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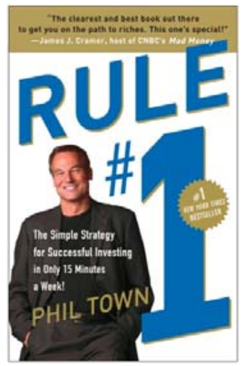
# Rule # 1

## The Simple Strategy for Successful Investing In Only 15 Minutes a Week!




**Authors:** Phil Town
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### About Author/s:

An ex-Green Beret and former river guide, Phil Town is a self-made millionaire several times over and America's most widely sought-after speaker on investing.

Philriverguide In his book, RULE #1 (March 2006; paperback, August 2007), he describes the Rule #1 personal financial strategy in detail so that anyone, even first-time investors, can get and stay rich.

Phil Town is the classic Everyman, albeit one whose education and resources were more limited than most.

An average high school student, he completed college on his fourth try. Of his early working years, he says he "mostly got dirty for a living", taking on jobs such as digging ditches and pumping gas. Town spent three and a half years in the Army, returned from the Vietnam War and found a job in the States as a river guide.

Drifting through California, Utah, and Idaho, he subsisted at poverty level, combining his wages from the guiding season and unemployment. He wore black leathers, sported a goatee, lived in a teepee in the woods near Flagstaff, Arizona, and "drove around in a really loud black Harley Davidson".

Phil Town appears regularly on the same dais as Rudy Giuliani, Jimmy Carter, and Colin Powell as part of the Get Motivated touring success seminar. He speaks to more than 500,000 people annually about Rule #1. He is a regular guest on CNBC's "The Millionaire Inside", alongside fellow wealth experts like David Bach, Barbara Corcoran, Loral Langemeier, and frequently appears on the MSNBC program "Your Business".

To know more about the author, go to: http://www.philtown.typepad.com/

### ■ The Big Idea

Most Americans are trapped in mutual funds that, at best, ride the waves of the market. They diversify to spread the risk. They are in this sort of investment for the long haul. But they still lose money in market downturns.

However, the confluence of technology, money and strategy is creating a revolution in investing at a time when small investors need it the most. Thanks to the Internet, people know a great deal more than they used to and can access this information very quickly, plus they can move in and out of markets far faster than ever before.

## Why You Need This Book

This book is a simple guide to returns of 15 percent or more in the stock market, with almost no risk. As a matter of fact, Rule #1 investing is practically immune to the ups and downs of the stock market. Rule #1 is the result of the one tried-and-true investing strategy meeting institutional control of the market at a time when the tools of investing are available to anyone with a computer.

The little guy who doesn't have eight hours a day to conduct exhaustive market research can implement Rule #1 – the tools to do so are already on everyone's computers!

## The Myths of Investing

To start, let's dissect some prevailing myths regarding investing today.

1. **You have to be an expert to manage money.** This would be true if investing were hard to learn, or getting the information to make a decision took a lot of time. But neither is the case any more these days, thanks to the Internet. The tools that used to cost $50,000 a year can be gotten for less than $2 a day and take only minutes a day to use – and are even more accurate than what your fund manager used a year back.

2. **You can't beat the market.** Efficient Market Theory (EMT) holds that markets in general, and the stock market in particular, are efficient – they price things according to their value, such that the price of the stock at all times equals the price of the value of the company. However, some people really do beat the market for long periods (as will be shown in the succeeding section).

3. **The best way to minimize risk is to diversify and hold (for the long term).** Not necessarily true – if you know how to invest – meaning you understand Rule #1 and know how to find a wonderful company at a very attractive price – you will not need to diversify your money into 50 stocks or an index mutual fund. You'll focus on a few businesses you understand, buy when the fund managers are fearful, and sell when they're greedy.

4. **Dollar cost averaging (DCA) will protect you.** It won't. DCA is the strategy of buying stocks or mutual funds every month with the same amount of money, regardless of the price of the stock or fund. Its objective is to minimize your investment risk by making the average cost per share of stock smaller. However, in a long sideways or down market, it's the

same as buy-and-hold, and you have to put in the same amount every month no matter what.

5. **Real estate is a better investment than businesses.** Not always true either. A reasonably good growth rate in a real estate market over a 30-year period is about 4 percent. A reasonably good rate of return for a Rule #1 investor is 15 percent.

## Rule #1 and The Four Ms

**Rule #1 in a nutshell**
Knowing you will make money – certainty – comes from buying a wonderful business at an attractive price. In essence, it's just about being a good shopper.

Rule #1 investing, then, comes down to four straightforward steps:
1. Find a wonderful business.
2. Know what it is worth as a business.
3. Buy it at 50% off.
4. Repeat until very rich.

**The Four Ms**
Use these as questions to evaluate a business and decide whether it can be a good investment:

**1. Does the business have meaning to you?**
This implies two other questions:
   a) Do you want to own the whole business?
   b) Do you understand it well enough to own all of it?

