CompuFest99

The Art and Science of Investing - Exploring Judgment

Weeding and Feeding Your Portfolio

by Philip J. Keating, CFA
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To help mark the Computer Group's national meeting this month, we are pleased to share with all our readers highlights of one of the most popular sessions held each year at CompuFest — Phil Keating's "Weeding and Feeding Your Portfolio." His words of wisdom are equally treasured at Congress. Mr. Keating is a firm believer in how important it is for individuals to build wealth over their lifetime, and in their ability to do so by following a few basic principles and a disciplined approach to their investing. We think all readers will find value in his comments.

Portfolio management is the process of taking care of a portfolio, maintaining its health. I come across many portfolios in my travels that need nurturing. I usually find that clubs and individuals amass a collection of stocks with little thought given to the interrelationships between the investments. Another common mistake is when investors sell their winners and hang on, against all hope, to their troubled stocks. Peter Lynch referred to this as "cutting the flowers, and feeding the weeds."

NAIC portfolio management principles are predicated on these basic principles:

Invest regularly. If you have a minimum of three to five years to allow values to grow, common stocks are a good destination for your investments. Avoid the temptation of market timing by waiting for "the perfect time." It's interesting that the bond market has been equally as volatile as the stock market in recent years. Develop a plan for identifying good companies to invest in. It takes discipline. Peter Lynch has strongly suggested that the formula for success is simply to "stick with the program."

Philip J. Keating, CFA, is honorary chairman of the Computer Group, a founder and director of NAIC's Southeast Florida Chapter and architect of the Computer Group's annual CompuFest gathering. An NAIC member for over 15 years, he heads his own investment management firm, Keating Investment Management, in Boynton Beach, Fla., where he uses NAIC principles, tools and techniques in his work as a professional money manager. He believes in empowering everyone to become a successful lifetime investor.

Reinvest all income and capital gains. Over the long term, academic studies have shown that as much as 40 to 50 percent of a portfolio's total return is contributed by reinvestment.

Identify leadership growth companies and accumulate them when the fundamentals are intact and the price is reasonable.

Diversify. This is our insurance policy against the risk of any one selection turning for the worse, because for every five selections that you make, it's probable that one will be a disappointment. Understand that there's nothing you can do about this most of the time.

In your investing adventures, you will encounter situations like Cendant, the merger of HFS and CUC International, where HFS ultimately discovered that CUC had been using some incorrect accounting practices. The stock price tumbled from over 50 to less than 10. Cendant was among the most widely held companies by mutual funds. If they didn't see it coming, I'm not sure that we can expect to either. It was a marriage "made in heaven." With deals like this one I try to remind myself that "if it's too good to be true — it's too good to be true."

Four Pillars of Portfolio Management

There are four pillars supporting a good portfolio. Here are brief comments on each:

Growth and Profitability. "Own the best companies in an industry." We usually don't want to own Number Two. Exceptions might be cases like PepsiCo, with its Lays franchise, and a number of the pharmaceutical companies. Search for track records that deliver predictability and demonstrate quality of management. Make sure that the growth rate is acceptable for the size of the company being considered.

Value. NAIC investors check the Relative Value, the relationship between the current price-to-earnings ratio (P/E) and the historical P/E for the company. I also like to make comparisons between a company's P/E and its growth rate, a ratio

referred to by some as the PEG ratio. In most cases, I expect that this will be around 1-to-1 or less at the time of purchase. Be willing to accept a higher PEG ratio for quality blue-chip companies (e.g. 130% for Merck.) Be suspicious of lower PEG ratios. The situation could be "too good to be true."

Expected Total Return. Based on the fundamental characteristics of a company and its market, the Stock Selection Guide generates a measure of reward versus risk, and an expected total return. The holdings are managed in an effort to maintain a collective expected return of 15 percent, enabling a doubling of assets every five years.

Safety. This is achieved by diversification, spreading the risk exposure to any one holding and by selecting companies with demonstrated track records and financial strength.

