Over the Long Term, Rational Prices Win Out

Structure and Discipline Will Pay Off

by Maury Elvekrog, CFA

What do you say to an investment club that basically has been doing everything the way it should be done and still has moderate results rather than ones that would blow your socks off? How about something like, "Welcome to the world of investing the way it has been for the last few years — and always?"

We go through all the trouble of learning to be stock pickers and then searching for ideas, evaluating them and keeping accurate information just so that we can do a little bit better than the overall market. Whether it pays to do all this depends on several circumstances, particularly on whether a person finds the search enjoyable or just drudgery. With hard work and experience, we can all expect to do better than the stock market averages, but only slightly. If the market's going down, nobody is going to do great except perhaps speculators who want to try fancy approaches such as selling stocks short, but they'll undoubtedly pay the price at some point later.

I think of this as I look at the portfolio of the Lunch Money Investment Club, whose members were originally information technology professionals working in the same building for Ford Motor Company. No matter how good a job each of us does, we're still, to a considerable extent, at the mercy of the overall market. For the last 10 years, the market has been full of twitches and ups and downs but has made little overall progress. This has been the investment world we've all had to live in.

As befits computer professionals, the Lunch Money Investment Club shows itself to be extremely organized based on the club's documents available online. Its operating structure is impressive, and I particularly applaud members for comparing investment results with that of an appropriate index. Of course, this is a lot easier for people in the computer field than for others, but it's wonderful considering so many clubs' total lack of performance information.

The LMIC does an excellent job of benchmarking its results. "We compare our IRR (internal rate of return) to VTSMX (Vanguard Total Stock Market Index fund) on a lifetime, 60-trailing-month, 36-trailing-month and 12-trailing-month basis," says the club's Robert Mann. "We are ahead of it almost as much as we are behind. We would like to get to the point where we are always ahead of VTSMX, or otherwise we should just be investing in the index!"

Lunch Money Investment Club

Company	Ticker	No. Shares	Cost	Sept. 5, 2008 Price	Sept. 5, 2008 Value	Gain/ (Loss)	%Gain/ (Loss)	Quality Rating*	% Growth Estimate**	% of Portfolio	Trailing P/E	Trailing EPS
Aflac	AFL	11.9	$ 644	$ 57.68	$ 686	$ 42	6.6%	1	14%	3.2%	16	$3.62
Best Buy	BBY	19.5	883	44.92	878	(5)	(0.5)	3	15	4.1	14	3.22
Coach	COH	33.0	1,160	28.60	944	(216)	(18.6)	3	16	4.4	14	2.06
Colgate-Palmolive	CL	14.9	1,078	77.07	1,148	70	6.5	1	10	5.3	21	3.65
FactSet Research Systems	FDS	13.1	669	57.93	757	88	13.2	3	18	3.5	24	2.39
Fastenal	FAST	35.1	1,254	50.85	1,787	533	42.5	3	19	8.3	29	1.76
Genentech	DNA	8.4	625	96.64	810	185	29.7	2	18	3.7	31	3.08
Harris	HRS	26.2	1,283	49.41	1,292	9	0.7	3	17	6.0	15	3.39
Infosys Technologies	INFY	38.5	1,989	39.39	1,516	(473)	(23.8)	3	22	7.0	19	2.08
L-3 Communications Holdings	LLL	14.3	1,078	102.64	1,467	388	36.0	3	10	6.8	15	6.97
Manpower	MAN	20.7	835	47.63	984	149	17.9	3	13	4.5	9	5.50
ScanSource	SCSC	36.4	1,000	30.92	1,125	125	12.5	3	17	5.2	15	2.11
St. Jude Medical	STJ	34.7	1,448	44.31	1,536	89	6.1	3	15	7.1	21	2.14
Stryker	SYK	27.7	1,495	65.08	1,806	311	20.8	2	18	8.3	25	2.64
T. Rowe Price Group	TROW	39.4	1,959	58.36	2,300	341	17.4	2	15	10.6	24	2.46
Teva Pharmaceutical Industries	TEVA	55.0	1,827	47.56	2,614	787	43.1	3	17	12.1	18	2.62
Cash			8		8					0.0		
Average									16		19	
TOTAL			**$19,235**		**$21,660**	**$2,425**	**12.6**			**100.0**		

* Based largely on rankings published by Value Line.

