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How to Make Over 40% in Stock Market Profits!

By

Don Soards

Let Capitalism make you Richer!

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Part 1

The Buy, Hold, and Collect System

Why Do Most Stock Investors Lose Money?

Investors start out as winners. Most are successful professionals and business people. They are educated, well disciplined members of society who have found profitable niches. They fulfill needs and get paid for doing so. They know how to work hard and save money. They have reached a high level of competence in their work. They know how to study, hang tough in the bad times, pay off a mortgage, be frugal, balance a checkbook, and a host of other skills that qualify them as financially responsible adults by any standard. These are the people who furnish the day-to-day leadership that makes our society run.

So why do two out of every three stock investors lose money?

Conventional wisdom blames the victim. People criticize those who lose by attacking their character or lack of intelligence. These criticisms completely miss the mark. After all, how did these people get the money to invest in the first place? It wasn't by being undisciplined, stupid, or ignorant. Something else is causing these losses.

To understand why people lose money on stocks, let's visit a place where even a greater percentage lose money, the horse racetrack. Very few people win at the track on any given day and I personally have never met anyone who has won money over a lifetime of betting. Why do people lose money at the track? The reasons typically given are that the races must be fixed or that "I just can't pick them". Neither of these two reasons explains the huge losses people endure by the end of a twelve-race day. Just look at all the frowning faces leaving the track, not to mention the aggressive angry drivers leaving the parking lot.

Where did all the money go? Answer: The state got it! Look at the fine print on the Racing Form and note the "Take". The take ranges from 15% to 18% of the amount bet. Furthermore the state also gets "breakage" keeping the odd pennies so that the payoffs are made in even dime amounts. The total take for win, place, and show pools is about 20%! Consider what happens to the crowd's money. Say the thousands of bettors at a track "invest" a million dollars in the first race. As soon as the horses are off and running the state closes the betting windows, grabs 20% (that's $200,000!), and then pays off the winners of the first race with the remaining $800,000. On the second race the state grabs another 20% ($160,000) leaving the winners of the second race with $640,000. After the third race the state

pockets another 20% ($128,000) leaving only $512,000 to be distributed among the winners. After only the third race the crowd has lost almost half its money! The fact that the state employs track personnel and pays purses to the winning owners is of little consolation to the bettors who have now lost almost half their money. After the sixth race the bettors have only about ¼ of their starting money. By the end of the 12th race the bettors have only about 1/16 of their original money left. The owners of the track (the state) have taken most of the bettor's money. It had nothing to do with "fixed races" or "can't pick them".

The same thing happens to stock investors. The original owners of well-functioning private company decide to go public. The principal owners of the firm sell stock to the public. This is how multi-millionaires become billionaires. Generous options are given to high ranking company officials and members of the board of directors. When these options are exercised then even more stock is sold to the public. Additionally, the principal owners did not sell their controlling interest at the initial public offering so they still hold shares that can be sold to the public at a later time. Much like the "take" by the state at the horse track, the initial public offering is a non-refundable "take" by the principal owners. No matter how high the share price goes the public is always in the hole over the lifetime of the corporation. If the initial public offering was for $89 per share and the current price is $489, the public stockholders have enjoyed a $400 asset increase, but have incurred a $489 liability when the corporation ceases to exist. Unfortunately, corporations are like people, we all die in the end.

If the stock went to $1489, the public stockholders would have a $1400 asset increase, but as a group the investing public would have a $1489 liability. If the stock price went to $1,000,089, then the investing public would have a $1,000,000 asset increase, but would have incurred a $1,000,089 liability. No matter how high the share price goes there is always some member of the investing public who has to "take the hit". The final bottom line is that investing public always loses money to principal owners in the amount of the initial public offering. As time goes by the investing public also loses more money as the principal owners, board of directors, and corporate officers sell-off even more stock. This system leaves the public shareholders competing among themselves in a game of "greater fool". The strategy of this financial form of musical chairs is to buy low and sell at the peak price to a greater fool than yourself. When buying stocks the investing public always has a net loss. Again it does not make any difference how much the stock price increases, the public as a whole

always loses. This is why two out of every three investors lose money in the stock market.

Public shareholders as a group always have and always will lose money on stock prices. As far as share prices are concerned it is strictly a "competition among the victims". Is there any hope for public stockholders to make money? Yes!

The Solution to Our National Problem

The notion that investors do not (as a group) benefit from stock price increases is mind blowing! All my life I have heard of people trying to "pick a winner" and get rich. It is not a zero-sum game. The principal owners and corporate insiders have taken a big cut of the capital gains and left the public to try to outwit each other for the left over crumbs.

So how does one make money in the stock market? There are only two places that a stock investor can get money: from other stockholders (a losing game for most) or from the company. This second source of revenue was the original intent when "shares" were sold. In the very olden days when Europeans were trying to colonize the New World capital was in short supply. Shares in the company were sold to finance shipbuilding, buying supplies, and paying wages. If the company made money, the shareholders were entitled to a "share" of the profits.

