnings. The purchaser of a stock whose earnings begin to grow rapidly has a potential double benefit: both the earnings and the multiple may increase.'*

Burton Malkiel

Alan M. Newman



Alan Newman has been the editor of HD Brous & Co., Inc.'s *Crosscurrents* since the first issue was published in May of 1990 and is also editor of www.cross-currents.net. Mr Newman is the firm's technical market analyst and is a member of the Market Technician's Association.

How to win the stock game

1. The stock market is like any other game; you have to know how to play in order to win.

Learn *all* the rules, such as placing limit orders, stops, good-till-cancelled orders *etc*. Does your firm accept ‘stops’ on OTC stocks? Some do. Find out everything you can about the ground rules as well.

2. Just like in other games, you are allowed to win when other investors lose.

Buying stocks is one way to profit, but there are losers in even the best bull markets. Short selling - selling stocks you don't own - is a way to make money in a falling market and can ramp your profits considerably. In fact, playing both sides at the same time affords what is known as a 'market neutral' or 'hedged' stance. Theoretically, a market neutral or hedged stance means less overall risk.

3. Stop playing the game if you are losing!

Know your pain threshold and don't linger in a bad position, especially one that is moving rapidly against you. It may get worse. Much worse. Never freeze like a deer caught in car headlights in the middle of the road. When in doubt, *exit the position.*

4. Sometimes, ignore rule #3 - particularly when your gut feeling is that you will be vindicated in the end.

In these cases, if you cannot run the risk of being 100% wrong on the position, then you *must* change the odds to 50% by exiting half the position. Then, you will only be 50% right, but you will never be 100% wrong. If the position moves in the direction you initially anticipated, you will profit. If the position moves further against you, you will lose less.

5. NEVER average down!

See rules #3 and #4 above. If the position is going against you, it is probably for a very good reason (e.g. it is a stinker that you should no longer own). Why add to the punishment by increasing the size of the position? If the position moves further against you, lowering your average cost only accomplishes one thing - you lose more money!

6. Don’t be afraid to pyramid your winning trades.

Conversely (to rule #5), if your confidence increases, don’t be afraid to pyramid your winning trades. Investors of all stripes generally have very good hunches and intuition, especially when decisions are based on fundamentals they are familiar with, like a new product. If the product proves successful, it may ensure the company’s growth for longer than initially expected. If your confidence increases as a result, consider ramping up your position.

7. Never risk more than 5% of your capital on any trade and always maintain a modest cash reserve to take advantage of a new situation.

If you are already extended when a good new idea pops up, extending yourself further by buying with borrowed money can only increase your overall risk if the market turns against you.

8. A background in fundamentals never hurts.

If you don’t read the financial journals, at least read the newspapers. If you are not up on current events, you should be.

9. Your best investments may come from your own experience and common sense.

Bear in mind that listening to others ideas is *not* the same as your own experience or common sense! Chances are that you are at least as smart as the broker who is recommending the stock!

10. Winning streaks are fun, but they all end way too soon.

When it gets too easy, pull back and trade less. That’s usually when the trend changes so fast it will rip your head off. On the other hand, losing streaks can seem to go on forever. When you’re on a losing streak, pull back and trade less or stop altogether for a week or two. Smell the flowers. Read a book. Call up an old friend. A fresh perspective will usually work wonders. Last but not least, remember, it’s only money.

David Newton

Since 1990, David Newton has been Professor of Entrepreneurial Finance and the founder and head of the Entrepreneurship program at Westmont College in Santa Barbara, CA, prior to which he taught for five years in the MBA program at Pepperdine University in Los Angeles. He worked for two years in investment banking in Boston in the early ‘80’s, and has been a consultant to more than 100 fast-growth emerging ventures in the areas of start-up business plans, small firm financial strategy, venture capital, IPOs, and firm valuation.

BOOKS

How to Be an Internet-Stock Investor, McGraw-Hill, 2000

How to Be a Small-Cap Investor, McGraw-Hill, 1999

Entrepreneurial Ethics, Kendall-Hunt, 1997

Investing in small-cap stocks

1. Today’s youngsters will one day grow up!

The ‘big’ publicly-traded firms that dominate the DJIA and SP500 were *all* at one time small-cap stocks. They just happened to turn into big companies over time. That same kind of growth is still available for investors willing to do the careful review of today’s smaller, less-popular and less-watched firms. Granted, not every small-cap today will be a mid-cap or large-cap industry leader tomorrow, but recognising future industry potential means that dozens of today’s $200M capitalization companies may one-day be $5+ billion caps when they finally hit full stride.

2. See through an ‘entrepreneurial perspective’.

Investors have to think like an entrepreneur and view small-cap companies with the same entrepreneurial eyes employed by venture capitalists and early-stage investors. Don’t look for some ‘quick-fix’ rapid return. Instead, nurture an entrepreneurial approach to spot solid opportunities, and then embrace a vision for potential extraordinary results. Ask questions like, “How will this firm reshape its industry?” and “Why will this company do it better than the others?” The result can often be several-fold increases in share prices for investors who gave these small ‘upstart’ challengers the breathing room to state their case, implement their innovation, and compete head-on with the established firms in the best industries and growth markets.

3. Keep sifting that profile colander.

It is imperative that investors systematically put new small firm prospects through a rigid and multifaceted review process, to continually screen the best industries for the most promising investment opportunities. Treat the external environment like a pool of interesting new ventures, each pitching their business model and management team to you for possible investment. So you'll need to keep regular incoming deal-flow in order to yield a consistent pattern of new equity investments throughout each fiscal quarter. Do this quarter by quarter, and year by year, and over time, this constant sifting will yield a nice cache of golden nuggets with extraordinary value.

4. “I’ll Be Watching You” - because nobody really is.

Understand this! If equity markets are weak-form efficient, then your systematic approach to research, homework, interviews, and due diligence will amount to far more than most other investors and analysts do with these same small-cap firms. And the overall picture that unfolds when all the data is in will likely be quite proprietary versus the generic near-consensus that typically happens in reviewing the large-caps. Good contacts, attending trade shows, talking with industry people, tracking product and service advances over time . . . these all yield insights into the small up-and-comers where virtually no one else is doing any regular monitoring and review. So “every breath they take, every move they make, you’ll be watching them", and that’s what makes small-caps well worth the effort.

5. Out of sight, but not out of mind.

Give the small-cap stocks some time to develop their great investment flavour. Like a fine wine sitting in a cellar, or a great sauce simmering on the back burner, great taste comes with patience. Stop chasing every short-term trend that surfaces, because you’ll probably end up buying after the upward movement, and selling before the peak anyway. Instead, invest systematically in an ongoing process over time, and then give these small firms ample time to put out roots, mature, and bear fruit. Just seven short years ago, those 10-foot Valencia trees in my backyard were scrawny 8-inch saplings with two leaves in a half-gallon bucket. Today they’re laden with hundreds of sweet ripe oranges three times a year. You cannot rush success, and your time is wasted chasing every new ‘hot-tip’. But patience cultivated over time is an invaluable small-cap investor virtue.

6. Follow the bread-crumb trail to a great investment pathway.

Spend time regularly reviewing the 8-10 year track record of investments made by twenty or so public small-cap stock mutual funds. What companies were they investing in 1992, 1994, and 1997? Look up those same companies today and calculate each fund's batting average, by taking the highly successful firms today divided by the total small-caps invested in over the entire period under review. Now, take a closer look at today's small-cap investments in those same small-cap funds, and target reviews for individual firms from funds with the highest success averages. It's fairly likely that many of the these small-caps will be well worth some additional homework on your part.

7. Diversity is the spice of your investment life.

Small-cap investing is not simply about technology companies. There are hundreds of great emerging companies across every sector of the economy, and in each of the dozens of industries that comprise those sectors. Be sure to represent numerous ‘types’ of smaller, emerging firms in your portfolio. A little-known manufacturer today may be acquired tomorrow by a global distributor at 6 or 7 times its current price. A tiny parts provider today could become the leader in its market niche over the next few years. And a small-cap engineering company might turn its patented speciality design into hundreds of strategic partners within five years. Good diversification across several strong industries will always provide a wider and more robust range of opportunities for company growth and share price appreciation.

8. VCs live with losers. You can too!

Thinking like a venture capitalist is the only way to approach systematic small-cap investing. Not every small-cap investment can be expected to provide huge returns. In fact, for every 10 firms in the portfolio, 3 small-cap stocks will most assuredly lose significant value while 4 others will probably end up in the general vicinity in which they were originally purchased, even after holding them for a long time. So deal with it; the VCs do. However, 2 other firms will perform very well over time, and 1 of those original 10 will be the star that soars geometrically ten or twenty fold in value. The expectations should be this: the net result of the combined performance on every 10 stocks purchased should be a positive return and significant, but not every individual stock will be a star performer.

9. “Hey buddy, can you spare some information?”

Smaller companies often do not show up on the radar in industry or consumer marketing reports. They are generally left out of the most noteworthy stock guides, or at best, have relatively little company information or news releases when compared with the ‘big names’ in their investment sector. But that also becomes your advantage, because you can uncover information that is not widely known if you’re willing to attend a few trade shows and product fairs, or speak with purchasing managers and company officials directly. And don’t rule out a site visit to the firm’s HQ. Less formal research and review may produce insights that are not common knowledge throughout the equity markets.

10. Hang out with the ‘players’.

You’ve heard that ‘misery loves company’. But on the flip side of that adage, ‘risky opportunity loves confirmation’. One such confirmation about a small-cap that passes your own systematic screening process, is that it has also been ‘approved’ by larger institutional investors (commercial banks, investment banks, insurance companies, broker-dealers, pension funds). Check to see if any common shares in your target small-cap firm are held by noteworthy institutions and if so, what is their relative percentage stake among all the equity holders. If a small firm is not closely watched, but a few institutions have decided to take a position, then they must know something, either better than your information or the same thing you’ve uncovered. This could serve as the affirmation boost you need to hear, and confirm that your thorough due diligence is probably trustworthy after all.

Victor Niederhoffer and Laurel Kenner

Victor Niederhoffer is a private speculator specializing in futures and options trading.

NIEDERHOFFER'S BOOKS

The Education of a Speculator, John Wiley, 1996

Practical Speculation, John Wiley, 2003

Fifty Years in Wall Street, John Wiley, 2006

Laurel Kenner is a financial writer in New York City.

Formerly head of US stock market coverage at Bloomberg News, she previously reported on police, politics and aerospace during her 17-year news career.

Rules for a life-time

1. Be humble.

The market is always creative in finding a way to make you eat crow - raw, squawking and fully feathered. Always have enough in reserve to meet any conceivable market eventuality.

2. Don’t get fixed in your ways.

The cycles are ever-changing. Just when you’ve found the perfect stream, the fish will stop biting, the weather will change, and other fisherman will appear, reducing the catch.

3. Count.

If a question is important, it deserves to be tested. That involves counting, and taking account of variability and uncertainty. Conventions for settling how much of a difference is enough to differentiate the result from randomness must be decided in advance. Read Stephen M. Stigler's *Statistics on the Table: The History of Statistical Concepts and Methods*, or anything by Francis Galton.

4. Buy-and-hold works.

Almost all portfolios of NYSE issues held for 10 years or more show returns of at least 8%. See Jeremy Siegel's *Stocks for the Long Run* or Louis Engel's *How to Buy Stocks*.

5. Be patient.

Don’t throw in the towel when things look worst, or pyramid when things look best. Stocks have a substantial tendency to reverse over all periods. See what the trend followers are doing, and do the opposite.

6. Follow the insiders.

Corporate officers and directors make an extra 3 percentage points on their buys and an extra 3 percentage points on their sells. They must disgorge any profits they make on shares held for less than a year. If they buy their company’s stock, usually it’s for a good reason, unless it is to lure you in with meaningless purchases.

7. Read good books.

The ideas in Shakespeare, Cervantes, Twain, Rand, Galton, Darwin and Hugo were canonical when published, and will continue to be so.

8. Play games.

Checkers and chess are better for market wisdom than browsing through the internet, both for you and your kids.

9. Be skeptical.

In no field are there more cranks and charlatans than in the market.

10. Pay attention to wise people.

The average reader who writes to us is much smarter and better versed on his subject than we are. Knowledge changes too fast and the level of specialization is too high for any Duo to be anything but behind the form, unless they pay close attention to you.

Michael Niemira

Michael P. Niemira is a vice president and senior economist for Bank of Tokyo-Mitsubishi in New York, and previously worked as an economist for PaineWebber, Chemical Bank and Merrill Lynch.

He has taught a class on economic forecasting at NYU's Stern Graduate School of Business and on interpreting economic statistics at the New York Institute of Finance.

BOOKS

Trading the Fundamentals, revised edition, McGraw-Hill, 1998

Forecasting Financial and Economic Cycles, John Wiley & Sons, 1994

The economic backdrop of investing

1. A roller coaster is no fun for the consumer.

The ‘Katona effect’ is named for the late founder of the University of Michigan’s Survey Research Center, George Katona, and is a little-known hypothesis which holds internationally among industrialized countries. It describes a relationship between consumer spending growth and the volatility in the overall price level. As price volatility in the economy increases, consumers spend less and save more, and vice versa.

The Katona effect is a clear window on when consumer’s spend - which is particularly important since the strength of consumer spending affects the bond market prices and the valuation of retail sector stocks.

2. ‘Technology has mastered the inventory cycle’ - wrong!

Curiously, it is widely felt that high-tech supply chain management has provided greater control over the aggregate inventory cycle. Maybe someday, but the reality is far from that now. On the contrary, U.S. inventories are increasingly more volatile relative to final sales. This raises an important question on the taming of the business and industry cycles: are shorter cycles emanating from demand spurts likely to be amplified by inventory management and in turn increase economic volatility? Probably so.

3. Don’t believe everything central bankers, economists or journalists say or write.

Although this axiom probably has greater acceptance when applied to economists, investors should be just as critical in evaluating all pronouncements and articles in the financial press. Too often a good story is better than a factual one. *Ask for the proof!*

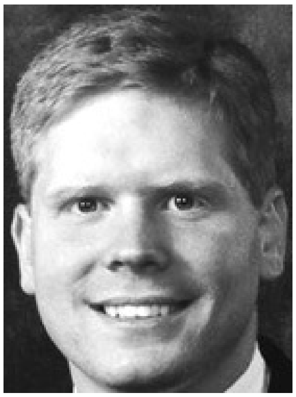
Case in point - the stock-market wealth effect: the econometric support is not strong, nor is the survey-based evidence. George Katona summarized the basic challenge to the logic for that seemingly popular view. Katona explained that as household financial wealth grew, economists turned their attention to how the increase in wealth affected consumption and savings (simple enough). Economists interchanged ‘wealth’ for ‘income’ in standard consumption analysis, since ‘in principle, consumer expenditures may be paid either out of income or from liquid assets.’ But the problem with that view, Katona pointed out, is that it is in essence built on a faulty logic that ‘money burns holes in people’s pockets’ and ‘incentives to save were supposed to weaken with an increase in wealth’.

4. Rumors of the death of the business cycle are greatly exaggerated.

In 1897, Mark Twain said it best: “reports of my death are greatly exaggerated.” So too is it with the business cycle. Just when the popular sentiment - led by a handful of unseasoned economists - questions the existence of the business cycle, one shows up to correct the misperception.

Although the business cycle is extremely important to investment decisions, the ‘growth cycle’ is far more important to watch. Growth cycles can be measured as deviation from trend growth or as cycles in growth rates - both have a stronger statistical relationship with the stock market. Growth cycles precede the so-called classical business cycle, which provide yet another reason to watch them.

James W. Oberweis



James W. Oberweis is President of Oberweis Securities, Inc. Senior Vice-President of Oberweis Asset Management, Inc. and Portfolio Manager of the Oberweis Mid-Cap Portfolio. The Oberweis Funds specialize in rapidly growing companies in the micro-cap, small-cap, and mid-cap asset classes.

Mr. Oberweis edits *The Oberweis Report* advisory letter which was ranked by Hulbert Financial Digest as the #2 performing investment advisory letter for the 10 year period ended 12/31/2000.

Investing in very fast growing companies

1. Look for consistent, rapid growth in sales - preferably internally generated and 30% or greater.

If you are looking for stocks with great investment potential, we recommend beginning with the most successful companies. If consumers or corporate purchasing agents are buying 40%, 50%, or 100% more of a company's products each year, then the company is a super-success in the marketplace. Whether they produce hamburgers, computers or widgets, one of the best indications of the success of their products is the rate at which sales are growing. Surprisingly, the industry in which a company operates should not be a critical factor. In fact, companies able to grow at rapid rates in industries with average growth rates are sometimes the best prospects. This indicates to us that the company clearly is doing something better than its competitors. We prefer internally generated growth rather than growth through acquisitions.