A Noah's Ark Portfolio

It's not unusual after a few years of investing to build a Noah's Ark portfolio — gathering two or three of everything. I've seen clubs with no more than one or two percent in their largest holdings, behaving like overly diversified mutual funds. One such portfolio had both of the leading waste management companies, three grocery chains, the two largest tobacco and consumer goods companies, a bunch of cyclical companies and shares of Wal-Mart, Kmart and Dayton Hudson.

This is pretty close to heading for Las Vegas and putting 50 percent of your money on red, and the other 50 percent on black. Why would you own all three retailers? You're betting against yourself.

Peter Lynch identified six types of companies in his book, *One Up on Wall Street.* The first three are growth oriented and the next three are the types that most NAIC investors would do well to avoid.

Lynch's Six Types of Companies

Stalwarts (Reliable Growth of 7-9 percent). These are generally large, mature companies that have established positions in their served markets. Their growth rate approaches that of the S&P 500 (6-8 percent over the long term) as they become large. GTE Corporation is an example of this type of company. You will generally find that these companies pay a dividend well above the market average.

Moderate Growth (10-15 percent). These are generally mid-cap, or medium sized companies, that either serve a niche or are earlier in their life cycle. Discovering a well-managed mid-cap as it delivers on its promise can be very rewarding. Some large-cap companies continue moderate growth well into their life cycle. Some blue chip examples over the years have been Abbott Labs, Wal-Mart, Philip Morris (a reliable leader for over 40 years) and General Electric.

Emerging/Rapid Growth (16-20 percent). These are often new companies, or technology companies that by their very nature are more "unstable." They are subject to technological obsoles-

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cence and aggressive competition. They're often characterized by higher profit margins and return-on-capital, conditions that foster competition. On occasion, a consumer goods or services enterprise will maintain exceptional growth for extended periods. Watch for companies that establish world class brands and rock solid franchises, with an "edge" that can't easily be replicated. My years of investing lead me to understand that strength of management and culture is essential. Coca-Cola is one example. PepsiCo, with its strength of distribution channels is another. Home Depot is renowned and respected for its service levels. Intel is innovative and continuously reinvents itself. Southwest Airlines has a culture of services that has been rarely emulated in its industry.

Cyclical companies are not advised for inclusion in a long-term growth focused portfolio. Although Peter Lynch claims Chrysler as one of his greatest achievements, bought at approximately $1 in the early 1980s, cyclical companies generally make little progress over the decades. Motorola, in recent years, has assumed cyclical status. This is observed when small fluctuations in sales results are regularly accompanied by large deviations in EPS. Other examples of cyclicals would be: Alcoa, U.S. Steel, General Motors and Caterpillar. *(Editor's Note: Readers might also refer to Maury Elvekrog's comments on this subject in this month's Repair Shop.)*

Turnarounds, or Special Situations, are a really tough call. Lynch's Chrysler experience actually fits this description. Investing in new management of a company or speculating on hypothetical cost reductions, etc. is very challenging and it's generally true that your time would be better spent investigating other opportunities.

"Hidden Asset Plays" refer to situations where the value of some asset is "unrecognized" by Wall Street. A study in hidden assets is for the Sherlock Holmes of investors. It could be real estate, or in some cases, an inventory of investments that is undervalued. This is also a fairly challenging analysis, usually with some traps along the way. The best "hidden asset plays" are those where the basic business has the growth characteristics mentioned in Lynch's first three types. When you play analyst detective and discover one of these — it's "frosting on the cake."

Peter Lynch describes one of the all-time asset plays in a gravel pit company in California. It was trading at nine times earnings, but had substantial real estate. Gravel, sand and aggregate construction materials is a boring business that appeals to few investors, and the company's stock price suffered. But the company was located on the California coastline, and happened to own a tract of land known as Pebble Beach — $900 million later — you know the rest of the story.

Most Wall Street reports are about cyclicals, turnarounds and hidden asset plays. Participate at your own risk. In my judgment, the odds are approximately 20-to-1 against you.

"Portfolio management doesn't mean that you have to be glued to the tube or graze in haste when the morning edition arrives. There's ample time to discover and act on most investment opportunities."

Portfolio Management

NAIC investors use a tool known as Portfolio Evaluation and Review Technique (PERT) to maintain their portfolios and monitor the condition of their holdings.