** As estimated by the author, with data from Thomson Financial Network.

Note: Numbers in the table have been rounded.

The total market is an appropriate bogey for most individual investors because it includes not only the large companies in the S&P 500 index but also smaller companies, which make up about 30 percent of the total market index. Most individual investors have both large- and small-cap stocks.

Comparing results with that of an actual fund rather than an abstract index has pluses and minuses. Every fund always has at least a little slippage compared with the index, so this is a problem. On the other hand, the club is comparing results with that of a real-world alternative, which takes into account the expenses of an investment.

The club believes its buying decisions are mostly on track. It invests only in stocks that have an upside-downside ratio (essentially the risk-reward ratio) of at least 3 to 1 on their Stock Selection Guides, with a relative value (the ratio of the current price-earnings ratio to the average P/E — adjusted by your judgment — over the past five years) of 0.85 to 1.0 and an expected total annual return of at least 15 percent. "How long to hold a stock is probably our biggest dilemma," Robert writes. I agree with his evaluation of LMIC — most of the club's buys are quite reasonable.

One of the irreconcilable conundrums for the investor is that in the long term, prices of stocks move to a rational, logical level. In the short term, however, prices are mainly influenced by the emotions of the moment. The only way to achieve good investment results is through rational analysis and decision-making. So in the short term, a rational investor is at the mercy of unpredictable, emotional surges both up and down.

In time, one gets used to this and learns not to overreact to short-term frustrations. This is because experience shows that rational analysis pays off in the longer term. For a new and relatively small club such as Lunch Money, however, making little progress can raise serious questions about whether the club has made mistakes or whether it's a matter of waiting for stock prices to reflect the underlying firms' fundamentals.

Regarding the proper holding period for a stock, there's no cut and dried formula. The important idea to keep in mind is to always make the decision based on the company's business results, not on the stock's price or speculation about what's likely to happen to the economy.

The two reasons for selling a stock remain: the company's business is deteriorating or you've identified a better alternative. These principles contradict the focus of the typical investing article you read in the Sunday paper, which emphasizes projections about what's going to happen to the economy in the next few weeks or months.

Nobody has been a successful long-term investor by trying to speculate on the jigs and jogs of the economy, so it's a waste of time to try. Instead, stay fully invested in whatever amount you've decided to place in stocks and hold whatever you believe are the best issues.

In tune with the club's organized approach, LMIC follows a defined structure to achieve diversification. "We have rules in place to prevent our overbuying in a sector (no more than 30 percent of the portfolio may be in any one sector)," Robert says. "We also have rules to prevent a stock from being too little (must be at least 2 percent) or too much (can only buy a stock until it's 12 percent of the portfolio, and it can't be more than 20 percent) of the portfolio."

I very much approve of setting up these kinds of parameters to keep a portfolio in balance. But I would advise not treating the rules as if they're in concrete or interpreting them with mechanical precision.

I agree, for example, with not having more than 30 percent of a portfolio in any one sector, because if all of the sector holdings were loaded up to that limit, the portfolio would have room for only three or four sectors. But then we come to the question of what sector a company belongs in. Particularly for larger firms, companies are often involved in several very different businesses. There are even disparities in how sectors are categorized and defined. Some analysts chop sectors into smaller pieces, and some get down to specific industry groupings.

TEVA, SYK, STJ, DNA

My first impression of Lunch Money's holdings is one of consistency, reflecting the club's systematic approach. Expected growth for almost all the stocks are in the mid-teens, a reasonable and moderate level of aspiration. Quality ratings for most of them are also in the middle range, as are the P/E calculations.

The stock with the biggest percentage gain in the portfolio is **Teva Pharmaceutical,** up 43 percent. Despite this strong movement, the stock still shows a P/E of just 18. This reflects the fact that the club has owned the stock for several years and during this period, the company's earnings have advanced as much as the stock's price, thus maintaining a similar P/E. Teva is one of the largest generic pharmaceutical companies, with facilities around the world to take advantage of lower-cost situations. The company also has some proprietary products. There's every reason to expect it will continue to be a solid investment.