2. Look for similar consistent growth in pre-tax income and earnings per share.

Similar consistent rapid growth in earnings is also required. A corollary is that the company must have earnings. It is frequently possible to increase sales in the short run by significantly cutting prices. But if such price reductions diminish or eliminate profit margins, such growth may not be in the long-term best interests of the shareholders. Be wary of companies and sectors experiencing rapid growth, but where that growth is not feeding through to increased earnings, as we saw with airline companies in the 1960s and internet companies in the late 1990s. While you may miss some opportunities in the short run, investing in companies with increasing annual profits will increase the probability of owning long-term successful businesses. We have seen far too many times the promise of future earnings fail to materialize.

3. Look at net income, of course, but pre-tax income is also very important.

If profit growth is resulting primarily from lower tax rates, such growth is not sustainable. There must also be similar growth in earnings per share. It is always possible for a company to increase its earnings by selling more shares and using the proceeds to pay off debt or even investing in T-bills. From the shareholders' point of view, this only makes sense if earnings per share are enhanced over the long run.

4. Buy stocks whose P/E ratios are not greater than half of the company's rate of growth.

Once you have identified a list of companies that meet the revenue and earnings growth minimums you must still make a value judgment. Is the current price reasonable in relation to the company's growth prospects? Are there even more attractive investment opportunities? Which is a better buy - a company selling at 20 times earnings growing at 30% per year or a company selling at 30 times earnings growing at 60% per year? Many investors - institutional as well as individual - would assume the first stock is a better value since it is selling at a lower price/earnings (P/E) ratio. All else being equal, I would argue that the second is more attractive since it is selling at a lower ratio of P/E to growth rate.

5. Look for companies with products or services that offer the opportunity for substantial future growth.

Looking forward also requires you to make a value judgment concerning a company's products or services. Was its recent growth due to a *temporary* or a *sustained* increase in demand for its products? For example, exceptionally low interest rates over the past several years have led to an increase in demand for construction and substantial profit increases for construction-related firms. However, are construction companies experiencing this growth due to solid, long-term increasing demand for their products? Probably not. When interest rates reverse course, you can bet your last dollar that demand for construction will slow as well.

A further desirable characteristic is that the product of service offered by the company should be capable of substantial future growth *without* attracting too many competitors, too quickly.

6. Pay particular attention to recent trends in quarterly sales and earnings. Look for companies whose rate of growth is expanding.

This (and the following rule) focus on the most recent quarterly results - perhaps the most important numbers when evaluating a company's direction - and how the market values the company in relation to its sales.

Investors should focus not on the year-over-year earnings gain but rather on the consecutive quarterly increase for non-seasonal, non-cyclical companies. In other words, if a company reports 1995 Q2 EPS of $.15 vs. $.10 a year ago, that report sounds great - a 50% increase. But if the first quarter was $.16 vs. $.08, then the second quarter was actually $.15 vs. $.16 in the prior quarter, indicating a slowing in the company's growth sequentially.

For seasonal companies, such as retailers, compare a company's latest quarter year-over-year growth rate with the prior quarter's growth rate, rather than comparing absolute numbers. The ideal situation is a company whose earnings and revenues grew at 25% or 30% last year, are growing 35% or 40% this year, and are accelerating towards 45% or 50% for next year. In these rare situations, the stock frequently rises not only because of the earnings growth but also due to multiple expansion - the PE becomes larger as investors begin to recognize the company's faster growth rate. Obviously such situations are wonderful for investors.

7. Watch for a reasonable price-to-sales ratio based on the company's growth prospects and profit margins.

A price/sales ratio of 2 means that the total market value of the company is twice its annual sales. Companies with fast growth and/or high profit margins should have a higher P/S ratio than companies with a lower growth rate or lower margins. When a company's P/S ratio exceeds 5, either the company must have excellent growth prospects or very attractive profit margins or the stock may be overpriced. A P/S below 1 may indicate modest growth prospects, lower margins, or an undervalued stock. These two guidelines help determine whether a stock is an attractive buy at any particular time.

8. Carefully review the company’s balance sheet.

Try to understand why and how the company is growing so fast. Sometimes unusual items may be discovered, such as a huge increase in receivables or inventories, unrelated to the sales increase. Pay particular attention to footnotes in order to identify unusual items, which may indicate future problems. Don’t be afraid of leveraged companies. Leverage tells us how a company is financed, not whether a business is successful. A successful, growing business can be financed primarily through equity, debt, or any combination thereof. In the case of a very successful company, some leverage may be a positive rather than a negative factor, but note that this leverage does increase the risk level.

9. Believe the tape!

A final check is relative strength. If a company shows consistent rapid growth in both earnings and revenues, has attractive P/E and P/S ratios, strong recent trends, and a product or service which offers excellent future growth prospects, yet its stock is underperforming the market, don't buy it. If everything looks good fundamentally, the stock should be rising faster than the market.

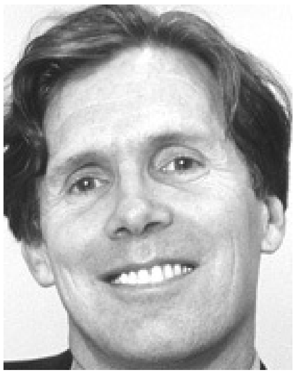
An easy way to check its relative performance over the last 12 months is to look at its relative strength. The number tells us how a particular stock is performing compared to the market. If everything looks strong fundamentally for a particular stock, but it has a low relative strength, something may be wrong. Your analysis may be missing something or insiders may know something you don't.

Generally it's best under such circumstances to wait awhile before buying the stock. If the fundamentals are as strong as you believe, the relative strength should begin to improve and you can buy the stock then, even though you may miss the first few points of a move. But frequently by waiting you may learn more and find you have avoided a disaster. For this reason, no matter how good a company looks on paper, if its stock is declining in a steady or rising market, don't buy it.

10. Diversify.

Finally, it’s especially important when investing in emerging growth companies to follow the Golden Rule of Investing - Diversify, diversify, diversify. If you follow these guidelines over long periods of time, at least 5 to 10 years, I believe you will be able to achieve above average investment results.

Terence Odean



Terrance Odean is an Assistant Professor of Finance at the Graduate School of Management at the University of California, Davis. His research on how psychologically motivated decisions affect investor welfare and securities prices has been cited in numerous publications including *The Wall Street Journal, The New York Times, The L.A. Times, The Washington Post*, *Time*, *Newsweek*, *Barron's*, *Forbes, Business Week, Smart Money*, *Bloomberg Personal*, *Worth,* and *Kippl*i*nger's Personal Finance*.

Lessons for investors from behavioral finance

1. Trading is hazardous to your wealth.

In a study of monthly positions for over 66,000 households with accounts at a large discount brokerage, Brad Barber and I found that the twenty percent of investors who traded least actively outperformed the twenty percent who traded most actively by an average of 5.5 percentage points a year. We believe that many active traders are overconfident in their ability to pick stocks.

2. Before you trade, consult your wife (if you have one).

Consistent with the overconfidence hypothesis, Brad Barber and I found that men - who tend to be more overconfident than women in areas such as finance - traded on average 45 per cent more actively than women. Both men and women tended to reduce their returns through trading, but men did so annually by 1 percentage point more, on average, than did women.

3. If you need to sell, sell for a loss.

When I studied the common stock trading patterns for investors at a large discount brokerage, I found that they are far more likely to sell their winners than their losers. This is backwards. While, in general, investors should avoid active trading, if they need to sell stock to raise cash they should sell their losers - at least in taxable account. In this way, they get a tax write off now and postpone realizing capital gains. If the loss is sufficient, they should consider selling simply to capture the tax benefit. (By the way, on average, those losers don’t bounce back. The losers people clung to on my sample subsequently underperformed the winners they sold.)

4. Do the things you can do, not the things you can't.

Many investors concentrate on picking winning stocks. For the most part they can't. I've found that, on average, the stocks investors sell subsequently outperform the stocks they buy - even before subtracting transactions costs. Most investors would be better off forgetting about picking winners and paying attention to doing the things they can actually do. Controlling trading costs, managing taxes, and diversifying.

5. When the market is crashing, go to the beach.

Don’t make long-term investment decisions in a panic. In a calm moment, evaluate your portfolio. Decide whether your mix of stocks, bonds, and other assets is appropriate for your goals and emotional and financial ability to sustain losses. If you need help figuring this out, get it. This is a much more fundamental decision than which stocks to pick. If a market downturn churns your stomach, go for a walk. When the market, and your stomach, have settled, re-evaluate the risk profile of your portfolio.

6. Diversify, diversify, diversify.

Mutual funds are the optimal investment for most investors. Buy funds with no-loads, low expense ratios, and low turnover. Index funds are a good choice for many people.

7. Get 90% of the thrills with 10% of the risk.

If you really enjoy trading common stocks consider putting 90% of your common stock portfolio into mutual funds and treating the remaining 10% as an 'entertainment' account. If you keep the entertainment account small enough that you can comfortable sustain some losses, you can go ride the rollercoaster of risky stocks to your heart's content.

8. Give your portfolio an annual check-up.

Don’t follow your portfolio returns day to day. If you do, short-term market losses may chase you out of the market. If you have an appropriate, well-diversified portfolio, it doesn’t need constant tune-ups.

Michael O’Higgins

Michael O’Higgins is President of O’Higgins Asset Management, Inc., an independent investment management firm which manages portfolios for high net worth individuals, institutions, and investment companies.

BOOKS

Beating the Dow, HarperBusiness, 2nd ed., HarperBusiness, 2001

Beating the Dow with Bonds, HarperBusiness, 1999

Beating the Dow

1. Get paid for taking risk.

Historically, investors have been paid handsomely for taking the risk of owning stocks. If the earnings yield, also known as the earnings/price ratio, is below the yield on AAA Corporate bonds, avoid stocks and put your money into long term 0% coupon U.S. T-Bonds.

2. If the price of gold is rising, don’t buy bonds.

The price of gold has correctly predicted the course of long term U.S. interest rates in 26 of the last 32 years. If gold’s price has risen over the past year, avoid bonds.

3. When buying stocks, stick to the ‘Dogs of the Dow’.

The 10 highest dividend paying DJIA components have consistently beaten the Dow by wide margins with below average risk.

4. Low price ‘dogs’ do even better.

A strategy of buying the 5 lowest dollar price of the 10 highest dividend yielders, has compounded at close to 20% per year since 1972 compared to 13% for the Dow and the S+P 500.

5. Asset allocation is your most important decision.

Long term studies have concluded that 85% of investment success is due to asset allocation. By using the above described strategy, an investor would have earned annual returns of over 22% versus under 13% for the major stock averages since 1968.

> *‘Virtually every blue chip growth company ultimately has matured and become a no-growth company. Of America's 100 leading companies in 1920, only one is on the list today (GE).’*

Steve Leuthold

Paul Ormerod

Paul Ormerod is a founding director of Volterra Consulting which calls on the skills of economists, mathematicians, physicists and statisticians to find innovative solutions to a wide range of business issues.

BOOKS

The Death of Economics, Faber & Faber, 1995

Butterfly Economics, Faber & Faber, 1998

Why Most Things Fail: And How to Avoid It, Faber & Faber, 2006

Rules for sceptical investors

1. Be sceptical of macro-economic forecasts.

They only seem to work when everything is quiet. Forecasters have a very bad track record in predicting genuine booms and slumps. They sometimes fail to forecast a recession even when it has actually started.

2. Be sceptical of anyone who claims to predict interest rates or exchange rates.

One of the most well established facts about markets is that these cannot be forecast over time with any useful degree of accuracy - if they could, we’d all be millionaires.

3. Be sceptical of arguments that just because an interest rate/exchange rate is high, it is more likely to fall than to rise.

At some point, the Euro will certainly rise against the dollar, but people have been predicting a rise ever since it fell after its launch in Jan 1999. At any point in time, a rise is as likely as a fall, no matter what the level is.

4. Be sceptical of track records.

There are so many funds and forecasts that at any point in time, someone has to have done well/been right. With enough monkeys in the room, one of them will type out Hamlet. But it doesn't mean the same monkey will then go on to write Macbeth.

5. Be sceptical of analysts’ reports on companies.

They usually know no more than a well informed reader of the quality business press. Monitor the press with a bit more care for a while, and see for yourself how many times analysts predict profit warnings in advance, and how many times they simply re-write the company’s press release.

6. Be sceptical of dynamic, new CEOs modernising and transforming the core elements of a business.

Most people think that this improves a company's prospects. It might do eventually, but companies going through major changes actually experience increased risk of failure.

7. Be sceptical of arguments that sheer size reduces a company's vulnerability to new competition.

The tendency to believe that the powerful will always be powerful is very deep seated. The Soviet Union looked invulnerable, but disintegrated in the space of a few years. The same applies to companies. IBM looked to have a lock on computer markets, but almost went under. Even in much more staid markets such as retailing, successful companies can implode quickly.

8. Investment is about risk management not prediction.

Here's a prediction: if anyone really can make consistently successful forecasts, he or she a) won't be reading this book and b) will have retired in complete luxury. For the rest of us, we need to decide for ourselves about the level of risk we are willing to accept. It's nice to be able to boast about the quick profit you have just made on a stock. But serious investment is much more mundane. It's about managing risk.

9. Diversify, but make sure you really are diversified.

Diversify, diversify, diversify is the slogan. But be sure you really are diversifying. It’s how the companies or bonds perform that matters, not their name, or the location of the issuer. Holding GE and American Express might look like a diversification play, but it probably isn’t, and not just because they are both in the USA.

10. Track what the trackers track.

Tracker funds are often a good way to invest in a low cost way, but the diversification you get is only as good as the index they track. And several of the indexes are dominated by assets which often move in step with each other, so the real diversification you get is much less than you might think. The NASDAQ in recent years for example has been dominated by the movement of ‘technology’ stocks, and many of its members have moved up and down in step with each other.

Lois Peltz

Lois Peltz is the president and chief executive officer of Infovest21, an information services company, located in New York City.

BOOKS

The New Investment Superstars, John Wiley, 2001

Selecting a hedge fund manager

1. Money should just be their way of keeping score.

Look for managers who are motivated by what they do - not by big bucks. The best managers make a total commitment. They are motivated by a job well done and gain satisfaction in finding things that others don’t. They love the intellectual and emotional challenge of the markets.

2. It’s like getting a report card every day.

Select a manager who has a strong work ethic, is intense, and is as demanding of himself as of the other people on his team.

3. Look for continuity of organization.

Search for a manager who has developed a team approach rather than a star system where he alone is the decision-maker. Many of the best organizations are built around teams and specialists, divided by industry, region, trading strategy and/or type of situation. Having a specialist, decentralized organization helps keep talented key employees on board because they have a degree of decision-making authority and responsibility as well as a stake in the firm. In those organizations where a star approach exists, key employees eventually leave to start their own fund where they have more authority, decision-making power and responsibility. Key personnel leaving doesn’t lead to a strong, lasting organization.

4. Require them to eat their own cooking.

Select those managers who put a significant amount of their own assets into their hedge funds. This means they have strong conviction in their own talent. It also means their own net worth is highly correlated to the performance of their funds and thus, they have a huge incentive to generate excellent performance.

5. Make consistency a virtue.

Find a manager who has a long track record and has generated consistently excellent returns during various market cycles. Examine years such as 1990 and 2000 which were negative years for the stock market (as measured by the S&P) as well as 1994 and 1998 which were difficult years for hedge funds.

6. Acknowledge the survival of the fittest.

At various times, all managers have gone through adverse times. Look for managers who are willing to learn from their mistakes. It is not so much about being right all the time as being able to adapt and find a strategy that works. Losses are expected because ideas are being tested. The best managers worry when losses are larger than expected/predicted or when risk levels are exceeded.

7. Be sure that they are controlling the downside.

Search for managers who put as much emphasis on controlling the downside as generating returns to the upside. Specific risk management tools to examine include strategy diversification, maximum allocation per position, number of positions in the portfolio and degree of leverage, as well as stress testing and the ability to reduce allocations quickly.

8. Technology is their friend - or should be.

Run from those managers who are afraid of technology. Technology is here to stay. Smart managers acknowledge the importance of technology information and rapid adoption of technology gives them an edge. They are able to harness information coming in and use it to their advantage.

9. When opportunity knocks, do they open the door?

Look for managers that view the world as having rapidly shifting opportunities. Opportunistic managers allocate capital where the opportunities are.

10. Be wary if the manager’s goal is to be the largest hedge fund.

Be wary of managers whose primary goal is to grow assets as large as they can in order to collect management fees. The best and brightest managers are often closed to new investment, acknowledging that being the largest hedge fund is not their main objective - having the best performance is.