Diversification is our portfolio strategy that moderates risk. The market is volatile. Stock prices do fluctuate. I believe that you should seek investments that you'd make even if you were prohibited from executing a "sell order" for the next five or 10 years. Warren Buffett says that he "buys stocks as if the market were going to be closed for the next five years."

But the undulations of the stock market are mesmerizing, frightening . . . and at times even entertaining. Just watch some of the business news broadcasts. They will do whatever is necessary to keep you on the edge of your seat, because if they can do that, they can sell advertising.

We all know some ticker tape addicts. But the reality is that there are much better things to do with most of your time, like playing golf, or sailing or spending time with people. My point is that portfolio management doesn't mean that you have to be glued to the tube or graze in haste when the morning edition arrives. There's ample time to discover and act on most investment opportunities and maintenance — so long as you maintain a commitment to a long-term perspective.

Two fundamental truths persist. Smaller companies generally grow faster, and they're usually first in line to be "savaged" when stock prices fluctuate down. Larger companies are generally more stable, and a little less susceptible to gyrations. This is one of the reasons that NAIC investors spread out their investments among small, medium and large companies.

A closer look at the Wilshire 5000, regarded by many as the "total stock market," reveals that it's made up of 72 percent large companies, 22 percent mid-caps, and 6 percent small-caps. Make an effort to shop among all three groups and distribute your holdings by size, but don't feel too "guilty" if your portfolio size profile resembles the total stock market.

How Many Stocks in a Portfolio?

How many stocks should clubs or individuals own? I recommend owning no more stocks than you can comfortably remain informed on. Of course, the advent of computers and online resources has not only made it easier to execute a transaction — access to information has expanded greatly. Most mature clubs will reach 16-25 issues as they progress through their third, fourth or fifth year. This eliminates 95 percent of the risk of catastrophe from any one company.

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No one and no company is immune from disaster. Do you remember Union Carbide's incident in Bhopal? A food chain, Bruno's, lost three of four key executives in a plane crash. The surviving Bruno family member struggled and the stock price sagged from 22 to 8 before an acquisition by the same firm that bought Borden.

Elmer's Glue and Elsie the Cow

Even strong brands and franchises can falter. Borden had Elmer's Glue and a formidable line of dairy products that featured Elsie the Cow as its mascot. Polaroid and Xerox are two other respected companies cited by Peter Lynch as significantly damaged during their histories. The IBM of the late 1980s and early 1990s was another. The Xerox of the 1960s was known as a "magic stock." Books were written about the "can't miss opportunity" that Xerox embodied. Xerox's challenges have spanned decades.

A potential client had inherited a portfolio of stocks. The lion's share of the portfolio consisted of shares of Borden. I strongly recommended that she pare back her holdings by selling a portion of her Borden shares over a series of tax years. She declined to do so. After all, what could possibly go wrong with Elmer and Elsie? Her stake in Borden was over $2 million. The problem is that when they stumble, sometimes they stumble big. Elmer and Elsie dropped over 67 percent in value in a fairly short amount of time with uncertain prospects for recovery. Borden's respectable dividend was discontinued. The damage was done. To me, the moral of the story is that "you should have no sacred cows in your portfolio!"

For large, established portfolios, diversification should include 16-25 companies of varying size — and different industry groups. I recommend that investors become familiar with the sectors and industry groups. The various resources that we use (Value Line, Standard & Poor's, MarketGuide, etc.) all have their own definitions and classifications. (Value Line tends to group companies by industry in its Investment Survey. Adjacent pages are usually similar companies from the same industry group. The industry summaries are also quite useful in your studies.) I like to use *Barron's* as an example. In its weekly Market Laboratory, *Barron's* provides the Dow Jones U.S. Industry Groups with details for nine sectors: Basic Materials, Conglomerates, Consumer Cyclical, Consumer Non-Cyclical, Energy, Financial, Industrial, Technology and Utilities.

I do not advocate "indexing" or distributing your investments to mirror the composition of the S&P 500, however, I do feel that a variety of sectors and industry groups should be found when looking over your 16-25 companies. As an example, the transportation sector accounts for 1 percent of the S&P 500, while consumer staples (or non-cyclicals) account for 23 percent.