You will want to think like a business owner and not just a stock investor; this is critical to becoming a successful Rule #1 investor. If you buy the business as a business and not just a stock speculation, then it becomes personal and you want to be proud of what you own.

Buy every business with the 10-10 Rule in mind*: I won't own this business for ten minutes unless I'm willing to own it for ten years*. As a Rule #1 investor you will own only a few businesses, so you must prepare to be certain you own the *right* few businesses that won't lose you money.

What's important here is to **understand your businesses inside and out.** Start your search for a wonderful business by discovering the kinds of business you already understand. To do this, ask yourself these questions:

a. What do you love to do, professionally and as recreation?
b. What things are you really good at?
c. What do you do to make money, or spend your money on?

**2. Does the business have a wide Moat?**

The next thing you want to know is whether or not the future of the business is predictable. Obviously you want a company that will be a winner, a business that will grow for decades. You don't want to buy a company with an uncertain future.

You want a business with a moat – a competitive advantage that protects it from attack and protects it from competition and price inflation, just like a moat protects a castle. (The 'wider' the moat, of course, the better.) This moat must also be sustainable – the company must be doing all it can to protect its interests.

There are *five moats*:

1. **Brand** – a product you're willing to pay more for, because you trust it.
2. **Secret** – a business that has a patent or trade secret which makes direct competition illegal or very difficult
3. **Toll** – a business with exclusive control of a market, which gives it the ability to collect a 'toll' from anyone who needs that service or product
4. **Switching** – a business that's so much a part of people's lives that switching to a competitor isn't worth the trouble
5. **Price** – a business that can price products so low no one can compete with them

Now, if a business has at least one of these moats, it'll show up in the **Big Five numbers.** All of these should be consistently equal to or greater than 10 percent per year for the last 10 years for you to consider buying into the company:

1. **Return on Investment Capital (ROIC)** – the rate of return a business makes on the cash it invests in itself every year; the percentage return you get back from the cash you put into it

2. **Sales (or Revenue) growth rate** – the rate of growth of the total dollars that the business took in from selling whatever it sells

3. **Earnings per Share (EPS) growth rate** – the rate of growth of how much the business is profiting per share of ownership

4. **Equity (or Book Value or BVPS) growth rate** – the rate of growth of what would be left over if the business were not considered a business; if everything were sold and all debts paid (if divided per share, this

becomes the Book Value or BVPS); important because spare cash can be spent on increasing market or developing new products

5. **Free Cash Flow (FCF) growth rate** – the rate of growth of free cash and whether it's growing along with the profits of the company

And regarding debt, go for companies with *reasonable debt* – those whose debt can be paid off within three years. Divide total long-term debt by current free cash flow to see if this is the case.

**3. Does the business have great Management?**

You have to know if the people running the company really have their act together and thus deserve to run it. You're looking for leaders who live and breathe this company and who have big audacious goals they want their company to achieve.

Good leaders will channel their egos away from themselves and into the larger good of building great companies. You want them to be, in a nutshell:

1. **Owner-oriented** – they must have their personal interests directly aligned with that of the shareholders of the business – the owners. They must keep the owners properly informed about the business (which can be tough because they can be afraid of looking bad or compounding any problems by going public).

2. **Driven** – they must really want to change the world in some small way (although a big way is fine too). They must have a BAG – a Big Audacious Goal that's far more than just a mission statement – that drives them and motivates their every professional (and maybe even personal) move.

To get more information about the CEO, consider checking out:

1. **Insider trading activity** (if they really love the business, they won't consider selling their own stock in it – although you have to be careful not to jump to conclusions if and when this takes place).
2. **Compensation** (they may be paid well, but it shouldn't be about the money).

And an excellent way to check if the management team and/or CEO is really good is to **have a look at their core figures, especially their Big Five numbers.** You can trust them more than just rhetoric. (If the company's had a bad year, check to see if the CEO acknowledges it in his annual letter to the shareholders. If he doesn't, don't get on board.)

**4. Does the business have a big Margin of Safety?**
The practical application of Rule #1 investing is to **buy $1 of value for 50 cents.** This is possible, even desirable, because sometimes the value of a business (what it's worth) is not equal to the price it's selling for (the going rate of the business in the market).

It's akin to waiting for the sticker price – what the market should be selling it for, but far too often doesn't – of an in-demand luxury car to drop before you buy one. *Buy businesses in a similar fashion – find a few businesses you love and which meet these stringent criteria, then patiently wait until you get the chance to buy them below sticker price.*

Technically, this means that you need to first determine the sticker price, then find the margin-of-safety price – which is half of the sticker price. And then wait until stocks reach this price before you buy.