Mitchell Posner

Mitchell Posner is President of Kirkwood Financial, Inc., an advisory firm to financial institutions around the world, providing equity research on emerging market companies and industries in South America, Africa, Europe and Asia.

Selecting emerging market stocks

INTRODUCTION

Any investor with experience in picking U.S. or European stocks can, in theory, pick emerging market stocks, because stock screening and selection methods should work anywhere. In practice, fundamental techniques of securities analysis require adjustment for the special conditions in emerging markets.

1. Choose performance and valuation measures according to the market you are studying.

Unless there is a specific reason to screen for price-earnings ratios, price-book value, price-sales and price-cash flow, you needn’t track each one. They will usually list the same types of stocks. Favor the most reliable data for the particular market. For example, in countries where book values are suspect, you might be better served by price-sales. In countries such as India and Malaysia, where strict American-style accounting practices apply, financial statement analysis is more worthwhile for screening. Market share is often a good benchmark. Well-managed companies tend to consolidate and increase market share when the economy expands.

2. Recognise the limitations of some traditional screening criteria.

Screen for both high-growth and high-dividend payout, and you won't have many stocks to choose from. It's like demanding fuel economy from a high-performance sports car: they just don't go together. Many fast-growing emerging market companies have limited access to financing and reinvest their profits rather than pay dividends.

Similarly, while P/E ratios enable you to make a rough approximation of a projected return on investment, they work best in situations that are slow and steady. And emerging market companies are anything but. So emerging market investors tend to pay less attention to P/Es as a measure of overpriced shares.

Local factors affect the P/E ratio. For example, accelerated depreciation can depress earnings, making the P/Es appear high relative to a similar company, because the local market adjusts for that depreciation.

3. Pay attention to company size.

Consider the size of a company from several perspectives: its ranking in the local stock market; in its sector; on the global scene. Some emerging market stocks, such as Argentina’s YPF and Russia’s Lukoil, are among the world’s largest companies. Picking one of the ‘ten largest’ in a market is a mixed blessing. You gain liquidity, and usually greater disclosure, and the benefit of available institutional research. Such stocks are usually at the high end of the valuation scale, however. There aren’t likely to be any bargains here. So there had better be significant growth in the company’s future to justify the high price.

4. Treat liquidity as a primary consideration.

Emerging market share prices are often determined not by rigid financial measures, but simply by how much investors are willing to pay and how much money is available. You can pay very little for a stock, or you can pay a great deal, but you can’t ignore market sentiment. That sentiment is best measured by how much capital is flowing in and flowing out, and who is buying or not buying. Local savings rates, the availability of pension fund investments, and the lifting of restrictions on foreign ownership also play a role in a foreign stock’s liquidity.

5. Check financial strength, but make allowances.

Size counts, but financial strength counts more. Examine the standard financial ratios and pay close attention to a deteriorating balance sheet or potential bankruptcies. While there are many excellent managers in emerging market nations, there is less depth, and it is easy for a once-healthy company to go into a tailspin.

Nevertheless, don’t set the bar too high. As financially-weakened emerging market companies tend to be heavily discounted by the market, you might find some bargains in potential turnarounds or acquisition targets.

6. Be careful not to pick low volatility and end up with low liquidity.

An emerging market stock with lower volatility than the overall market might seem like a more conservative buy. However, its lack of fluctuation could be a sign that the stock is quiet and liquidity is very low.

7. Don’t rely solely on brokerage reports.

There are often conflicts of interest between research and investment banking departments. Aggressive investment bankers seeking new business and the chance to manage privatizations sometimes put pressure on research departments to avoid critical reports. Much of the available research is in the ‘top ten’ stocks. Don’t expect the same depth and insight you are accustomed to finding in U.S. and European markets.

Stocks followed by fewer than eight analysts are called ‘underfollowed stocks’ and they offer the greatest opportunities. Fewer institutions are likely to participate. While this may add to volatility and lower valuations it also creates opportunity.

8. Get your portfolio balance right.

A common mistake in emerging markets investing is getting the stock picks right but the portfolio wrong. If strict application of your stock screens generates a list that is 75 percent Mexican, adjust your criteria to allow more diversification. A single-country bet is generally unwise over the long term.

9. Don’t place too much reliance on technical analysis.

Certain technical indicators, such as relative strength, may be useful in emerging markets, but for the most part there is not enough reliable historical data for proper technical analysis. Technical analysis may have its day in emerging markets, but that day has not yet arrived.

10. Do not act impulsively on rumors.

Emerging markets move on rumors such as the pending resignation of a finance minister, a corruption scandal, local resistance to privatization, and so forth. If you are interested in emerging markets and have money in them, you won't be able to ignore these rumors. They will find you. However, do not be impulsive. Acting on rumors is often expensive.

> *'Don't pay active management fees for passive management by buying closet index funds.'*

Joe Mansueto

Henriëtte M. Prast

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The emotional investor

1. Take control of your own investments.

Keep in mind that fund managers and investment analysts aim to maximise not your return, but their own future income, which depends on their reputation for being smart. Keynes observed that: “It is better for reputation to fail conventionally than to succeed unconventionally.” By disappearing in the crowd, professionals make sure that their mistakes will be forgiven, as others made the same faults. This mediocrity preserves their reputation, but does not enhance your return.

2. Don’t be conventional.

A corollary of the first rule - since you should be more concerned with returns than reputation - is to avoid convention. Keynes’ observation may have been right for financial industry participants, but only for those with mediocre talents - and not for readers of this book!

3. Blame your faults on yourself, not others.

‘Heads I win, tails it’s chance.’ Blaming someone else for your mistakes, and claiming the honour for your successes, may seem pleasant, but it does not make you either good company or a good investor. Moreover, you won’t learn from past investment mistakes. Cognitive psychologists have labelled this behaviour ‘biased self-attribution’. It leads to another empirically verified phenomenon: individuals are, on average, overconfident. If you are overconfident, you trade too much, as you think you are smart enough to see valuable information in what is actually irrelevant news. The excessive trading lowers your return, as transaction costs exceed the return from trading.

4. Dare to be a loser.

Do not expect all your investments to be successful. Even the best investors are not right all the time. In a success-oriented culture this is a difficult lesson for many investors to learn. But the success of each individual trade is not as important as the profitability of the whole portfolio. Sometimes it is necessary to sell the losers, for the sake of the wider portfolio. In military terms, some battles have to be lost to win the war.

5. Watch out for starry nights.

Experimental studies find strong evidence that investors chase trends once they think they see them. This is because, as psychological research shows, we have a tendency to see patterns in random events. For example, in a random pattern of stars we are determined to see the Great Bear. Due to this phenomenon, which is called the ‘representativeness heuristic’, we overestimate the news value of one element in a series of similar messages. As a result we over-react to information that is part of a string of similar, but unconnected, events.

6. Hip is out: stay away from cascades when you see one.

As our private information is never perfect, we infer much from the behaviour of others. The cascade model of investment predicts that we tend to follow others, perhaps neglecting our own valuable information. Try to think of investments as places to eat. When you see a queue outside a restaurant, you might conclude that it is a great place to eat. However, that queue might be there precisely because the person last in line followed your reasoning, and the one before him did too *etc.* Rely on your own information unless you are sure that others know more. The cascade may change direction quickly and in that case it is unlikely that you will survive.

7. Beware the gambler’s addiction.

Addicted gamblers want to lose, not win. That is why they are easy prey when it comes to beating ‘the market’. According to Freudian psychoanalysis, the addicted gambler is motivated by his repressed Oedipal conflicts. The male child’s wish to become his mother’s object of desire creates an ambiguous relationship (love/hate) with the father. Destiny is an avenging father substitute, and gambling challenges it. By losing, the gambler pays off his moral debt to his father. Important: before entering a casino you should see a psychiatrist to make sure you do not suffer from this neurosis!

8. Crisis, what crisis?

We tend to be ‘disaster myopic’. If a long time has elapsed since the latest crash, we believe it will never happen again. Stay awake and look out for signs indicating that a crisis is looming around the corner.

9. Don’t fall in love with your portfolio - or it will betray you.

According to cognitive psychologist Leon Festinger, we filter information to make it correspond to our fundamental opinion. Think of wishful thinking by a person who is in love and does not see the nasty habits of the objects of his desire. Investors, similarly, tend to turn a blind eye to information that does not suit them, and actively search for information that confirms that they have made the right investment decision. Be aware of this, and don’t turn away from bad news about your portfolio.

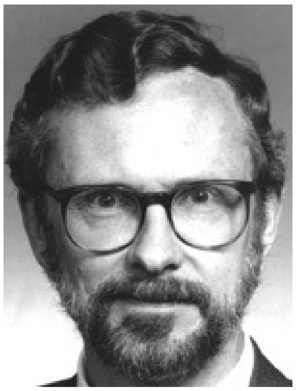
10. Carpe diem.

Sit back and reflect before even thinking about investing. Remember that the purpose of investing is future consumption. Reconsider whether you really want three pairs of Jimmy Choo shoes by the time you are 65 rather than one pair of them now.

> *'If the Price-Research Ratio (share price divided by R&D per share) is 5 or less it is nearly always worth buying the shares. This applies particularly to recovery situations.'*

Conor McCarthy

George Putnam III



George Putnam, III is the editor and publisher of *The Turnaround Letter* and several other bankruptcy publications, including *Bankruptcy Week*, *The Bankruptcy DataSource* and *The Bankruptcy Yearbook and Almanac*.

His material can be found on the Internet at www.bankruptcydata.com and www.turnarounds.com. He is also a Trustee of the Putnam Group of Mutual Funds.

Turnaround stocks

1. Be willing to go against the crowd.

By their nature, turnaround stocks are unpopular. That's why they have so much profit potential. If you wait until they are popular again, you will miss most of the gains. For example, back in 1993 when IBM dropped down to about 10 (adjusted for splits) most analysts called it a dinosaur. Then, when the stock got back up to 100 a few years later, everyone loved it again.

2. Previous stock prices are irrelevant.

Too often investors fall into the trap of saying “This stock used to trade at 50, and now it is at 5 - it must be a bargain.” A stock is only a bargain if it is currently undervalued, and that depends solely on what the stock is actually worth today - not what investors thought it was worth last month or last year.

3. You can lose just as much money in a $1 stock as in a $50 stock.

This is a corollary to Rule #2. Many investors also say "The stock has dropped to $1 per share; how much lower can it go?" The answer, of course, is "to zero." Stocks do become worthless. And if the stock goes to zero, you will have lost just as much, on a percentage basis, if you bought it at 1 as you would have if you'd bought it at 50: 100% of your money.

4. Look for a solid core business.

A company can only rebuild if it has a solid foundation on which to base its recovery. If the business was based on a fad or an obsolete technology, the stock is not likely to rebound. But if the company's basic business remains sound, there is a better chance the stock will bounce back.

5. Evaluate management's ability to turn things around.

Evaluating management is important for any stock, but it is particularly important in a turnaround situation. In many cases, the management that got the company into trouble isn't likely to be able to get it out of trouble again. Therefore, a change in top management can be a good sign.

6. Look for someone else to do the heavy lifting.

The presence of a big investor who is willing to get involved and shake up the company can be a good thing. But make sure that the big investor owns the same security that you do. Sometimes the big investors own bonds or preferred stock, in which case they may not care what happens to the holders of the common stock.

7. Check the debt.

A heavy debt burden is often part of the reason that the company is in trouble in the first place. And a high level of debt significantly reduces the company's flexibility in making necessary changes to its business. Finally, if the company must restructure, the debt has to be taken care of before stockholders get any value.

8. Avoid stocks of companies in Chapter 11.

This is related to Rule #7. If a company goes into Chapter 11, the basic rule of bankruptcy is that senior creditors must get paid off before junior creditors get anything. Stockholders have the most junior claims of all in a bankruptcy, and very rarely is there enough value in a bankrupt company for the stockholders to receive anything. This is also related to Rule #2 and Rule #3 because Chapter 11 stocks are often temptingly low in price, but they almost always end up being virtually worthless.

9. Be patient.

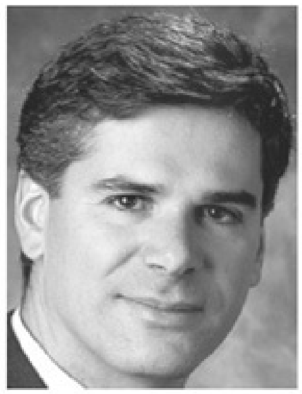
Turnarounds take time. Moreover, even if the company has turned around, it may take still longer for investors to recognize the turnaround and to get comfortable with the stock again. (After all, many investors were burned by the stock on the way down.)

10. Diversify.

Diversification is important in any type of investing, but it is particularly important in turnaround investing. Turnaround situations always are affected by a large number of variables, and no matter how much research you do, you will always have some situations that don't work out the way you expect them to. The best way to minimize your risk in turnarounds is to spread your money over a large number of different stocks. That increases your chances of having some big winners to offset your inevitable losers.

> *'Rising inflation is toxic for both bonds and stocks because it points to tighter monetary policy and rising interest rates. Falling inflation is extremely bullish for the opposite reasons.*
>
> *Most bear markets have occurred in response to rising inflation pressures, while falling inflation was the single most important force behind the powerful bull markets during the 1980s and 1990s.'*
>
> Martin Barnes

Alfred Rappaport and Michael Mauboussin

Al Rappaport is the Leonard Spacek Professor Emeritus at J. L. Kellogg Graduate School of Management, Northwestern University. He also directs shareholder value research for L.E.K. Consulting. He originated the Shareholder Scoreboard for *The Wall Street Journal.*

BOOKS

Expectations Investing, HBS, 2001 (with Michael Mauboussin)

Creating Shareholder Value: A Guide for Managers and Investors, The Free Press 1998

Michael Mauboussin is a Managing Director and Chief U.S. Investment Strategist at Credit Suisse First Boston in New York. He is an acknowledged leader in the application of value-based tools in security analysis, and has lectured and published widely on the subject. He is an adjunct professor Columbia Graduate School of Business

BOOKS

Expectations Investing, HBS, 2001 (with Alfred Rappaport)

Expectations investing

INTRODUCTION

‘Expectations investing’ represents a fundamental shift from the way professional money managers and individual investors select stocks today. It recognizes that the key to achieving superior results is to begin by estimating the performance expectations embedded in the current stock price and then to correctly anticipate revisions in those expectations.

Conventional wisdom suggests that investors need a host of approaches to value different businesses. Expectations investors recognize that while various businesses have different characteristics, it is important to value all companies using the same economic approach. Here are 10 expectations investing rules to increase your odds of generating superior returns.

1. Follow the cash.

Investor returns come from two sources of cash - dividends and changes in share prices. But a company cannot pay dividends unless it is able to produce positive cash flows. So without the prospect of future cash flows, a company commands no value. Stock prices therefore reflect transactions between investors willing to sell the present value of a company’s expected cash flows and buyers who are betting on higher cash flows in the future. Cash flow is how the market values stocks.

2. Forget earnings and price-earnings multiples.

Savvy investors don’t rely on short-term metrics such as earnings and price-earnings multiples because they fail to capture the long-term cash-flow expectations implied by the stock price. Indeed, the most widely used valuation metric in the investment community, the price-earnings multiple, does not determine value but rather is a consequence of value. The price-earnings multiple is not an analytic shortcut. It is an economic cul-de-sac.

3. Read market expectations implied by stock price.

Rather than forecast cash flows, expectations investing starts by reading the collective expectations that a company's stock price implies. By reversing the conventional process, you not only bypass the difficult job of independently forecasting cash flows but you can also benchmark your own expectations against those of the market. You need to know what the market's expectations are today before you begin to assess where they are likely to move in the future.

4. Look for potential causes of revisions in market expectations.

The only way for an investor to achieve superior returns is to correctly anticipate meaningful differences between current and future expectations. Investors do not earn superior returns on stocks that are priced to fully reflect future performance. Where do you look for revisions? Changes in volume, selling prices, and sales mix trigger revisions in sales growth expectations. Revisions in operating profit margin expectations originate from changes in selling prices, sales mix, economies of scale, and cost efficiencies.

5. Concentrate analysis on the value trigger (sales, costs or investment) that has the greatest impact on the stock.

Identifying the so-called turbo trigger enables investors to simplify their analysis and channel their analytical focus toward the changes with the highest payoffs.

6. Use competitive strategy analysis to help anticipate revisions in expectations.

The surest way for investors to anticipate expectations revisions is to foresee shifts in a company’s competitive dynamics. For investors, competitive strategy analysis integrated with financial analysis is an essential tool in the expectations game.

7. Buy stocks trading at sufficient discounts from expected value.

The greater the discount from expected value, the higher the prospective excess return - and hence the more attractive a stock is for purchase. The sooner the stock price converges toward the higher expected value, the greater the excess return. The longer it takes, the lower the excess return.