Nor do I suggest that investors engage in sector rotation, a game in which the participants attempt to identify and chase the hottest performing sectors while selling the cold or dormant ones. A number of institutional investors use this strategy. I think the approach is insane. Keep in mind that their incentives are generally focused more on the short term. Their objectives are different than most taxable and NAIC investors.

Big Picture Shopping

That said, it can be informative to watch the developing trends among these sectors. Studying the sectors provides an opportunity for "big picture shopping." For example, the energy sector accounted for 33 percent of the S&P 500 market capitalization in 1980. By 1995, it had dwindled to 7.7 percent. Over the same time frame, financials increased from 4 percent to 18.5 percent. A prevailing trend for the last several years has been growth in technology and services.

Most portfolios were underweighted in financials in the late 1980s and early 1990s. Yet, with 20/20 hindsight, the opportunities were abundant. The point is that when magazine covers are telling you that the price of gasoline has never been higher and it's soaring — then it's probably time to look at something other than energy stocks. The next week the magazine covers might display gloom and doom for computers and software, and that's the time to go shopping in that arena. The *Barron's* sector profile (published weekly) includes the rate of change over the last week and year-to-date. The buying and selling is generally way overdone, and it's an chance to uncover opportunities. Take substantial positions when you discover the best companies at attractive values. The telephone utilities of a couple of years ago are an example of a group that was depressed and poised for recovery. After all, they benefit from technological change and increasing demand for convenience and services.

Even the worst industry group can produce stellar performers. Cyclicals, like steels, are best avoided in most portfolios, but Nucor Steel is a company that prospered within a cyclical industry. (*See related story, page 75.*) Good managements can perform well even in less attractive industries. *Better Investing* featured Schlumberger, an energy company, in the June 1998 issue. This has historically been a magnificent performer, and opportunities to acquire it at good values should be carefully studied.

The Local Electric Utility

Another common mistake that I've witnessed in investment club portfolios is the presence of the local electric utility. It must be somehow related to motherhood and apple pie. The problem is that unless you have an extraordinary situation, electric utilities are not growth companies. They typically pay higher dividends which produces taxable income for the investment club. I don't mean to suggest that there aren't some value opportunities in utility stocks from time-to-time, because there are. But they're not appropriate for most portfolios with a growth objective. Peter Lynch recounts the story that a mother, while on her death bed, issued the following investment advice: "Whatever you do, son, don't ever sell San Diego Gas and Electric."

An investment objective, such as income, may have been appropriate for the mother but ill-suited for her son. She was right, and he'd probably be right to focus on growth instead.

The study of a portfolio requires that a list be prepared which includes the investments and their characteristics. In order to follow NAIC principles, we need to itemize the specific holdings with some classification of company size and industry group. We also need to review the fundamentals including sales and EPS growth rates, relative values and expectations for each holding.

". . .we work to identify and acquire quality growth companies, with the intent of holding for a long time. As Warren Buffett has suggested, "when we find a great one, our holding period is forever."

Before the advent of computers, this was a formidable undertaking. It still is, but it is considerably easier using the NAIC Investor's Toolkit software. With this software, you simply maintain a collection of Stock Selection Guides (SSGs) for the holdings.

Three Portfolio Management Reports

This portfolio management feature provides three basic reports. The Portfolio Evaluation and Review Technique (PERT) report includes a ledger which details the following fundamentals for each company: past sales and EPS growth rates, EPS growth rate expectations, pre-tax profit margin results, current price, current P/E ratio, relative value, historical P/E range, P/E vs. growth rate (PEG Ratio), upside-downside ratio, expected high and low prices, and estimated compound price appreciation. The user can sort on any one of these characteristics in the study of the portfolio. The SSG can be accessed to review the underlying details for each company by simply clicking on the company name.

Investors attending last year's Norfolk CompuFest (photos) were able to get plenty of hands-on experience in the computer lab. A similar lab will be open during the Dallas CompuFest beginning July 16.