Stryker Corporation is an outstanding growth company in the field of orthopedic appliances. Its growth has been about 20 percent a year for a long time. Management has indicated its hopes of continuing this growth rate. Since the company is so well recognized by the investing world, the stock's price is almost never cheap, but the ongoing growth makes it worth something extra.

I view the third medical company, **St. Jude Medical,** as more moderate or average in its investment potential. Analysts following the company look for about 15 percent growth, with a ratio of P/E to growth (aka PEG ratio) of about 1.5. St. Jude is a high-quality, well-established company, but it might be possible to find stocks offering higher potential.

The last health care stock, **Genentech,** is apparently the club's effort to reach for that higher potential. Genentech is a headline-grabbing developer of biopharmaceutical products. Its offerings constitute cutting-edge therapies with an emphasis on cancer-related treatments. The biggest concern about this stock is the price. The company has such high potential that it appeals to investors. The stock sells at a P/E of 31, producing a PEG ratio of 1.7. I don't believe a company can produce ongoing growth at a level to justify a P/E of 31.

TROW, AFL

Financial stocks of all sorts have been under a great deal of pressure because of the tremendous turmoil mostly relating to the mortgage crisis. But the club's two financial stocks are both solid citizens and are doing decently. **T. Rowe Price** is one of the biggest mutual fund companies. The company, of course, has been influenced by the stock market's very unsettled state. It's difficult to sell people on the idea of buying mutual funds at a time of stress such as the present, but T. Rowe has been doing quite well and maintains reasonable growth. As the stock market rises, the company's results should continue to improve. This should be a solid long-term investment.

The other financial company, **Aflac,** is very well known to readers. The chief concern is that the company's business is so heavily located in Japan. It seems to have done quite a good job managing around currency translation risks and Japan's changing regulatory situation. I think the stock's price is reasonable.

INFY, FDS, HRS, SCSC

IT is a sector offering interesting potential. **Infosys Technologies** is an Indian software company undergoing tremendous turmoil, as are all the Indian technology companies. Forecasts for growth rates range between 15 percent and 22 percent, depending on the analyst.

Problems include the increasing expenses for technology companies in India and the reality of being influenced severely by currency fluctuations. The U.S. dollar's appreciation against the rupee is significant for the company, but so is the impact of the euro, the pound and the Australian dollar. Who can calculate how these changes will affect reported earnings? Thus, there's a good deal of uncertainty, but the company still has a history of solid accomplishment with very impressive growth, and the stock's price isn't at all unreasonable.

FactSet supplies packaged financial and economic information to the investment community. One would expect that with market conditions being as they are, this would be a very difficult business to be in at this time, but growth has continued. The stock's price is high, but so is the company's quality.

Harris Corporation provides communication and information technology to government and commercial organizations. The stock price is undoubtedly somewhat low because half the business is defense-related. We all hope that the Middle East turmoil settles down and results in less need for defense-oriented products. But any decrease would probably be quite moderate because even if the shooting war continues to ease in the Middle East, the need for communication will certainly persist. I believe the stock's price more than discounts the chance of a moderate drop in defense-oriented work.

The last IT company is **ScanSource,** a distributor of bar coding and other approaches to gathering point-of-sale information for retailers. Being a distributor is a business that can be solid, but it offers less potential than a company that's developing proprietary products or services. A distributor is competing with everybody else offering the same types of products. ScanSource has moderate rather than high potential, but it has shown an extremely regular pattern of growth and seems well worth the current price.

Robert is somewhat apologetic in his letter about the club not always beating the total market. I consider doing this a significant accomplishment: It isn't easy to beat the market, and if the club can maintain its consistency, only a moderate improvement with additional experience should produce worthwhile results. The club's focus might involve looking for stocks with somewhat greater growth potential while continuing its emphasis on getting good value. I expect that LMIC will do well in the future.

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