8. Sell stocks that trade at sufficient premiums over expected value after accounting for taxes and transactions costs.

The higher a stock price’s premium to its expected value, the more compelling the selling opportunity. Investors should sell a stock for three reasons: It has reached its expected value, better investment opportunities exist, or the investor revises expectations downward. But even these reasons may not be decisive after incorporating taxes and transactions costs into the analysis.

9. Don’t overlook other significant value determinates that don’t appear in the financial statements.

For example, ignoring employee stock options can lead to a significant underestimation of costs and liabilities. Past grants are a genuine economic liability and future option grants are an indisputable cost of doing business. In contrast, real options, the right but not the obligation to make potentially value-creating investments, are often a meaningful source of value for start-ups and companies in fast-changing sectors.

10. Heed the signals sent when companies issue or purchase their own stock.

An acquiring company’s choice of cash or stock often sends a powerful signal to investors. Under the right circumstances, buybacks provide expectations investors a signal to revise their expectations about a company’s prospects. Correctly reading these signals provides investors with an analytical edge.

> *‘Confidence factors are the primary influences on price levels in the U.S. market, not fundamental factors like growth and real interest rates.’*
>
> Jeremy Grantham

Jay Ritter

Jay Ritter is Cordell Professor of Finance at the Warrington College of Business Administration, University of Florida. He writes extensively for *The Journal of Finance* and other financial journals, and has contributed chapters on IPOs to several books, most recently, The Handbook of the Economics of Finance, published by North Holland.

IPOs

BUYING AT THE IPO

1. ‘Increase the price, double my order. Decrease the price, cancel my order.’

When an initial public offering (IPO) is being sold, a price range is listed in the preliminary prospectus, such as $12-$14 per share. The day before trading starts, a final offer price is set. Sometimes, before the final price is set, the price range will be revised up or down. If the price is lowered, it indicates that the underwriter is having trouble finding buyers, and the stock is unlikely to jump at the opening. If the price is increased, this indicates that it is a hot issue, and the price is likely to jump at the opening. During 1990-1998, if the offer price was lowered, the average first-day return (from offer price to close) was 4%. If the price was increased, the average first-day return was 32%. With short-term profits in mind, you should ask for more shares the more the price has been increased. The reason that wanting to buy more, the higher the price, doesn’t violate the laws of economics is that the price change is telling you about the state of demand.

2. IPOs are a marketing tool.

In recent years, IPOs have become a marketing tool. That is, with many IPOs jumping up to far above the offer price on the first day of trading, receiving shares has become a source of profits for investors. Brokerage firms reward their most profitable customers with IPOs. If you are a profitable customer, due to having a large account or being an active trader, don’t be bashful about asking for IPOs. Brokerage firms know that they risk losing customers if they don’t give their best customers hot IPOs. If you don’t ask, you won’t get the hot IPOs.

3. If a broker asks you to buy, stay away from the issue.

Unless you are a very profitable customer for a broker, if the broker offers shares in an IPO to you, it probably indicates that the broker is having trouble selling the issue. This is a bad sign.

4. Check out what the web sites are saying.

There are a number of web sites that cover IPOs, and give updated information on whether a given issue is hot or cold. These differ from chat rooms, where anyone can say anything that they want. Some of the web sites include www.ipohome.com (Renaissance Capital) and www.ipomonitor.com. Links to other websites can be found at my homepage (bear.cba.ufl.edu/ritter), at www.iporesources.org, and on Yahoo's IPO page.

BUYING AND HOLDING

5. Pay attention to valuation.

A great company doesn't necessarily make a great investment. In recent years many technology companies have gone public and subsequently grown rapidly. But if the stock price already reflects huge future profits, the upside potential is limited.

As an example, on October 22, 1999 a young company, Sycamore Networks, went public. Sycamore had $11 million in sales during the prior year, and at the end of the first day of trading had a market capitalization of $14 billion. The chance that Sycamore's sales and profits would grow to numbers that could justify this valuation is miniscule.

When Microsoft went public in March 1986, it already was profitable, it had $162 million in annual sales, and its market cap was only $700 million. At a valuation of $700 million, Microsoft had a lot of upside potential. At a valuation of $14 billion, Sycamore did not have a lot of upside potential, even if things went right. In mid-2001, the market cap of Sycamore was less than $2 billion.

6. The IPO market is never in equilibrium. It's either too hot or too cold. Buy in the cold periods.

Since 1990, the U.S. has averaged 35 IPOs per month. But this average masks considerable variation. There have been 44 months with at least 50 IPOs, and 15 months with fewer than 20 IPOs. Periods of low volume include the six months after Iraq invaded Kuwait in 1990, the six months after Long-Term Capital Management ran into trouble in 1998, and the six months after the collapse of internet stocks in late 2000. During these periods, the IPO market virtually shut down.

In general, the best time to buy IPOs for the long run is when the IPO market is in one of its cold periods, with low volume. One of the great all-time investments in a company going public was that of Cisco Systems, which went public in February 1990, a month when only 12 other firms went public in the U.S.

Research that I have conducted with Tim Loughran of the University of Notre Dame shows that since 1970, firms going public during low-volume periods have outperformed firms going public during high-volume periods, where the performance is measured from the close of trading on the first day of issue to five years later. Of the internet IPOs from 1999 and 2000, by April of 2001 97% were trading below their offer price, and 99% were trading below their first-day closing price.

7. Avoid young companies in hot industries.

Historically, in the five years after issuing, IPOs have underperformed the market. Measured from the closing market price on the first day of trading, IPOs have underperformed the broader market by about 4% per year during the five years after issuing. This underperformance starts six months after the IPO, and is most pronounced for young companies going public during hot IPO markets.

A contrarian strategy works best with IPOs: older, more established, firms in industries that aren’t hot have historically produced the best long-run returns, especially if the offering is from a period when valuation levels are relatively conservative and few companies are going public.

8. Beware of the lockup period expiration.

When a firm goes public, the pre-issue shareholders commit to hold their shares for a set period of time, during which selling is prohibited without the express written consent of the lead underwriter. This period is typically 180 days. Around the time of the lockup period expiration, the stock price drops several percent, on average. The drop is even bigger for tech stocks.

Laura Field and Gordon Hanka, in an article published in the 2001 *Journal of Finance*, show that this drop occurs during the period from a week before to a week after the lockup expiration. If you are thinking of buying a stock which went public five months ago, it is best to wait for a little over six months before buying. But beware, because starting six months after the IPO is when the long-run underperformance starts.

9. Don’t confuse growth with profitable growth.

A firm or industry can grow rapidly, but this doesn’t necessarily mean that the profits will grow rapidly. If there are no barriers to entry, stockholders won’t benefit from growth. As an example, the airline industry has grown from almost nothing to one of the biggest industries in the country, as measured by sales and employment. But the airline industry has never been very profitable. Competition from new entrants (almost all of whom have gone bankrupt) and higher labor costs from unionized pilots have kept profits down.

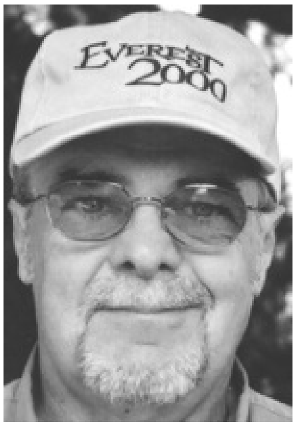
Even with rapid technological progress, a firm won’t make large profits unless its competition doesn’t have access to the technology. If all of the firms in an industry gain from new technology, competition drives down prices. Consumers benefit, but stockholders don’t necessarily benefit. Managers sometimes lose sight of this and overinvest.

10. Evaluate the prospectus, focusing particularly on the management.

As explained in *IPOs for Everyone* by Linda Killian, Kathleen Smith, and William Smith of Renaissance Capital, evaluating management quality and incentives, and the company's fundamentals, helps to pick the good IPOs and avoid the bad ones. Checking management is especially important with IPOs where there is no venture capitalist involved. If management compensation is set up to enrich management whether or not shareholders do well, it is a warning sign. A board of directors that is dominated by insiders is a warning sign. If management has granted large numbers of options to themselves, this is another warning sign. If the earnings numbers are boosted by aggressive accounting procedures, this is another warning sign.

But nothing is foolproof. A company might have entrenched management but still do well. For many years, America Online (now part of AOL-TimeWarner) boosted earnings by aggressively booking revenue from future monthly fees. AOL's stock climbed as their market share expanded and they crushed the competition, and after a few years they changed their accounting policies.

John Rothchild



John Rothchild is the bestselling author of the critically acclaimed *A Fool And His Money*, and *Going For Broke*. He co-wrote, with Peter Lynch, *One Up On Wall Street*, *Beating The Street*, and *Learn To Earn*.

A Former Editor of *Washington Monthly* and financial columnist for *Time* magazine and *Fortune*, Mr Rothchild has also written for *Harpers*, *Rolling Stone*, *Esquire*, and many other periodicals. He has appeared on The Nightly Business Report, the Today Show, and CNBC. His latest book about finance, *The Davis Dynasty*, is published in Fall, 2001.

BOOKS

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Surviving a severe bear market

1. Long-term may be longer than you think.

After severe bear markets, there are apparently endless stretches when little, if any, money is made from owning a typical portfolio of stocks. Judging by the Dow Jones Industrials, when stocks get ahead of themselves and falter, it can take many *years* - not many *months* - for them to regain lost ground.

The overused example is 1929, when the Dow topped out at 381 and took 25 years to go higher. Similarly, the Dow hit 685 in 1957 and traded lower than that in 1970. It hit 995 in 1966 and traded at 776 in 1981.

People who aren’t prepared for a decade or more of mediocre to nonexistent returns, especially after an exciting run-up that often precedes these bearish intervals, tend to lose enthusiasm for buying and holding, and often quit the market at disadvantageous times.

2. After the bears ruin the party, don’t keep dancing with the same old stocks.

Stocks that lead the rally to the top in late stages of bull markets - witness the so-called Nifty Fifty group in the early 1970s - aren’t likely to lead the rally off the bottom in late stages of bear markets. Newer, smaller, and faster-growing companies rise to the top.

3. Don’t be tempted by sucker rallies, unless you can love them and leave them.

Severe declines and lengthy recoveries (1929-1949; 1969-1981) are enlivened by exciting rallies that take stock prices to as much as a fourfold gain. These gains are lost just as readily, and the true recovery may lie years ahead.

4. When the last Chicken Little is debunked, the sky finally falls.

As stock prices rise into the thin air of overvaluation, leading to a big fall, all the bearish prognosticators are proven wrong.

In the mid-1990s, for instance, numerous high-profile Wall Street types turned publicly bearish, then lost credibility as prices continued to advance for five more years. At the market top in early 2,000, no high-profile bears were left to sound the alarm.

5. When bears rule the street, it pays to own things that pay you to own them.

This includes stocks that pay high dividends, preferred stocks, REITS, convertible bonds, and balanced mutual funds that own a mixture of the above assets. If it takes years for stock prices to rise, you might as well get some return while you wait.

6. 50 million Frenchmen can’t be wrong, but a consensus of economists can.

Recessions are bad news for the stock market, and severe recessions can be terrible news, but don’t rely on ‘most economists’ to give you the early warning. According to published reports, ‘most economists’ agreed the U.S. would avert recession in 1969-70, 1973-74, 1981-82, and 1990. They were wrong all four times.

7. Beware the New Era.

Every new generation or so, there’s talk of a ‘new era’, a Camelot where the economic climate is forever balmy, and companies bask in a garden of prosperity. New era talk was popular in the late 1920s, the late 1960s and the late 1990s. In the first two instances, these new eras led into the worst two bear markets of the 20th century. The latest new era was followed by the great technology bust when investors in the tech-heavy NASDAQ market were down more than 50 per cent from NASDAQ’s high.

8. Even bonds aren’t bear proof.

Bond investors lose a lot of money in severe bear markets, such as the one that lasted 34 years from 1947 to 1981.

9. Your mutual fund won’t save you.

Numerous big-name funds from the 1960s were gone by the end of the 1973-74 market wipe-out. Fund assets overall were down more than 30 per cent.

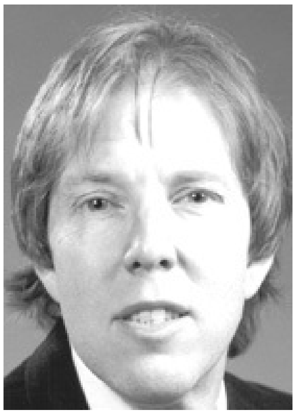
10. Ride with small stocks in post-bear rallies.

Small stocks tend to outperform off the bottom of bear markets, while larger-cap stocks tend to outperform near the tops of bull markets.

> *'Be leery of any company in which the analysts raise their target price while cutting earnings estimates. It simply doesn't make sense unless they're trying to hype it to issue stock.'*

Herb Greenberg

Thomas Schneeweis



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He is President of Schneeweis Partners, LLC, which specializes in analytical support in the areas of multi-advisor fund creation, asset allocation, and risk management services. He also edits *The Journal of Alternative Investments*, is head of the educational committee of the Alternative Investment Management Association and is a frequent speaker at academic and industry events dealing with alternative investments.

Hedge funds and managed futures investing

1. ‘Beware of the unknown, beware of hedge funds.’

In fact, most hedge funds have lower risk than individual stocks or even stock indices. Individual stocks have an annual volatility (i.e. standard deviation) of about 30%. The S&P500’s annual volatility is about 15%. Most hedge funds (with the exception of some long bias or global macro hedge funds) have an annual volatility below 15% and even commodity trading advisors (futures and option traders) have annual volatilities close to that of the S&P500.

2. ‘Stocks for the long run.’

In fact, hedge funds do add benefits to established traditional stock and bond portfolios. Most stocks move up together and down together. As a result, in order to diversify, investors need to invest in investment vehicles such as hedge funds which are constructed to be less sensitive to stock market movements.

3. ‘To know the future look at the past.’

The past foretells the future in many areas but not in stock and bond investment or in hedge funds. Each strategy makes money in unique markets. Only if the market conditions remain constant will the immediate past reflect the future.

4. Just look at the tracks if you want to know the animal.

Some hedge funds maintain that they are not correlated with the stock market when in fact they are merely an equity fund in hedge fund format. Test the actual performance of the hedge fund with indices which reflect traditional stock and bond investment, as well as hedge funds which reflect hedge fund performance. Stock and bond indices exist which reflect the performance of equity and fixed income portfolios

Similarly, there are a number of hedge fund indices (e.g., Zurich Hedge Fund Indices) which offer similar performance tracking for hedge funds.

5. Beware the man behind the curtain.

Some hedge fund managers maintain that their system is so secret that they cannot tell you how it works or why it works. When you meet these managers simply walk away. Never trust a man who will not tell you what is behind the curtain.

6. When all else fails, manipulate the data.

Many hedge fund managers will promote ideas that have no historical record of performance. At times this may be okay, but never rely solely on the data. Place your trust in the foundations of the trading idea not in the performance data.

7. ‘Clothes maketh the man.’

In fact, as for any investment, one must look behind the size of the firm, the office space and so on, and concentrate on the actual source of the return. If the manager cannot tell you why the strategy makes money in less than five sentences, move on.

8. ‘The Government will protect you.’

Some investors believe that there is greater government oversight and protection in traditional stocks and bonds than in hedge funds. In fact, most hedge funds have to meet regulatory requirements subject to the markets they trade (e.g., register as a CTA if trading in futures and option markets). However, in both traditional and alternative investment, no amount of government oversight can protect you from an incompetent manager or one who wishes to defraud you.

Caveat Emptor.

9. ‘One always knows the value of one’s stock portfolio but not one’s hedge fund.’

Unfortunately, many stock and bond funds’ net asset value does not reflect its true market value. For instance, emerging market prices are often outdated. By contrast, many hedge funds trade in the most liquid markets, such as futures and option markets, or in highly liquid equity markets. In addition, for most large investments daily pricing and evaluation is normal.

10. ‘Only the wealthy should invest in hedge funds.’

Traditional Assets Forms of Investment (e.g. mutual funds, structured notes) exist for hedge funds. Moreover, new forms of investment are being created which let individuals invest in hedge funds with less than a $10,000 investment.

> *‘Be aware of the economic cycle. While spending on eating out, health, fitness and other leisure pursuits is undoubtedly in long-term secular increase, it is also highly discretionary and one of the first to go in economic downturns.’*

Simon Johnson

Steven Schoenfeld

Steven Schoenfeld is a Managing Director of Barclays Global Investors, and the chief investment strategist and team leader of its International Equity Management Group, which manages over $65 billion in developed international and emerging market index investments. He is the editor of *Active Index Investing*.