So to calculate the sticker price:

1. You first need the following numbers:
    a. *Current EPS (Earnings per Share)* – reported on most financial websites
    b. *Estimated EPS growth rate* – one of our Big Five numbers
    c. *Estimated future PE* – the multiple of EPS we should assign a given company ten years from now to determine its value then. This is a multiple to change the earnings-per share number into a price-per-share number.
    d. *Minimum acceptable rate of return* – 15% a year. It's high enough to cover reasonable inflation, taxation on the gains and the risk of giving money to someone else – but not so high that you can't find wonderful business at prices that will give you a good return.

2. And then you need to:
    a. Grow the current EPS at the estimated EPS growth rate for ten years to provide the future EPS.
    b. Multiply the future EPS by the future PE to obtain the future market price.
    c. Shrink the future market price by the minimum acceptable rate of return per year – this will get you your sticker price.

## Know the Right Time to Sell

In a nutshell, the right time to sell a business – in theory – is never. The ultimate objective is to buy a company so wonderful at a price so attractive that you never ever sell it and it will continue to make you rich for the rest of your life!
By definition a good business must be predictably profitable (see previous discussions). But we must keep in mind that things do change over time, and even our best money-making investments may not be as profitable five or ten years down the road. This is why we must keep checking how companies do vis-à-vis the criteria we established.

If and when a business is no longer outstanding, we must sell it and move on:

1. **When it has ceased to be wonderful by Rule #1 standards**, thanks to an outside attack by a competitor who's managed to breach the Moat, or an inside one by a CEO or top manager who's not working to improve the company any longer
2. **When the market price is above the sticker price.**

Regarding retirement, it's always best to sell only what you need for living, and keep the business compounding the rest of your money. *Never* sell all your stock in a company unless it's for the reasons discussed above.

## Grab the Stick

Because we're only human and far from infallible, here's what to do if and when you make a mistake with Rule #1 and your investment consistently loses money instead of making it.

In a nutshell, we have to "grab the stick" from the market to prevent it from beating us.

While a really good investor would simply fill in the hole by making more money out of another short-term investment, this is what we can do to solve the problem:

1. **Understand stocks**. Stocks go up for one and only one reason: because more money wants to buy than wants to sell (increase in demand). So even a business that's on sale for 50 percent below its sticker price could go down some more in the short term if fund managers keep selling its stock, even though it shouldn't.
2. **Understand how to interpret the behavior of fund managers**, who are akin to cruise ships in that their movements are enormous and easy to see.
3. **Use the following Three Tools to tell you the direction things are moving, so you'll be able to decide what to do:**
    a. **MACD (Moving Average Convergence Divergence)** – probably the most consistent indicator of significant trend changes in a stock.

It looks at several price average changes over time, generally in the short term, to show when momentum pressure is getting stronger either upward or downward. In other words, when the big investors are getting out.

b. **Stochastics** – a momentum tool that tracks overbuying and overselling of a stock (overselling occurs when a big institution sells and others join in, which creates a lot of downward price pressure). Other institutions join in, which pushes the price even lower. The Stochastic tool will see that and tell us to buy.

c. **Moving average** – this tool tracks an average of price during a specific time period. It smoothes out the peaks and valleys of daily price fluctuations and gives traders an easy view of the price trend.

It's important to realize that in and of themselves, these tools won't make you money unless you know the value of the business you're buying. So use the Four Ms that were discussed earlier!

## Eliminate the Barriers

Before you leap into Rule #1 investing, you have to work to eliminate the following barriers:

1. **Bad debt** – your own consumer debt, money borrowed at a high interest rate to buy things that don't produce income or grow in value, such as consumer products. (Good debt is money borrowed at low interest and used to make a high rate of return.)

2. **Taxes on gains** – use the government loopholes set up to help defer taxes, such as SIMPLE IRAs, Roth IRAs, SEP IRAs, 401ks, and Defined Benefit Plans, among others.

3. **Over-diversification** – as mentioned before, focus by buying a few businesses that have meaning to you.

4. **Your manager** – why hire someone to take care of your money for you when you're on the verge of financial literacy (or are close to that point)?

5. **Fear** – the only real way to overcome fear of loss is to know you won't lose. The minimum amount of money you can do this with is zero, and that's the minimum amount for your starting investment.

## Your First Rule #1 Purchase

Now that the rest of that's been settled, here are steps to take to make your first Rule #1 purchase.

1. **Open a brokerage account** – brokers play a very important role in making it easy to buy and sell stuff; they let you know what people are willing to pay for an item, make sure both sides know what to do to complete the transaction, and facilitate the deal.

2. **Purchase shares of stock** – the broker will take the money out of your account, buy the number of shares you specified, and hold the stock certificates until you sell the shares.

3. **Set limit, stop, and stop-loss orders** – in case you want to buy a stock that's bouncing around in price quite a bit, you have to do this to protect ourselves from paying way more than we should.

4. **Buy a business**

5. **Use the Three Tools, and check the Tools every day at some point.**