The Portfolio Trend Report includes: a quarter-over-quarter comparison of sales, EPS, and pre-tax margin results. The EPS trend for the trailing twelve months is provided, as well as the expected EPS growth rate. The expected total return for each holding is displayed along with number of shares, dollar value and the portfolio distribution is calculated so that the composition (percent of portfolio value contributed by each holding) can be monitored. The percent distribution by company size (small, medium and large) is also provided.

The Portfolio Trend Report also includes a general "rating" extracted from the Portfolio Management Guide (PMG). To be displayed as a "Buy," all three of the following conditions must be met: The stock price must be in the "Buy Zone" of the SSG, the upside-downside ratio must be greater than 3, and the relative value must be under 100 percent.

The Portfolio Summary Report is a text file, including some key fundamentals (price, P/E, Relative Value, and Upside-Downside.) It can be edited on screen and then saved. The report can be used with a word processor or notepad to prepare a valuable, customized, monthly report for a club.

With an up-to-date set of SSGs, the various characteristics of the holdings can be studied. As much as I wish it would be so, having this tool and resource still doesn't make the decision any easier. It makes finding the "evidence" and exploring the reasons a whole lot easier — but the tool can't make the decisions for you. A sale consideration has always been, and probably should always be, a challenge. After all, we work to identify and acquire quality growth companies, with the intent of holding for a long time. As Warren Buffett has suggested, "when we find a great one, our holding period is forever."

Guidelines for Cutting the Weeds And Feeding the Flowers

The study of a selling situation should come with some "agony." But we also have to recognize that portfolio management revolves around cutting the weeds and feeding the flowers. What does a weed look like? Why and when should a holding be sold? Here are ten guidelines that I use:

Buy the best companies. Be reluctant to sell. Remember that stock market corrections are a "side show." These price swoons are actually opportunities to purchase stocks of the same or better quality, in an effort to improve the collective quality of a portfolio.

Never sell simply because of sluggish or volatile price action. Sell if you discover a mismatch with portfolio objectives.

Consider selling if your analysis is that a company is threatened by an adverse management change. I keep a watch list of companies in my left pocket that I would sell if "the executive plane went down." Included on this list are companies

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like General Electric, which has prospered under the leadership of Jack Welch. I keep another list of companies in my right pocket. These are companies that I'd definitely study and consider buying, if "their executive plane went down." Unfortunately, the list in my right pocket is longer than the list in my left.

Consider selling when profit margins slow noticeably. In some cases, I look for a down trend for two years. The Investor's Toolkit software includes some graphics in the portfolio manager features that provide a display of these fundamentals, including quarterly comparisons of pre-tax profits, and rolling four-quarter averages for a closer look.

Consider selling when the company displays a declining return on capital. Be particularly wary when increasing debt load has resulted in lower profits or lower EPS growth results.

Consider selling if growth has materially declined, or become cyclical. This is a red flag. I recommend that investors give considerably "more rope" to larger established firms with world class brands. I also suggest that small and medium-sized companies be kept on a shorter leash.

Consider selling if one stock accounts for more than 15 percent of the portfolio. Examine the sales growth trend and expectations, and consider the probabilities that a natural balancing might develop with contributions (cash inflows) into the smaller holdings.

Never sell solely because the price has not moved or is below your cost. Stock prices move in surges, sometimes massive gains, and staying abreast of improving fundamentals during periods of sluggish stock price trends is critical. Never sell because of temporary bad news. NAIC investors seem to endure feelings of guilt whenever they execute a sell transaction. To some extent, this is a good thing, when practiced in moderation. I know some NAIC investors who are convinced that their "stocks" know who they are and where they live.

Make the best judgments and assumptions that you can. Take a deep breath. Assertively sell when the conditions warrant it. I suggest that you only look back to derive potential lessons from your decisions and judgment. Remember, we can only act on the best information available to us, and probabilities are all we've got.

The Investor's Toolkit software also includes a feature known as the New Challenge, an appropriate label for a selling evaluation. It permits you to compare the sale of one holding, with the expected benefits of switching to another company. The analysis includes the expected total returns for both companies, and includes the impact of capital gains taxes and brokerage commissions. The feature includes a graphic which displays the future value of either position (including all taxes and costs.) You can visualize the payback or breakeven period for executing the transaction. It's a powerful tool for pulling a weed and planting a flower in its place. ▭