Effective international equity investing

1. An international/non-domestic equity allocation always provides diversification to an investor's portfolio.

International investing has come under fire in the US for two main reasons: tighter correlations between global markets, and the huge U.S. bull market of the late 1990s. Both these reasons are clear examples of short term performance and 'rear-view mirror investing'. Looking at long term performance, in the 336 months between 1973 and 2000, international equities (proxied by MSCI EAFE) and US equities (S&P 500) moved in opposite directions 115 times or 34% of the time. However, in the 132 months in which the S&P 500 went down, EAFE posted a positive return in 55 of those months - 42% of the time.

So, even though the common argument is that international doesn't provide diversification in the times when it's most needed (when the domestic market is falling), in reality, international markets have posted positive returns more often in those periods than over all periods. Higher correlations in recent times were driven by the increased dominance of tech stocks in all global markets, and as their weight has dropped the correlations are dropping as well.

In fact, the truly risky portfolio is the one that does not include some foreign equities. Even in the 90s, investing 20% of a portfolio in international equities (EAFE), would have reduced volatility from 13.4% to 12.9%. More impressively, over the last three years (ending Dec 2000) when the argument for international not being a good diversifier has been most popular, an equity portfolio with a 30% allocation to EAFE would have been less volatile than a portfolio fully invested in the S&P 500 - 16.4% vs. 17.7%.

2. Don’t define international/foreign too narrowly - you’ll often miss the best action.

Many investors define ‘international’ in a constrained way, for example: US investors just investing in EAFE/developed markets, thus missing out on opportunities in Canada and emerging markets. Similarly, many European investors focus too much on their home region, and outside the continent.

A broad, international portfolio that includes emerging markets and Canada in the proportion of their market capitalization (ACWI ex-US), has delivered better risk and return characteristics than one invested solely in the developed international markets (EAFE). The more complete portfolio would have returned 7.2% with an annualized standard deviation of 16.5% as opposed to a return of 6.9% with an annualized standard deviation of 16.9% for EAFE (Jan 1988 - Dec 2000).

3. Even as globalization accelerates, national factors/country allocation still matters - a lot!

As the world has become more integrated, the influence of sectors has increased. However, countries are still the key drivers of return differentials. This is because, even in an area as closely linked as the EMU, there are significant differences in government economic and fiscal policies.

More importantly, the level of human capital differs substantially across countries. This translates into either different industry compositions or, at the very least, different levels of value added processes in the same industry. For equity markets, this means divergent market returns and therefore far from perfect correlation. Some sectors have always been global in nature (oil, technology etc.) while others are clearly driven by local factors (retail etc.).

4. All emerging markets are not created equal - and those with a potential to 'graduate' are the long-term winners.

It is important to distinguish between 'top-tier' emerging markets which are on the path toward convergence with developed market standards (and often into developed-market trading blocs such as the EU and NAFTA). Portugal and Greece have both successfully graduated, and those investors who were there early benefited.

Future 'top-tier' emerging markets would include Mexico, Brazil, Israel, South Africa, Poland, Taiwan and Korea. It is countries such as these which have the potential for the most rapid economic growth and market returns.

5. Domestic multinationals - or even global multinationals - are no substitute for broad international equity exposure.

As attractive as the concept might sound - generally something like “buy global winners to capture the benefit of international markets without the risk” - the reality is that one does not get the diversification advantage of foreign stocks with multinationals.

Domestic MNCs tend to have a beta close to 1.0 with their home market, and large-cap global MNCs are usually the most highly correlated both with each other and with large developed markets. To truly reduce risk and potentially enhance return, one needs stocks with a high degree of local content, and adequate exposure to at least the top 15-18 emerging markets.

6. Concerns about the currency exposure of international equity investment tend to be overblown - for allocations of less than 15%, the appropriate attitude should be "don’t worry, be happy"

The currency risk you take with foreign stocks is not always a bad thing. In fact, if international stocks are less than 15% of your total equity portfolio, the currency exposure actually adds diversification with minimal risk. That doesn’t mean it will always help absolute returns, but it is not a cause for major concern.

7. Always/only using traditional active management isn't optimal for international equity exposure.

Despite the conventional wisdom that the inefficiency of international markets requires active management, it is important to remember that costs are typically higher outside the home country. And the more the manager trades, the higher these costs can be.

Traditional active funds have higher costs and fees due to higher turnover, a disadvantage of approximately 100 bps, resulting in a performance hurdle of approximately 150 bps relative to the index. Exploiting inefficiency is easier imagined than done: while many active managers beat benchmarks like EAFE in the 90s by systematically underweighting Japan, this is a much harder exercise today.

Furthermore, the move by MSCI and other benchmark providers to float-adjustment and broader coverage will provide fewer outperformance opportunities in non-index stocks. The most important benefit of international diversification comes from simply getting the exposure - international/global index funds let investors own the market and thus efficiently capture the primary benefit of foreign equities.

8. Global index investment is anything but passive.

Investment styles are often broadly divided into active and passive. The term passive is used to indicate the lack of a mandate to produce an excess return over the benchmark. However, in practice, a well run index fund is anything but passive. The first decision is the choice of benchmarks - this depends on the client's preferences for factors such as comprehensiveness, investability and degree of acceptance. The next step is to decide how to weight the component countries if the choice is a regional/global benchmark. The default is of course market capitalization weights. But, several other weighting methodologies exist - equal weights, minimum variance weights, GDP weights *etc*. For any set of weights except market capitalization weights, the rebalancing schedule also needs to be decided. That could again be based on either a calendar cycle or on a target percentage deviation from the initial weights.

Replicating the performance of the index within countries is not just a matter of buying the initial set of assets and letting them run. There is a litany of events that need to be addressed on a regular basis. These include reinvesting dividends, ensuring the optimal decision is made during all types corporate actions and managing the level of cash efficiently. A key area that differentiates a good index manager is how they respond to large index changes. Each index change requires a specific trading strategy that takes into account the magnitude of changes, the period between announcement and implementation, the amount to be traded and the presence of other parties on the same and opposite sides of the trade.

9. If you invest internationally ‘a-la-carte’ make sure you use the appropriate vehicles.

ADRs can be an effective tool to buy foreign stocks, but can give lumpy exposure. Single country closed-end funds tend to have erratic discounts and very high expenses. Regional mutual funds (and closed-end funds) provide uncertain asset allocation within the region - it’s hard to know exactly what exposure you’re putting in your portfolio.

International/global Exchange-Traded Funds (both country/regional and global sectors) are appropriate and efficient for both short-term and long-term investors - and for both passive and active approaches . You know what’s in the fund, you can get in and out efficiently and at close to NAV, and you can use their modular structure to create virtually any variety of customized portfolios.

Charles Schwab

Charles R. Schwab is founder, Chairman of the Board and Co-Chief Executive Officer of The Charles Schwab Corporation. Mr. Schwab started his San Francisco based firm in 1971 as a traditional brokerage company and in 1974 became a pioneer in the discount brokerage business. Today, the firm is one of the nation's largest financial services firms, serving 7.7 million active investors with $858 billion in client assets.

BOOKS

Charles Schwab's New Guide to Financial Independence, Random House USA Children's Books, 2004

Make Money Work for You Instead of You Working for It: Lessons from a Portfolio Manager, John Wiley & Sons Inc, 2004

It Pays to Talk, Random House USA Children's Books, 2002

Succeeding with What You Have (1920), R A Kessinger Publishing Co, 2003

*You're Fifty-Now What? Investing for the Second Half of Your Lif*e, Crown Business, 2001

Charles Schwab's Guide to Financial Independence, Crown Business, 1998

How to Be Your Own Stockbroker, MacMillan, 1985

Schwab principles for long-term investing1. Start with the basics for long-term investing.

Begin by setting aside in cash at least two to six months' living expenses - an emergency fund that will be available in the event of illness or a period of unemployment. Then take advantage of employer-sponsored retirement plans and IRAs by contributing the maximum amount allowed. Finally, commit yourself to regular investing now so that you and your family will have enough later.

2. Get started now.

Every year you put off investing makes accomplishing your ultimate retirement goals even more difficult. As a rule of thumb, for every five years you wait, you may need to double your monthly investing amount to achieve the same retirement income. Social Security and pension plans alone are not enough for a comfortable retirement.

3. Know yourself.

Understand yourself as an investor: your emotions, your fears, and your tolerance for risk. Make sure you choose investments that you’re comfortable with and that are appropriate for your long term goals. For some investors, particularly those with large or complex portfolios who want ongoing investment management, the services of a fee-compensated financial advisor may be appropriate.

4. Invest for growth.

Invest in stocks, either individually or in mutual funds, for long-term growth. In any given year, stocks can be more volatile than other investments, but over time, stocks have typically outperformed all other types of investments while staying ahead of inflation. Stocks should be the core of a long-term investing strategy.

5. Take a long-term view.

Patience is a virtue. Maintain the discipline to hold onto or add to appropriate investments through down markets as well as up markets.

6. Build a diversified portfolio.

In deciding how to allocate your assets, be sure to diversify, both among asset classes (stocks, bonds, and cash equivalents), and within each class. Choose an appropriate asset allocation model. Doing so can spread risk over a variety of investments and may provide more consistent and reliable outcomes.

For many investors, broad-based index funds are an excellent investment strategy. Index funds are a sound, low-cost choice for a core holding designed to track the market's performance.

7. Consider bonds and cash for diversification and income.

Bonds and cash can play an important role in an investor's portfolio, providing solutions for income and diversification needs. But to achieve your long-term growth objectives, look to stocks and stock mutual funds.

8. Minimize your expenses.

Over the long run, sales charges, loads, and high expenses can drag down the performance of even a well-diversified portfolio. Reduce your investment expenses by using no-load funds, low-cost stock and bond trading services, and tax-efficient mutual funds. For many investors, a buy-and-hold strategy can minimize the impact of capital gains taxes.

9. Stay on track.

Review your portfolio at least once a year, and certainly whenever personal circumstances change. You'll need to evaluate the performance of your investments against relevant risk-adjusted benchmarks, and, when necessary, to rebalance your portfolio to stay on track with your long-term financial goals.

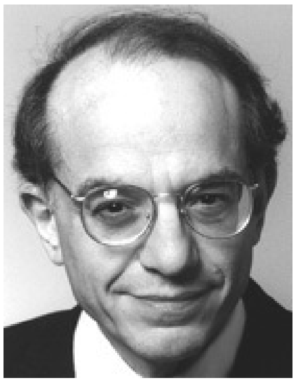
10. Become a lifelong investor.

Investing for growth shouldn't stop when you retire. To make your money work for you throughout your retirement years, keep investing a portion of your portfolio for growth. Don't automatically shift all of your money into fixed-income and money market investments too early.

> *'Most of the time the market rises. Unless it is a real bear market, all attempts at market timing backfire and become very costly. But when you actually encounter a real bear market, recognizing it and taking corrective actions is near life saving.'*

Ken Fisher

Jeremy Siegel



Professor Jeremy Siegel has been a Professor of Finance at The Wharton School of the University of Pennsylvania since 1976. Professor Siegel received his Ph.D. from MIT and taught for four years at the Graduate School of Business of the University of Chicago before joining the Wharton faculty.

His book, Stocks for the Long Run, was named by *Business Week* as one of the top ten business books of the year in 1994. An expanded version was published in 1998 and was named one of the ten-best investment books of all time by *The Washington Post.*

BOOKS

The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New, Crown Business, 2005

The Strategy of Core Investing: Profiting from Stocks That Will Stand the Test of Time, Free Press, 2004

Stocks for the Long Run, McGraw-Hill, 1998 - expanded edition, 3rd 2002

Stocks for the long run, and diversification

1. Stocks should constitute the overwhelming proportion of all long-term financial portfolios.

Stocks are unquestionably riskier than bonds in the short run, but for longer periods of time, their risk falls below that on bonds. For 20 year holding periods, they have never fallen behind inflation, while bonds and bills have fallen 3 per cent per year behind inflation over the same time period. So although it might appear to be riskier to hold stocks than bonds, precisely the opposite is true if you take a long-term view.

2. Investors worried about equity exposure should consider government inflation-indexed bonds as an alternative.

Inflation-indexed bonds offer after-inflation returns that are competitive with standard bonds, and much safer in terms of purchasing power because the rate they pay is linked to inflation. Although they currently offer only half the long term yield of stocks, history suggest that over ten year periods they will outperform equities about one-quarter of the time. For investors who do not have a long-term time horizon, they are a safe alternative to stocks.

3. Invest the largest percentage - the core holdings of your stock portfolio - in highly diversified mutual funds with very low expense ratios.

Unless you can consistently choose stocks with superior returns, a goal very few investors have reached, your best balance of risk and reward will be achieved by investing in index funds or other highly diversified funds with very low expense ratios. Index funds do not attempt to beat the market, but by holding a large number of stocks in proportion to their market capitalization, they match the performance of the market as a whole at very low cost. From your point of view, matching the market is good enough to obtain the superior returns that have been achieved in stocks over time.

4. Place up to one-quarter of your stocks in mid-and small-cap stock funds.

Small stocks sometimes outperform large stocks, and sometimes underperform them. Since it is not possible to predict the times of relative performance, and since it is impractical to invest in all small caps individually, the best strategy is to invest in a small-stock index fund and leave your money there. If you ignore small caps entirely, your long-term returns are likely to be lower.

5. Allocate about one quarter of your stock portfolio to international equities, divided equally among Europe, the Far East, and emerging markets.

Since almost two-third's of the world's capital is now located outside the United States, international equities must be the basis of any well-diversified portfolio. Japanese stocks, despite their long bear market, should not be excluded because they have a low correlation with the rest of the world's markets, making them good portfolio diversifiers.

6. Do not overweight the emerging markets. High growth is already factored into the prices of many of the stocks of these countries.

There is a tendency for many investors to overinvest in emerging markets where promises of capital appreciation are high. But the markets of developing countries are extremely risky. It is important to spread your investing globally between Latin America, the Far East, and Central and Eastern Europe. As investors witnessed in 1997, problems can strike whole geographical areas quickly, such as the currency crises that began in Thailand and spread to other Asian markets. Again, diversification is the key to reducing your risk exposure.

7. Large ‘growth’ stocks perform as well as large ‘value’ stocks over the long run.

Tech stocks on the whole have not been good long-term performers and investors should avoid or underweight stocks with P/E ratios over 50. Historically, large growth stocks with low dividend yield and high P/E ratios, have performed just as well over the long run as large value stocks with higher dividend yields and lower P/E ratios. But when the P/E ratio becomes excessive, as it did in 2000 for tech stocks, it is mandatory to cut down on one’s exposure.

8. The ‘Dow 10’ strategy of buying the 10 highest-yielding Dow Industrial stocks has outperformed the market consistently over long periods of time.

This outperformance is mostly due to the fact that all of the Dow Industrials have been superior companies in their respective industries. These stocks are very responsive to a contrarian strategy that accumulates the stocks when they have fallen over a period of several years. A high dividend yield by itself is not a very important criterion in performance.

9. Small value stocks appear to significantly outperform small growth stocks.

In contrast to the big capitalization stocks, value does appear to outperform growth among the mid-and small-cap stocks. The very small growth stocks do worst of any class of stocks examined. Dreams of buying another Microsoft or Intel often compel investors to overpay for these stocks.

10. Avoid initial public offerings (IPOs) unless you buy at the offering price.

If you can buy new issues at their offering price, it is usually wise to do so. But don’t hold on. IPOs, which often include small growth stocks, are extremely poor performers for long-term investors.

> *‘Making an investment in a supposed beneficiary of a government decision is highly dangerous, because helping private sector companies make money is bottom of any government’s list of priorities, while getting them to spend money on the government’s behalf for no return is pretty high up.’*

Max King

Andrew Smithers

Andrew Smithers founded Smithers & Co. Ltd which provides economics-based asset allocation advice to 80 of the world's largest fund management companies. He is a columnist for London's *Evening Standard* and Tokyo's Nikkei Kinnyu Shimbon's *Market Eye*.

BOOKS

Valuing Wall Street (with Stephen Wright), McGraw-Hill, 2000

Japan's Key Challenges for the 21st Century (with David Asher), published in Japanese by Diamond

Protecting wealth and valuing the stock market

1. Never delegate asset selection.

Your interests, as the investor, are different from those of your broker or fund manager. It’s not their fault; it’s a fact of life. In the case of the broker this is obvious. You both want to make money. The more you deal, the more money he makes and, as a general rule, the less you do. But your fund manager also has different interests from you. As I write [July 2001], Wall Street is over-valued by about twice. The risks of the stock market falling over the next 12 months are around 70%. No one who understands this would put his money into shares. But for a fund manager the risks are different. If he goes liquid with his client’s money, he has a 30% chance of damaging his business and possibly losing his job.

