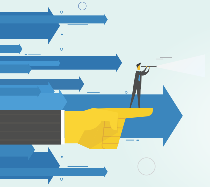
#WiseWithEdelweiss

Edelweiss MUTUAL FUND
Ideas create, values protect

Insights



16 guidelines that stock investors must adhere to

When one thinks of money managers with skin in the game, Walter Schloss comes to mind. He started Walter J. Schloss and Associates in 1955. He charged NO management fees but opted for a 25% share of the profits.

A very smart move. From 1956 to 2002, his fund generated a CAGR of 16% post profit sharing. The S&P500 delivered 10% over the same period. His initially seed capital of $100,000 swelled into a very impressive $350 million.

What makes Schloss stand out is his clarity – cheap stocks. Not so much earnings growth or management. As Warren Buffett put it in Superinvestors of Graham-and-Dodsville: “He knows how to identify securities that sell at considerably less than their value to a private owner. And that’s all he does. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me. He is far less interested in the underlying nature of the business.”

But that does not mean he bought junk. All cheap stocks don’t automatically fall into the bargain bin. Cheap is always relative to a company’s assets or its value as a business.

Over 4 decades ago, in an interaction with Forbes, he explained that he was scouting for stocks of good companies that sell at one-third of book value, or BV. When asked why not earnings as a benchmark, he explained that earnings have a way of changing and earnings projections matter. Even if the projections turn out to be accurate, people’s idea of the multiple has changed.

He cited the example of the steel industry needs a lot of capital investment and does not make much money. Since the market is aimed at earnings, no one wants a company that does not earn much. The aim is to buy such companies and wait for things to turn in your favour. Republic Steel had a BV of $65 but he did not believe it could be replaced at $130/share. Keystone Consolidated dropped from $25 to $14 but had a BV of $49. He rationale: Would you rather own a 7.5% bond that guarantees you that until it matures, or a stock that yields 5% and could end up at $35 instead of $14?

A decline does not mean it is the end. Buying depressed stocks means any of the three:

- Earnings improve and the stock price goes up
- Another company will want to buy control of the company
- The company will start buying its own stock and ask for tenders

Here’s what he believed are the factors needed to make money in the stock market

1. Price is the most important factor to use in relation to value.
2. Try to establish the value of the company. Remember that a share of stock represents a part of a business and is not just a piece of paper.
3. Use book value as a starting point to try and establish the value of the enterprise. Be sure that debt does not equal 100% of the equity. (Capital and surplus for the common stock).
4. Have patience. Stocks don’t go up immediately.
5. Don’t buy on tips or for a quick move. Let the professionals do that, if they can. Don’t sell on bad news.
6. Don’t be afraid to be a loner but be sure that you are correct in your judgement. You can’t be 100% certain by try to look for weaknesses in your thinking. Buy on a scale down and sell on a scale up.
7. Have the courage of your convictions once you have made a decision.
8. Have a philosophy of investment and try to follow it. The above is a way that I’ve found successful.
9. Don’t be in too much of a hurry to sell. If the stock reaches a price that you think is a fair one, then you can sell but often because a stock goes up 50%, people say sell it and button up your profit. Before selling try to reevaluate the company again and see where the stock sells in relation to its book value. Be aware of the level of the stock market. Are yields low and P/E ratios high? Is the stock market historically high? Are people very optimistic? etc...
10. When buying a stock, I find it helpful to buy near the low of the past few years. A stock may go as high as 125 and then decline to 60 and you think it attractive. 3 years before the stock sold at 20, which shows that there is some vulnerability in it.
11. Try to buy assets at a discount than to buy earnings. Earnings can change dramatically in a short time. Usually assets change slowly. One has to know much more about a company if one buys earnings.
12. Listen to suggestions from people you respect. This doesn’t mean you have to accept them. Remember it’s your money and generally it is harder to keep money than to make it. Once you lose a lot of money it is hard to make it back.
13. Try not to let your emotions affect your judgment. Fear and greed are probably the worst emotions to have in connection with the purchase and sale of stocks.
14. Remember the work of compounding. For example, if you can make 12% a year and reinvest the money back, you will double your money in 6 years, taxes excluded. Remember the rule of 72. Your rate of return into 72 will tell you the number of years to double your money.
15. Prefer stocks over bonds. Bonds will limit your gains and inflation will reduce your purchasing power.
16. Be careful of leverage. It can go against you.

Credit - Content created by Morningstar