

# Investment Rules to Live By

*Private Client Research Group*

Benjamin Graham remains the central figure in the world of financial analysis. Although primarily an academic, he was also a highly successful portfolio manager. None of that “Those who can’t, teach,” for him! His views have withstood the tests of time.

## **DIVERSIFY, DIVERSIFY, DIVERSIFY**

When one asset class or investment vehicle experiences losses, others may gain. Benjamin Graham advocated broad diversification and included both bonds and stocks in his preferred structure. The mix could fluctuate between the two investment forms, but he held that neither allocation should ever exceed 75%.

## **YOU CANNOT TIME THE MARKET**

Benjamin Graham tried to derive formulas to get into and out of the market and concluded that all formulas failed. More effective, he concluded, is to buy stocks when they were available for comfortably less than your best estimate of their intrinsic value and sell them when you can readily collect more than that sum.

## **DO NOT TRUST THE MARKET TO VALUE A STOCK**

The market price is frequently out of line with the intrinsic value of a stock, and these disparities inherently tend to correct themselves. Before the inevitable correction, under-valuation or over-valuation may persist for an inconveniently long time. This wisdom is often reduced to the observation that over the short-term period, the market is a voting machine, but over the long term, it is a weighing machine.

## **FOLLOWING TRENDS WORKS OVER SHORT PERIODS, BUT NOT OVER LONG PERIODS**

This rule sounds like a corollary to the “do not trust the market” comment above. Stocks that are already expensive in relation to their fundamental business value become absurdly expensive, and then they crash. Graham regarded momentum investing as a sure way to be propelled off a cliff. The opposite of trend following is the philosophy that price matters. When the investors forget to ask “How much?” really dreadful losses could follow. The great instructor and investor thought that the biggest losses came from buying bad companies in good times.

## **DO NOT THINK IT IS EASY TO BEAT THE MARKET**

Just ask your favorite professional portfolio manager.

## **ASSESS THE RISK YOU ARE TAKING**

In strong markets, the frequency of initial public offerings (IPOs) increases and investors forget the “How much?” question when an industry is popular. Risk can be in the form of over-paying for a stock, but there is no risk in paying less than the intrinsic value. Again, the “How much?” question is important.

## **BUY COLD INDUSTRIES**

Careful and extensive research has consistently indicated that companies selling at low P/Es provided significantly higher returns. The problem is that projections tend to be too optimistic for winners and too dire for losers.

When stocks sell well above intrinsic value, the more the “value” will depend on shifting moods and measures of the stock market. Shades of “do not trust the market,” above, linger within this advice.



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## *Investment Rules to Live By, continued*

### **BASE YOUR EXPECTATIONS ON ARITHMETIC, NOT OPTIMISM**

Graham believed that the kind of investing that leads to capital losses views a company's assets and past earnings as irrelevant; the mistaken optimist focuses only on future events as determining value. Here, following trends may be at work or the "How much?" question may not have been asked. Revenues alone, popular at the height of the Internet bubble, are an inadequate solitary guide to value. Graham pointed out that obvious prospects for physical growth do not translate into obvious profits for investors. The shining example of this point in the past few decades would be airlines.

### **UNDERSTAND WHAT YOU ARE BUYING**

Benjamin Graham often reminded investors to keep in mind that they were buying a business organization when they bought a stock. Consequently, your investment enthusiasm may chill upon learning that your favorite new technology name may require scads of additional capital to achieve the long-term objectives. Just how long might it take the company to complete anticipated massive capital expenditures? How easily might high leverage work against profitability and capital adequacy and ratings?

### **DIVIDENDS ARE IMPORTANT**

Real, inflation-adjusted returns for several decades have averaged about 7% for equities. More than half that total return came from dividends.

### **HANG IN THERE**

Wealth is not accumulated rapidly. Adhering to sound investment principles will keep you from investing on too narrow a base. Keep seeking value and stay invested with a steadfast commitment to building the appropriately diversified portfolio. This approach puts you in the position of taking advantage of the prices available during market corrections, providing a great chance to keep your average cost down. Peter Lynch says, "Build a long-term plan, and stick to it."

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