2. Learn how to value the stock market.

Remember that price matters. Anyone who tells you that it’s always sensible to buy stocks is dotty. It’s a sign of the times. No one said this in 1932, which was a wonderful time to buy stocks, but lots said it in 2000 which was a lousy year. Remember it can take you up to 20 years to get your money back even from a badly timed purchase of an indexed fund, and individual companies go bust. It’s quite easy to know when share prices have gone too high. In a competitive economy, everything from toothbrushes to computers sells for what it costs to produce. The same is true for companies, though their prices can be above or below cost for several years. This is the problem. Sensible investors can have a bad time at cocktail parties for several years. They will get out of the market too soon in the bubble years. There is no answer to this. If there were, the stock market would never get over-priced. Sensible investors can’t be greedy or boast at parties. (This doesn’t just apply to bull markets. Humility is valued in those rare bear market parties).

3. Know your aims.

Think carefully about what you want. If you are saving for a comfortable retirement, remember that when you invest. Don't forget to diversify - concentrated portfolios have huge risks. It's different if you think you are rich enough to retire and have made some money. Then you can have fun trying to pick winners. Unless the market is generally over priced (remember Rule 2), this is rather like playing the tables at Monte Carlo, but with odds in your favour. Instead of being certain to lose if you play long enough, you should win and you could win a lot. It's not very sensible, but if you want to have an outside chance of riches it's better than anything else on offer.

4. Remember your age.

If you are aged 30, stocks will normally be the right asset class for you. Even then remember Rule 2. If you are 70 it won't. Concentrate on TIPS (Treasury Inflation-Protection Securities) or cash. For ages between 30 and 70, the proportion of TIPS and cash should rise steadily. Over 10 years the real return on 10 year TIPS is virtually certain, but stocks can give big losses. At 70, 10 years is a lifetime.

5. Understand risk.

Stocks are highly volatile and therefore very risky. They are less risky over the long term than over shorter periods. In addition to the normal way that risks even out over time, there is an added reason for this. It is because their long-term returns tend to ‘revert to a mean’. After periods of low returns, the next period has an above average chance of being a good time to hold stocks. Equally after a good period - and the last 20 years have been phenomenal - it is a bad time to hold stocks.

6. Costs are important.

Investors nearly always underestimate the importance of costs. The longer term your investment horizon, the more important this is. Over the long term, the real return on stocks, before tax or expenses, has been around 6.5% p.a. So if inflation runs at 2.5%, the nominal return that an investor can reasonably expect is around 9%. If you get this over 30 years, and start with $200,000 you will have $2.6 million at the end. If your costs come to 2% p.a., which they easily can, you will only have $1.5 million.

7. So is tax.

This is even truer of tax. There are ways in the US and UK for investors to save tax-free for their retirement. If you paid tax at 30% every year the investor who would have got $2.6 million will only receive $1.25 million. If he paid 2% costs he would only get $700,000.

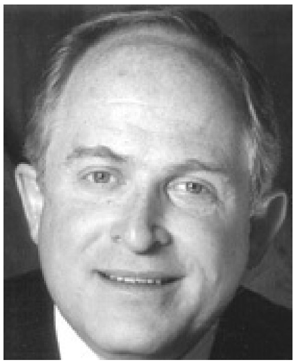
8. Get interested and enjoy it.

This is a hard world where professional investors' interests are in conflict with yours. Understanding investment pays better than trust. Those who enjoy learning are those who do it best. If you can, get interested; if you can't, get out.

> *'Many investors try to place buys with limit orders just below the ask, and wind up missing the purchase. If you really want a stock, particularly a big position, place a limit order at the ask, or even slightly higher. You will at least get the order. Don't miss the train to shave a dime.'*

Robert V. Green

Joel Stern



Joel Stern is managing partner of Stern Stewart & Co., the New York corporate finance firm which devised the concept of EVA. He has advised companies of all sizes and on all continents on the implementation of EVA processes, and has lectured widely at business schools in the USA and Europe.

BOOKS

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The EVA Challenge, John Wiley, 2001

Revolution in Corporate Finance, Blackwell, 1998

EVA as an enhancer of shareholder value

INTRODUCTION

Each day, millions of managers systematically destroy shareholder value. Why? It is not because they are incompetent, nor is it because they are dishonest and are diverting corporate assets to their own use. No, it is because they are responding rationally to the compensation systems used by the vast majority of corporations which actually reward them for over-investing in mature industries, over-spending on labor-saving automation, and overpaying for acquisitions.

EVA is the system developed by Stern Stewart to bring the interests of managers back into line with the interests of shareholders. The rules below explain why their interests are often misaligned, and how the implementation of an EVA system encourages management to make decisions that enhance rather than destroy shareholder value.

1. Rewards based on growth in EPS lead to over-investment.

In most companies, the measure of success is accounting earnings (or earnings per share). This measure includes a deduction for interest paid on debt, but no charge for the cost of equity capital. The result is that earnings often go up even though economic performance declines, a fact that can propel over-investment. Consider a company that borrows at 8% interest and pays a tax rate of 40%. The company's after-tax borrowing cost is 4.8%. But if it finances new investments with a target ratio of 70% equity and 30% debt, its after-tax interest cost on added capacity is only 1.44% (30% of 4.8%). Any investment that returns more than 1.44%, even if it is far below the company's weighted average cost of capital, will cause earnings and EPS to rise. Managers who are rewarded for growing earnings are sure to over-invest in expansion that causes earnings to rise but returns less than the full cost of capital. They also will over-invest in labor-saving automation even when the full cost of capital on the new equipment exceeds the savings in labor costs, because the reduction in labor costs boosts earnings, while the greater cost of capital on additional equity goes uncounted.

2. Rewards based on size encourage empire-building.

A second reason that conventional compensation systems encourage managers to destroy wealth is that most of them are based in one way or another on size. Under the Hay system that has become virtually universal, an executive’s fixed compensation is a function of the number of people reporting to him or her, the size of the budget or the amount of revenues. This carries down from the chief executive to virtually every manager in the company, so every manager profits by empire building and pursuing growth for its own sake, regardless of whether the new business earns enough to cover the cost of additional capital.

3. Capped incentive compensation plans backfire on shareholders.

Most managers have incentive compensation plans that are capped, often at 150% or so of the target bonus level. No matter how much wealth they create for shareholders, their compensation tops out at the bonus cap. Yet managers do have a way of working around the cap. If they can make the business bigger, their Hay points go up, and since the target bonus is a percentage of fixed pay, their potential bonuses go up as well. It's a formula for growth at any cost, no matter how much it hurts the shareholders. It's not that these managers want to diminish shareholder wealth. Quite the contrary. All things being equal, they would much rather increase shareholder wealth. But all things are not equal. Because non-EVA systems use the wrong performance measure and poorly designed incentive structures, they make it perfectly rational for managers to do things that owners never would do. The managers, like the shareholders, are victims of perverse rewards.

4. The present value of expected future free cash flows is mathematically identical to a firm's economic book value plus the present value of expected future EVA.

The theory of modern finance and the associated empirical evidence tie changes in value to changes in the expected growth in EVA. Modern finance says that a firm's value is the present value of the free cash flows it will generate in the future. While it is not obvious to everyone at first glance, the present value of expected future free cash flows is mathematically identical to a firm's economic book value plus the present value of expected future EVA. Thus, if management drives the firm to increase EVA, this is consistent with increasing shareholder value.

5. To provide a superior return, management must bring about increases in EVA which exceed market expectations.

Since the current share price of a stock already incorporates current expectations about future EVA, increasing EVA at the rate already expected will simply earn shareholders a rate of return equal to the cost of equity capital, which is the required return for equity risk. To provide a *superior* return, management must bring about increases in EVA greater than the figure expected by the market.

To do this, management should focus on measuring economic book value and the components of EVA very carefully, and then use supportive management tools that are reinforced by an incentive system based on sustainable improvements in EVA. If CEOs and their management teams are paid significant rewards for achieving sustainable improvements in EVA, that is what they will strive to do. And those who succeed will produce significant improvements in shareholder value.

6. EVA makes a charge for equity capital.

In the accountant's version of residual income, management gets to use ordinary equity free of charge. This encourages the use of too much capital in the business because not enough is charged for the use of capital. EVA is Stern Stewart's special version of residual income

First, we levy a charge for equity capital at the minimum rate of return that shareholders demand.

Second, we make modest adjustments to both income and capital in measuring the return on capital employed. As an example, we capitalize investments in intangible assets such as research and development and brand value. This removes the charges for those investments from the income statement and puts them on the balance sheet. The reason accountants expense these items is that accounting originally evolved as a framework to help lenders determine if borrowers could repay indebtedness. If a firm fails, intangible assets clearly will have little or no value. EVA, in contrast, focuses on going-concern value - the measure that matters most to shareholders - instead of the lender's liquidation value.

7. EVA discourages excessive off-balance sheet borrowing.

When management borrows off the balance sheet, the borrowings are not recorded as capital employed under the normal accounting framework. The effect is to overstate the return on capital employed. EVA requires adjustments for off-balance-sheet borrowing - for instance, for operating leases - so that the borrowings are capitalized and the return on capital accurately reflected. If managers know that they cannot inflate ROCE through off-balance-sheet borrowing, they will be less inclined to do it.

8. EVA discourages expensive acquisitions.

EVA requires that goodwill on acquisitions remain on the balance sheet as part of the price paid. Only by including the full price paid as part of capital employed - and charging for the use of capital - will management be discouraged from overpaying. At the same time, we do not want to discourage genuinely profitable acquisitions or other investments simply because they do not have an immediate payoff. So we record strategic investments with delayed payoffs in off-balance-sheet ‘suspense accounts’, and move them onto the balance sheet (and into the calculation of EVA) when the investments are expected to produce income. In the interim, however, the suspense account grows by the cost of capital it has yet to produce. Some adjustments to accounting are industry specific. In natural-resource companies, for example, each year’s gains or losses on reserves in the ground should be included in EVA.

9. EVA works best when it is used at all levels of an organization.

Once management decides to use EVA, it must ensure that EVA tools for decision-making are carried down through the organization. With the reinforcement of a strong incentive plan tied to changes in EVA, companies will not consider capital outlays that are value destroying. Investments earning less than the cost of capital will be rejected, both because they destroy shareholder value and because they reduce bonus payments. At the same time, managers will rush to make investments that increase shareholder value and bonuses. Most firms implement incentives down through middle management, but the very best performers carry it right down to the shop floor, so that all employees can earn significant variable pay and more closely align their own interests with those of shareholders.

Catherine Tan

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Before joining Lloyd George Management in Hong Kong in 1998, she was a portfolio manager with DBS Asset Management in Singapore for 4 years. She was voted one of Asia's top ten fund managers in *Asiamoney* in 1997.

Investing lessons from the Asian markets1. The only no-brainer is the person who believes in a no brainer. Challenge the consensus.

Stay clear of stocks labelled no-brainers. There is no such thing. The best investors are those who work the hardest. It is a knowledge game and superior knowledge leads to superior returns. Read widely, think laterally and remember that history has a tendency to repeat itself.

At the top of a cycle, excess capex (capital expenditure) is always disguised as productivity increase. Think USA today, and remember the Japanese and then later the East Asian miracle, where there was a clamour to explain why productivity (later exposed as a myth) was substantially higher. Special mention goes to Singapore's Senior Minister who claimed it was because of East Asia's Confucian values.

2. The only constant is change.

When a practice is continued because it has worked very well in the past, warning bells should ring. That is the worst reason to do something and is a sign of inertia or, worse, mismanagement. What is good today is easily bad tomorrow.

A case in point was the Thai dollar peg. In 1995, when asked if they would relax it, Bank of Thailand happily and adamantly rejected the idea saying it had worked so well in the past. In the process it built up pressure for the subsequent implosion. For everything, there is a time and season.

3. Earnings are well and good but cashflow rules.

Earnings can be ‘manufactured’ more easily than cashflow. If it’s such a great business, it will show in the cashflow. Likewise when things seem bleakest - at the height of the Asian crisis, for example - you can make a lot of money buying stocks trading at huge discounts to their cashflows. Buy strong cashflows. Caveat below.

4. Cashflow return on investment (CFROI) matters.

Even with a cash cow business, be careful of majority shareholders or management whose interests may well be different from those of minority shareholders. Often cash-generative listed businesses are used to bail out failed or failing private enterprises through dilutive injections. If they cannot generate a decent return, the money should be returned to you.

5. Balance sheets, accounts and prospectuses are a good source of information.

They are underutilised and should be scrutinised. There is a lot hidden in them which tells you more than any analyst could. Look for inter-company loans, bank guarantees, receivables etc., and read the risks.

6. Macro matters.

No market is an island. Sector investing has taken roots and affects stocks everywhere. When America catches a cold, the rest of the world is still susceptible to pneumonia. In a liquidity rally, turkeys fly highest.

7. Know why you are in the stock.

This will help you know why and when you should get out of it. Revisit the reasons why you bought a stock often. Ask if anything’s changed. Be very honest. If you are in it for the ride, don’t try and cloak the decision. That way, you are more likely to get off before the ride ends.

8. Take profits. Take losses. Protect NAV (net asset values).

A bird in the hand is worth ten in the bush. If the stock has reached your target price, realise your profits. Revisit the fundamentals. If the only things that have changed are price and sentiment, sell. On the other side of the coin, don’t be afraid to realise losses. If you wouldn’t buy it today, don’t hold on to it.

9. Follow the insider.

Monitor insider actions, management transactions and company buybacks. If the people on the inside are selling shares to you, it’s a strong signal that the market’s overheated.

A particularly savvy insider is Li Ka Shing whose cash raising has generally coincided with the top of the markets and whose buybacks have coincided with its bottoms. His IPO of Tom.com, for instance, was right at the height of the internet mania.

Research unusual stock actions, whether surging volumes or unusual price movements. They are often the first indicators that something’s happening, for good or bad.

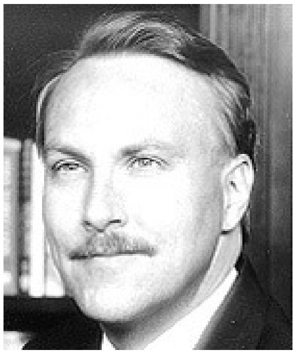
10. Asia is no different to the rest of the world, and the same global rules apply.

Don’t make an exception. Don’t be fooled into making exceptions.

> *‘Study long-term charts. Once the long-term has been established, consult daily and intra-day charts. A short-term view alone can often be deceptive. Even if you only trade the very short term, you will do better if you're trading in the same direction as the intermediate and longer term trends.’*

John Murphy

David W. Tice



David W. Tice is President of David W. Tice & Associates, Inc., based in Dallas. The firm employs 11 full-time analysts to search for companies which are likely to fail to meet Wall Street expectations. The research is used to publish ‘quality of earnings’ warnings, and ‘sell’ recommendations to more than 200 money managers who collectively manage more than $2 trillion. His firm’s work has gained recognition through several Barron’s articles and from his appearances on CNBC and other financial cable programs.

Overvalued stocks and Ponzi schemes1. Study stock market history - recognize where you are in the long-term secular cycle.

Most investors remember and learn from what has occurred in the recent past. Investors must realize that they must learn from periods that might extend beyond their own memory. Market cycles can last a long time, and people have too much at stake to make all the mistakes themselves, so they must learn from market history.

Most of the money in the stock market over the last 104 years has been made in secular bull markets. However, being invested at the tail end of secular bear markets can result in very poor investment performance for a very long period of time. Recognize that the greatest contributor to stock market performance is the P/E multiple afforded to earnings, and that in bull markets, the P/E multiple expansion is what drives stock prices.

2. Uniform opinion among analysts about an individual stock is dangerous.

When many Wall Street analysts are unanimously positive on a company, the stock price tends to be too high and reflects very favorable expectations. The key to making money in stocks is selecting companies where your analysis of fundamentals shows better prospects than the current Wall Street expectations. However when all analysts have very high expectations for a company, then it becomes very difficult to beat lofty expectations.

3. There are elements of Ponzi schemes in many areas of investment.

Always keep your eyes open for investments that require a bigger fool to continue to pay a higher price to have the investment make sense. These investments are dangerous, as eventually you run out of buyers willing to continue to pay a higher price. Determine that there are underlying economic fundamentals that justify the investment based on future cash flows, not just that someone is willing to pay a higher price.

These ponzi-like situations can be found both in the investment markets as well as in the fundamentals of real businesses. For example, the recent telecom boom was founded not on the ability of companies to make money, but on their ability to sell the bandwidth they developed on to a bigger company. This was a classic Ponzi scheme. When it was realised that the bigger telecom companies couldn’t buy all the bandwidth that was being developed, stock prices crashed because the business models were not viable on their own merit without the benefit of a bigger fool buying them out.

4. Buy low, sell high - don’t buy high, sell higher.

This advice seems straight forward, but is always difficult to follow. Attractive sounding growth stories have the most intrinsic appeal, but are always the highest priced in the market. These companies have the highest expectations, and it normally requires a bigger fool to keep paying a higher price to keep the stock price rising. Also, there usually exists very little downside asset value support in those cases where the growth story does not come through.

5. Consider selling short to reduce exposure and to create outperformance.

There are always many stocks which reach outrageous price levels and can be sold short. One great attribute of selling short is that it reduces overall equity allocation which reduces portfolio risk and equity exposure. Short exposure of 15% offsets long exposure of 75%, thereby resulting in net long equity exposure of 60%. Reduced equity exposure means lower risk, thereby helping investors generate improved risk-adjusted returns if stock selection is done well.

6. Be a contrarian and independent thinker

Always attempt to challenge the conventional wisdom which is normally wrong. Following the crowd is not normally the way to get rich. Great riches are typically earned by people who identify an opportunity before anyone else and who exploit those opportunities successfully. You should invest in the same manner.

7. Have a long time horizon - it’s the key to riches.

Look for companies that are experiencing short term disappointment. Most investors attempt to chase short term performance which is very difficult to achieve. Earning a 50% performance return over three years, is equivalent to a 15% annual return. The chance of earning that 50% return is higher if all the other investors ignore a stock because they see the performance being too far in the future.

8. Look at micro-cap companies. The market is more inefficient, and the profits can be huge.

Companies with smaller market values are followed less by Wall Street and therefore generally carry lower expectations. If you can identify companies with great prospects before others do, your chances of generating outstanding returns are much greater.

9. Always think about risk vs. return.

Always seek the optimal trade-off between the two functions. Stocks that most people already know about generally possess lesser return potential. Companies that sell at significant multiples of revenue, possess the highest risk in case of disappointment or in a bear market. In a mania bull market, stocks with the highest risk can earn the highest returns for a while, but if market conditions change, they will decline the most.

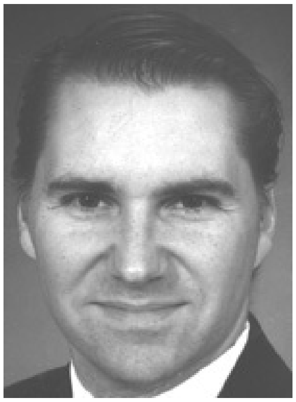
10. Follow the smartest analysts who are indepedent thinkers.

Read and follow the advice of the most insightful analysts you can find. Sometimes those analysts with the best short term track record have been the ones taking the most risk. This should always be assessed. Look for analysts who make sense and who consider downside support as an important element of the investment strategy.

> *‘Many investors concentrate on picking winning stocks. For the most part they can’t. I’ve found that, on average, the stocks investors sell subsequently outperform the stocks they buy, even before subtracting transactions costs. Most investors would be better off forgetting about picking winners and paying attention to doing the things they can actually do - controlling trading costs, managing taxes, and diversifying.’*

Terrance Odean

Timothy P. Vick



Timothy Vick is the senior investment analyst for Arbor Capital Management, and a partner and co-portfolio manager of The Power Fund, a partnership that invests in emerging companies in the alternative power industry. He writes about economic trends, business strategy and valuation, corporate performance, and portfolio management.

BOOKS

How to Pick Stocks Like Warren Buffett, McGraw-Hill, 2000

Wall Street on Sale, McGraw-Hill, 1999

Finding value in the market1. Picture yourself as the owner.

When I see a stock priced at $50, my first instinct is to multiply the price by the shares outstanding - let’s say 10 million - and ask myself whether the whole company is worth $500 million. My second question evolves from the first: If I had $500 million to invest in the company and could be the sole owner, would I buy it? Starting from this premise, your mind naturally will focus on basic business issues such as payback (how fast can the company generate $500 million in profits to return your investment), cash flow, debt levels, taxes, sales prospects, capital expenditure needs, and profit margins. Price fluctuations, moving averages, and chart patterns have no place in this exercise.

Generally, the longer it takes a company to return my investment, the more I am inclined to walk away, whether I’m looking at public or private entities. If I wouldn’t want to own the entire company, I won’t buy even 100 shares of it.

2. You win in investing by not losing.

Investing is, by virtue of its competitive nature, a ‘Loser’s Game’ - winners are those who make the fewest mistakes. The most revered investors in history, those sitting atop the largest pile of assets, did not make a killing on one or two stocks, but sat tight with their money, deployed it slowly and prudently, and exploited opportunities that negated their chances of losses. Experience has taught me that if you minimize your chances of losing money each time you buy a stock your overall returns will greatly exceed the average investor’s. In contrast, short-term traders and institutional money managers are naturally prone to mistakes and underperformance. By doggedly chasing short-term returns to beat their peers and to keep pace with market indexes, they unwittingly force themselves to make dozens of poor investing decisions each year, which tends to limit and commoditize their returns.

3. Keep your eyes off the market - but be prepared to exploit it.

Confident investors don't look at stock quotes once a day, once a week, or even once a month. If you purchase an investment at a good price and are sure of the company, pricing will take care of itself. Daily fluctuations become just noise. I am always amazed by investors who claim to buy a stock for the 'long-term' yet continually monitor every price change, press release, and earnings revision. Eventually, their penchant to absorb useless news evolves into a psychological obsession to act - more often than not they will buy or sell prematurely for the wrong reason. Financial markets exist solely to execute your buy and sell orders: nothing more. Focus first on the performance of companies and use the market solely as a reference point to see if other investors are pricing the company properly. When you see a wide discrepancy between price and value, be ready to exploit the situation.

4. If you cannot understand it, don’t buy it.

One of the chief ways I minimize mistakes is to invest only within my circle of competence. That should be an easy rule to apply, but humans have a tendency to beat their chests and feign unlimited knowledge when money is at stake. Every company or industry possesses, at most, two or three ‘critical factors’ that you need to analyze to determine your chances of making money. If you can understand the critical factors that make an airline, a hotel chain, a bank, or a maker of programmable logic chips, profitable, you will invest more confidently. If you cannot identify these factors, avoid the investment altogether. Likewise, if you cannot understand the company’s earnings releases or its annual report, take your money elsewhere.

5. Rely on yourself, not on the opinions of others.

Ten days before the 1929 market crash, *The Wall Street Journal* jokingly questioned why “any ignoramus” can get away with talking about investments. Indeed, a man with an opinion is as common in finance as mosquitoes in summer - and is just as much of a nuisance. Because investing is as much an art as science, it invites anyone to pass judgment with little fear of reprisal. Great investors rely on facts (never on opinions) and their own ability to decipher facts. They rarely get good ideas talking to others and will never buy and sell solely on others’ counsel. Think back to your worst investments over the years - likely they were bought on the recommendation of someone else. That’s because every investor has unique risk and reward profiles - what’s good for your neighbor, physician, golf partner, or brother-in-law will rarely work for you too.

6. Forecasts are useless, especially those about the future.

Aristotle once said that man has an innate desire to know the future, and that no desire is exploited more by his fellow man. The entire financial industry exists to sell product. If you don't understand this basic maxim, you'll be misled time after time.

The brokerage industry figured out long ago how to play to your hopes and fantasies, to conjure up forecasts and spurious mathematical reasons why an investment will sell for more in the future than it does today. Yet, in all my years of studying in business school, observing the conduct of managers, and practicing portfolio management, I've never come across anyone who has consistently been able to predict the direction of the market, the economy, interest rates, or a company's sales and earnings. As long as markets are emotional and fickle, and as long as business managers and investors are prone to react irrationally to fickleness, this poor track record will continue unabated. Invest in what *is*; not what could be.

7. Time is your natural friend.

In finance, time corrects all short-term anomalies. It exposes poor businesses masquerading as great entities, and gives truly great entities sufficient chance to maximize the reward to investors. Choosing good companies at fair prices seldom has produced losses for patient investors.

A company that increases earnings by 12% a year over 20 years will experience a roughly 12% yearly increase in stock price. However, if you bought and held the stock for just one of those 20 years, any return is possible. Great investors always stay mindful of their opportunity costs. Every poor investment has two costs - the near-term loss you generated and the long-term money you gave up by choosing poorly. A $10,000 loss early in your investing career costs you more than $2 million at retirement if you could have compounded the money at 20% annual rates. An investment sold too early can have the same effect. Most investments you sell today will one day trade for much higher than the price at which you sold. Think about that before you sell.

8. Don’t diversify - it breeds sloth and mediocrity.

If you want to be simply ‘average’, behave like the averages. Nothing breeds middling returns more than collecting stocks as if they were postage stamps or vases. Pension and mutual fund managers have to diversify portfolios to protect their jobs and to counter the effects of huge money inflows. You don’t. Having to watch 40 or more companies poses the same burden on an investor as owning 40 apartment buildings, or 40 restaurant franchises. Why diversify, if you’re not up to the task? At some point, your portfolio of assets becomes impossible to monitor and you’re left hoping that nothing extraordinary happens to any of the 40. Worse, you guarantee yourself middle-of-the-road returns - that has been proven mathematically. The great money is made holding a small collection of assets that you understand intimately.

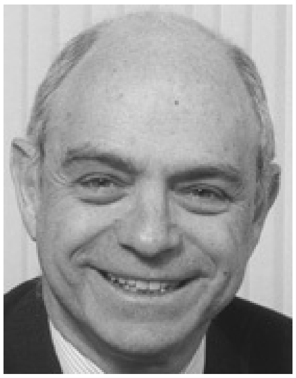
9. Know the difference between ‘investing’ and ‘gambling’.

If you buy any asset without first valuing it, you should admit to gambling. Indeed, any stock-picking method that isn’t premised on a sober appraisal of intrinsic worth is useless, and ultimately degenerates into trial-and-error forecasting. If you cannot reasonably calculate what the asset is worth before you buy it (or what it could be worth) you cannot determine whether you will make money. More often than not, you will have to gamble on the actions of others to make a profit. True investing entails reducing the probabilities of error, which is accomplished only through objective analysis. When gambling, you lose all control over the outcome. Before you buy a stock, ask yourself what you really are relying on to make money - is it the growth in the value of the company, or are you simply hoping for a magical increase in price after you buy it?

10. Calculate what you can take out of the company.

Since most investors fail to appraise a company before buying it, they usually have no preconceived idea of what they can earn over time. That's a fatal mistake. You should be able to estimate the annualized rate-of-return you expect from every investment and be able to quantify how you derived that figure. If your criteria for investing are nebulous, you're more likely to make back-end mistakes about selling. Are you looking for a 50% price increase in one year? If so, what factors can cause that to occur, and how likely are those factors to occur? Are you looking for 15% a year for 10 years? If so, calculate what the stock must trade for in 10 years and determine the earnings that will be needed to support the price. Then ask yourself whether those earnings can be attained. In this business, price and return are inextricably linked. The lower the price you pay, the greater your potential return. It's that simple.

Ralph Wanger



Ralph Wanger is Founding Partner of Chicago's Liberty Wanger Asset Management. Wanger is responsible for $8 billion in five mutual funds: Liberty Acorn, Liberty Acorn International, Liberty Acorn USA, Liberty Acorn Twenty and Liberty Acorn Foreign Forty. A graduate of the Massachusetts Institute of Technology with a Masters degree from the same university, Ralph Wanger lives in Chicago.

BOOKS

A Zebra in Lion Country, Touchstone, 1999

Reasons to invest beyond the USA

1. Bet on good companies, regardless of what country they're in.

In about 1985, I realized that many of the U.S. companies I owned were getting their asses kicked. I started hearing all kinds of stories from my companies: "We had to close down our factory in Kentucky because somebody's bringing up stuff from Guatemala that we can't compete with." I figured we had better start looking at some of these foreign companies. I told my staff that we would find winners wherever domiciled, and bet on them. In investment, if you want the best returns, you have to ignore patriotism and sentiment.

2. Locals always have the edge.

Some investors insist that it is best to stick to U.S. companies where you can count on full disclosure, protective regulation, and plenty of Wall Street research. By owning multinational companies, they argue, you can still reap the harvest of growing economies abroad. In answer I would say that where U.S. companies do business abroad they are always going to be treated as outsiders. U.S. money is welcome, but there is a common tendency to take care of your own and freeze out foreigners, whether by legal or illegal means.

3. Don’t keep all your assets in one currency.

You wouldn’t put all your money in one stock or in one industry, and you shouldn’t keep it all in one currency either. Owning foreign stocks and diversifying away from the U.S. dollar is probably valuable in itself, given the U.S.’s massive federal deficit and balance-of-trade deficit, both of which work against the dollar. With such a prospect, I want to own foreign as well as U.S. securities.

4. Look for industries where the U.S. has no equivalent.

Another reason why sticking to American multinationals isn’t the same as directly investing abroad is that some foreign industries don’t have counterparts in the United States. For instance, in Singapore you can invest in shipyard stocks. There aren’t any shipyard stocks in the U.S. In Britain, you can buy an airport management company. There’s no such thing in the U.S. Many of these stocks are very good investments.

5. Take advantage of less efficient markets.

Investing overseas nowadays is like investing in the U.S. twenty-five years ago. It’s tough to find small companies in the U.S. that aren’t followed by at least a regional firm of brokers, and the companies themselves are accustomed to media releases and conference calls. Everyone hears the news within seconds, so it is extremely difficult to gain an information edge. Overseas markets, in contrast, are far less efficient. You can still find businesses that others know little about - businesses growing at very fast rates. For several years at least, I see enormous potential.

6. Invest for the long term.

In many foreign markets, the dominant mentality is a trading one. Insider trading is permissible and rife, turnover is very high, stories abound, and the locals are mainly interested in running a stock up 25 percent and dumping it. There's no way you can outtrade the locals, so the secret is to become a long-term investor, to adopt a different time scale. Then, their edge washes out over time. If you can be in for the long haul - sometimes buying the stocks the nationals are dumping - and just sit with those stocks, you can realize the high growth available without being nailed by the short-term stories.

7. Consider mutual funds.

It’s getting easier to be a direct investor overseas, but there are still difficulties in tracking companies, assessing economies, worrying about currencies, and dealing with local regulations, accounting differences and indifference to stock manipulation. For all these reasons, consider getting exposure to overseas stocks thrugh a mutual fund. But the chief argument for going the mutual route is that professional fund managers traversing the globe to develop corporate and analyst relationships are able to dig up investments that a private investor by himself could not hope to find.

8. Spread your bets.

At Acorn our emphasis is on picking companies rather than countries, but it’s important to make top-down judgements as well. You don’t want too much exposure in unstable countries. Too many people assume that their money will be safe in places where they wouldn’t drink the water. In assessing how comfortable we feel about investing in a country, we consider the usual factors of political risk, inflation and interest rates, balance of payments, and the like. We want to feel the country is on the right track. And because it’s impossible to eliminate all risk, we diversify.

9. Remember why you’re there.

Sometimes you will get fed up with the smaller, developing markets - their illiquidity and volatility, the insiders’ edge, the struggle to find out what’s really going on. You have to remind yourself that with countries growing at 6 to 10 percent and companies growing at 25 to 30 percent, it’s worth putting up with such inconveniences. A recent study conducted by Morgan Stanley Capital International for the years 1985-1993 showed that a combination of U.S. and non-U.S. stocks produced a higher return with less risk than a 100 percent U.S. portfolio. The allocation that promised the highest return with least risk was 60 percent U.S. and 40 percent non-U.S. combination. If you went to 80 percent non-U.S. stocks, your risk would rise to about the same level as if you had a 100 percent U.S. portfolio - but your return would also rise, by a couple of percentage points.

10. Final word.

The issue really isn't whether or not you should invest in non-U.S. stocks. The issue is whether or not you should be in stocks altogether. If you are in pain when a stock or stock mutual fund drops 5 percent, the answer is negative. But if you are a stock investor, you should be country-blind.

> *'The presence of a big investor who is willing to get involved and shake up a company can be a good thing. But make sure that the big investor owns the same security that you do. Sometimes the big investors own bonds or preferred stock, in which case they may not care what happens to the holders of the common stock.'*

George Putnam III

Ben Warwick

Ben Warwick is Chief Investment Officer at Sovereign Wealth Management. He is the Market View columnist for worldyinvestor.com, a contributor to numerous industry publications, and the publisher of a free monthly newsletter at www.SearchingForAlpha.com.

BOOKS

The Worldly Investor's Guide to Beating the Market, John Wiley, 2001

Searching for Alpha, John Wiley, 2000

The Futures Game, McGraw-Hill, 1999

The Handbook of Managed Futures, Dow Jones Irwin, 1997

Event Trading, Dow Jones Irwin, 1996

Searching for ‘alpha’

INTRODUCTION

Alpha: investment return above a market index.

Considering the small number of mutual funds that produce market-beating returns, the task may seem nearly impossible. Even so, there remains an elite group of investment professionals who manage to produce market-beating returns, year after year. What is their edge?

1. Embrace diversification.

The real trick to beating the market is not portfolio concentration - it’s holding a little bit of everything, and overweighing the sectors that have the best chance to outperform. Although famous investors like John Maynard Keynes and Warren Buffet have produced fabulous returns through a small number of large positions, they are the exception rather than the rule.

2. Index the hard stuff.

Market sectors vary in how quickly they respond to information. Large cap U.S. stocks, for example, are followed by so many analysts and reflect company fundamentals so quickly that it is nearly impossible to add value through active strategies. I recommend indexing such sectors.

3. Use active strategies in inefficient market sectors.

Although some parts of the market are tenaciously efficient, there are certain sectors - small cap stocks and high yield bonds are two examples - where active management can really pay off. For these sectors, use active managers that have a unique and scalable methodology to produce alpha (i.e. return over a market index).

4. Use the credit spread to ‘tilt’ your portfolio toward growth or value stocks.

The stock market is not one coherent group of equities. Different types of stocks react to changes in the economic environment in unique ways. Small cap stocks, for example, do better during recessions or when equities are in a downtrend. Large cap stocks tend to lead the market higher during the good times. Look at the credit spread (the difference between the yield of government and corporate bonds) to determine whether the economy is expanding or contracting (a growing economy is associated with a narrowing of the spread), and tilt your portfolio to the market sector that is poised to benefit the most.

5. Consider the yield curve when buying fixed-income investments.

An ‘inverted yield curve’ - a scenario when Treasury bills yield more than ten-year U.S. government notes - boasts a 30-year record of flawlessly predicting recessions. If this occurs, the long end of the yield curve will generate the best performance over the intermediate term. In a normal yield curve scenario, the middle part of the curve will usually deliver the best risk-adjusted return.

6. Utilize momentum strategies only during periods of economic growth.

Momentum traders buy stocks that have increased the most in the belief that they will continue to do so in the future. Although there is a plethora of evidence showing that market sectors exhibit trend-following behavior during periods of expansion, a weak economic environment usually prevents such momentum players from generating a market-beating return.

7. Consider alternative investments.

With the increased integration of the world economy, stock and bond markets have become globally linked. Prudent investors should consider skill-based investments in the futures markets and through market-neutral hedge funds (unregulated investment pools that generate profits through an arbitrage approach) to add value diversification to their portfolios. The steady returns of these investments go a long way in producing market-beating returns.

8. Think about taxes.

Taxes are frequently the largest expense investors face, surpassing both commissions and investment management fees. Tax gains are largely the result of the efforts of money managers who attempt to add value to the investment process by buying and selling of securities. Taxes can be minimized by indexing the hard stuff and by keeping all actively managed funds in a tax-deferred account.

9. Don’t pick an investment manager based solely on past performance.

When considering a fund investment, there are more important things to look at than the manager’s past return stream. Consider transaction costs, fees, and the fund’s research budget. These three criteria are much better indicators of what may occur in the future.

10. Rebalance your portfolio on a regular basis.

Over the long-term, markets exhibit mean-reverting behavior; in other words, winners become losers and losers become winners. For this reason, it is important to periodically rebalance your portfolio by taking money away from those investments that have performed well in the past few months and reallocating it to those that have suffered losses. By doing this, investors can both increase their returns and reduce their dependence on a few bets that have appreciated significantly.

> *‘Profits are higher in fast growing industries. Myth! They're not, because everyone else knows they are fast growing. Returns are often higher in unfashionable activities, like tobacco. Best are industries that grow faster than expected - whether expectations are high or low.’*

John Kay

Henry Weingarten

Henry Weingarten, has been a professional astrologer for over thirty-four years. Since May 2, 1988, he has been the Managing Director of the Astrologers Fund, Inc., which employs astrology as the primary analysis tool to manage investment funds and advise institutional investors and money managers worldwide.

BOOKS

Investing by the Stars, McGraw-Hill, 1996, 2nd ed. Traders Press, 2000

The Study of Astrology, ASI Publishers, 1969, 5th edition 1988

Ten guidelines for a stellar performance

1. Ubung macht den meister (Practice makes perfect).

Practice first, before using/losing real money.

2. Think global.

Most of a stock's price movement can be attributed to the broad market and sector participation. Plan top-down: First select countries/bourses/currencies, then sectors, then individual stocks. Bottom-up investing should be reserved primarily for special situations.

3. Timing is everything.

It is not what you know, but when you know it! I use astrology to ‘be there first’.

4. Two out of three ain’t bad.

When investing, I use fundamentals and astrology; when trading I use technicals and astrology. The best results *i.e.* most profitable, occur when several investing criteria, gurus or screens agree.

5. When in doubt, don’t.

Even when I am ‘sure’, I am not always right (and I am a Leo!). If you are not sure, do not act unless necessary.

6. Make mistakes.

Nothing ventured, nothing gained. If you are never wrong, you are a newbie, a liar or a con artist. Learn to take losses quickly - the moment you recognize that the market is telling you that you are wrong.

7. Dance when the markets are wrong.

Trading and hedging can be used to hold long core positions without giving up too much.

8. Live on the edge.

Find your own edge or personal knowledge that is not priced into the market. Often, it is from your life experience. For me, astrology is my edge. Similarly, wear your portfolio like comfortable clothing - buy stocks that are you are comfortable owning.

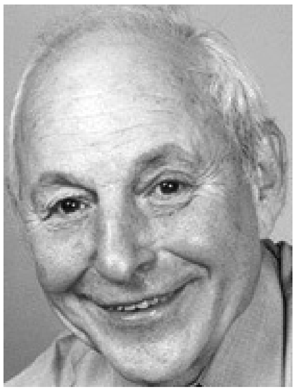
9. Know when to hold them, know when to fold them.

Decide your exit strategies in advance. Most investors know how to buy, but few have learned how and when to sell. I believe that when a stock is more expensive than you are currently willing to pay for it, it is time to place a trailing stop or sell it.

10. Make a profit - don’t be a prophet.

Use prudent money management and capital preservation. Never let one or two bad investments destroy your portfolio; diversify it sufficiently to manage risk and reward appropriately.

Martin J. Whitman



Martin J. Whitman is Chairman of the Third Avenue Value Fund. The investing principle of the Fund is to acquire common stocks of well-financed companies at a substantial discount to their private market value or takeover value. The Fund also seeks to acquire senior securities, such as preferred stocks and debt instruments, that have strong covenant protection and above-average current yields, yields to events, or yields to maturity.

BOOKS

The Aggressive Conservative Investor, John Wiley & Sons Inc, 2005

Value Investing - a Balanced Approach, John Wiley, 1999

Active Investing, John Wiley, 1998

A fresh look at the Efficient Market Hypothesis

INTRODUCTION

Since the 1960's the theories embodied in Academic Finance have taken over security analysis almost completely. At its core is the Efficient Market Hypothesis which assumes that the market is efficient in its pricing. Put another way - security prices quickly and accurately reflect all the relevant information that might affect them, and it is pointless for ordinary investors to try to outperform the market consistently.

At TAVF we have a markedly different view of market efficiency than the academics. The difference is partly explained by the tale of the finance professor and the student who came upon a $100 bill lying on the ground. The student stooped to pick up the bill. "Don't bother," says the professor, "if it really were a $100 bill, it wouldn't be there."

The observations below explain how our view departs from that of the academics and why it is possible, in certain markets and using certain techniques, for investors to consistently beat the market.

1. While markets tend towards efficiency, very few ever achieve instantaneous efficiency.

The Efficient Market Hypothesis (EMH) argues that the market is efficient, or achieves instant efficiency, and that 'Outside, Passive, Minority, Investors'(OPMIs) should acknowledge this by using indexed portfolios, top-down market strategies and valuation methods based strictly on forecasts of discounted cash flow. While there are some 'special cases', in most markets the tendency towards efficiency is quite weak, especially where efficiency is defined as appraising a business or a security at a price that approximates to underlying value.

2. There exist myriad markets, not one.

One of the failings of the Efficient Market Hypothesis is that it fails to recognise that there are many different markets, not one. There are OPMI markets, hostile takeover markets, leveraged buy-out markets, strategic buyer markets, m&a markets based on ‘paper’ not cash, and so on. And - critically - each market has its own pricing parameters.

3. An efficient price in one market is often an inefficient price in another market.

The efficient price of a security depends on your perspective: for example an activist operating in an LBO market knows that in the vast majority of cases a buy-out will not be a do-able transaction unless the price offered in the takeover process represents a meaningful premium over the OPMI market prices. The OPMI market price may be ‘efficient’ within its own parameters, but it is an inefficient price as far as the LBO operator is concerned.

4. If you are an OPMI you should not generally participate in the markets that tend towards efficiency.

As noted, there are many different markets and some tend towards efficiency more than others. The markets that are most efficient are characterized by short term trading, and the securities being traded can be analyzed by reference to only a limited number of computer variables. Examples are the markets for credit instruments without credit risk (e.g. U.S. Treasuries), derivatives (e.g. options, convertibles, warrants, swaps) and risk arbitrage. Except in rare cases, the OPMI should steer clear.

5. The path to earning excess returns for OPMIs is not to obtain superior information, but rather to use the available information in a superior manner.

One of the tenets of the efficient market hypothesis is that OPMIs cannot consistently outperform the market, or relevant benchmarks, unless they have access to superior information. For ‘activists’ - the promoters, investment bankers, lawyers, and management who drive market actions - having this superior information can be the route to outperformance, but for OPMIs it is difficult to access the information. That does not mean outperformance is impossible. It just means that the route is to use available information better, rather than to obtain superior information.

6. The main item of underused information is the balance sheet.

Most analysts, most of the time, ignore the corporate balance sheet in their analyses, focusing instead on earnings growth. If you are an OPMI, and you are looking to buy $100 bills for $50, it is much easier to do so using a balance sheet, rather than an income account or cash flow statement.

7. The market’s long term tendency towards efficiency will reward purchases at a discount.

The main problem for fundamental investors is not in identifying $100 bills that can be bought for less, but rather in getting enough efficiency back into the price such that you can sell your $100 for its ‘true’ value - or at least, for more than the $50 you paid for it. Some funds try to force a market revaluation by identifying catalysts or becoming catalysts themselves (e.g. Gabelli in encouraging a bidding process at Paramount) but at TAVF, we spend little time identifying or seeking catalysts. We rely instead on a long-term tendency towards efficiency. Our view is that while it is difficult to time when individual situations will work out, enough situations in the Fund’s portfolio are likely to work out on a lumpy, rather than consistent, basis, so that overall the portfolio ought to perform okay.

8. Fundamentals matter.

I started my observations about EMH with a story about a finance professor and a student picking a $100 off the sidewalk. The story highlights one weakness of EMH, but it misses the main point: Neither by training nor background would the finance professor have been able to identify what the piece of paper lying on the ground was - a $100 bill or a scrap of worthless paper. You have to be literate about fundamentals if you are to have any hope of distinguishing between $100 bills and garbage in the field of security analysis.

> *'Consider selling short to reduce exposure and to create outperformance. There are always many stocks that reach outrageous price levels, that can be sold short. One great attribute of selling short is that it reduces overall equity allocation, which reduces portfolio risk and equity exposure.'*
>
> David Tice

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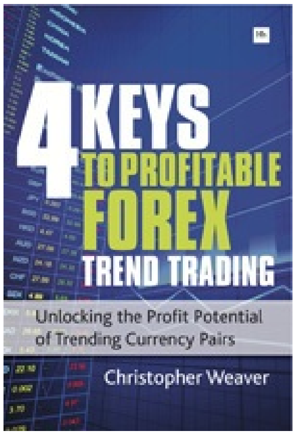

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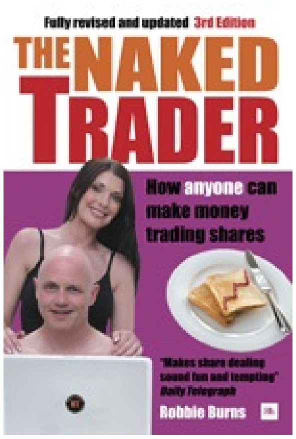

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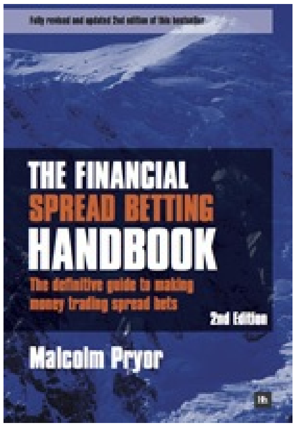

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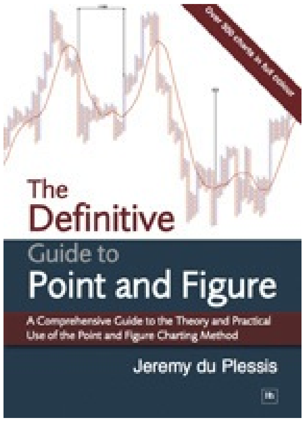

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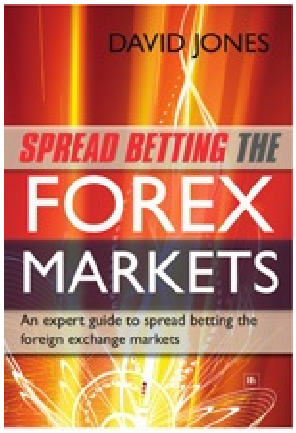

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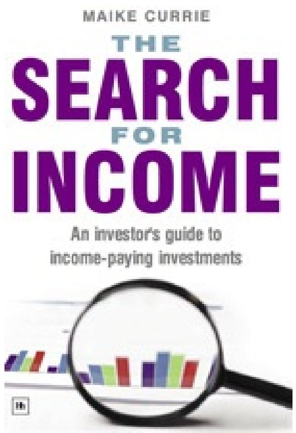

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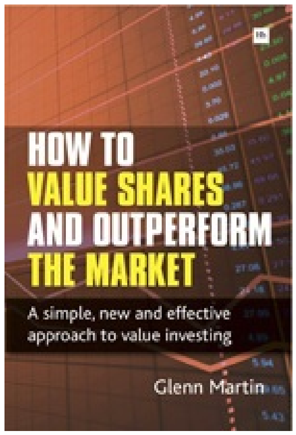

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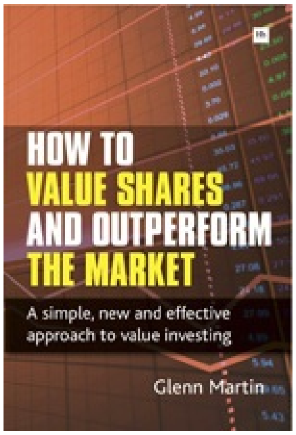

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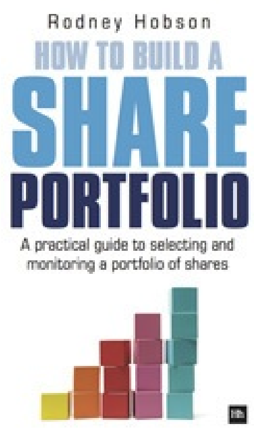

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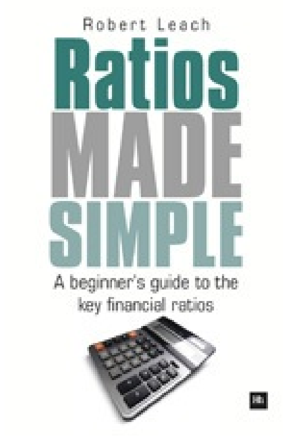

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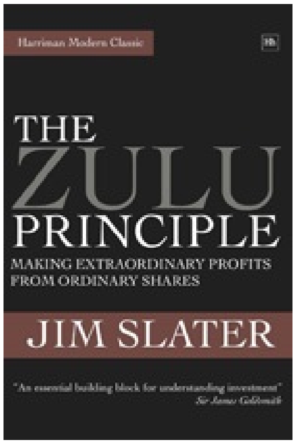

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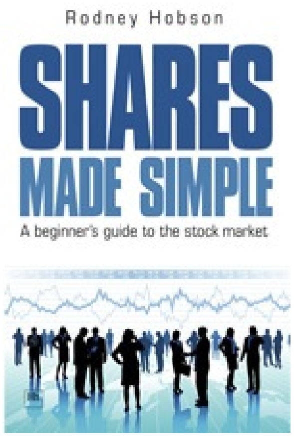

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