This has changed. When I was getting close to graduating in Civil Engineering I called a broker and asked about selling shares to form a construction company. His reply was, "They don't do it that way." He told me to see a banker to get financing. If you look at companies that currently go public, they have little need for the money. If a promising company wants to expand there are many willing lenders. If these companies are good enough to get the favorable financial reviews required to go public; they would have very little trouble in borrowing money from banks or in selling corporate bonds. They are already successful. Most of the time Initial Public offerings in established companies are little more than "owner's sales". The major purpose for a company owner to give-up some control in his or her company is to make a fortune by selling stock to the public.

There is a two-step process to becoming a billionaire. First you "build better mousetraps" and a company that manufactures and sells these things. This makes you a multi-millionaire. Next you sell stock in that firm, and this makes you a billionaire. The basic idea behind this process is that if your product makes money then you can sell stock that pays the value of interest. For example, if your product makes 100 million dollars per year and the interest rate is about 5%, you can sell 2 billion dollars worth of stock. I have no quarrel with this process. I believe it is good for the economy as a whole.

Unfortunately, it is what follows that is a black eye for capitalism and a detriment to the American Way of Life. Too many CEO's have managed to hoodwink the investors into believing that they need the profits "to expand" rather than pay dividends. One excuse after another is given to the investing public as many increasingly greedy CEO's and principal owners manipulate the company in an effort to keep share prices high to maximize profit when they sell their own shares.

In 2005 there was more money spent by S&P 500 companies on share repurchase, than on paying dividends! Unscrupulous owners, officials, and boards of directors prop the price of stock by buying back shares with money that should have been used for dividends. Then they sell their shares while the stock price is high. Once you have firmly grasp the notion that rising share prices do not benefit the investing public as a whole, then you can understand the folly in share repurchase schemes. Spending the public's would-be dividend money in an attempt to raise the share price does zero good for the public. I recommend that **Congressional legislation be passed that requires corporations to get public stockholder approval (on an annual basis) to have share repurchase programs.** Personally, I would vote for increased dividends rather than sleazy share repurchase schemes.

According to Trim Tabs Investment Research in 2006 there were 600 billion dollars spent by firms to buy back there own stock! That's 600 billion that could have and should have been paid to stockholders as dividends. One interpretation is that it is a good thing for the market to have all this buying back because it indicates a renewed faith in the upward price movement of stocks. If this were so then why did insiders sell over 60 times as many of their company's shares as they bought back? What is really going on (data from Trim Tab) is that corporate owners and select insiders just dumped 120 billion dollars worth of their own shares on top of collecting 230 billion in initial public offerings! They are dumping their shares at a massive rate and propping the price up with money that should have been given out as dividends. The only way to stop this unethical theft of our dividends is to require corporations to get public shareholder approval for any share repurchase programs.

During the past two decades the rich have gotten much richer, while the middle class has seen only paltry gain, and poor have made no progress. This book is not about making the rich richer. It is about getting middle class stockholders the profits they are due. Any political party that could aid the middle class stock holder to gain their rightful share of corporate profits would get considerable support, since there are many middle class

stockholders and a high percentage who vote. The current low-dividend status quo will be increasingly distasteful to American stockholders who now have the ability to invest their capital into the hot growth Asian markets. In fact my own broker is putting some of his other clients into Asian growth funds. Even the rich American corporate owners selling their stock will find a collapsing market in which to dump their remaining shares, if this lack-of-dividend situation is not corrected.

Buy, Hold, and Collect!

Until most corporations start paying a lot more dividends, the average investor will have to hunt for solid dividend payers. Fortunately there are some exceptions to the little- or no-dividend policy. Use Internet stock yield screeners to find high yielding stocks. There are many companies that oscillate in the 15% to 20% yield area. **Locate these stocks in an industry that you have some feel for, and check to be sure that this company is making enough money to pay these large dividends.**

These companies constitute your "candidates group". Examine your high-yield candidates to see which have share prices on the rise and which have share prices that are likely to drop (more on this later).

Set-up a brokerage account that gives you the right to buy on margin and do "covered calls". I have several. Both full service and discount brokers have reasonably priced account fees. Your feeling of comfort is most important. I remember getting my first account (at a full service brokerage). I was scared. I was afraid that opening a brokerage account was the road to ruin. It has been for many. I hope that the ideas presented in this book will enable you to be a steady consistent winner who gets a good night's sleep. My first purchase was a municipal-bond fund recommended by my broker. I had my broker buy them. He did an excellent job of steadily accumulating the thinly traded stock. The steady federal tax-free monthly check sent to my bank account was an incredible joy. It paid over 6.4% federal tax free and gave a post tax yield that was double what I could get with CD's or bonds. The bond fund was extremely diversified with purchases in all the states. It was also a closed-end fund, so that it stayed small and maneuverable. If the 15% to 20% yield stock list makes you feel uncomfortable, then consider a muni-bond fund for your first Buy, Hold, and Collect experience. I recommend muni-bond funds because they don't need to be in an IRA to be federal tax-free. They are much better than CD's where your money is tied-up (you pay a penalty to get it out) and then you have to pay taxes on it every year. I hated that! I no longer use CD's; instead I have my conservative money in muni-bond funds.

My first successful experience with a discount broker was to have some spare cash put into a tiny account. Every month I received a check in the mail for $102.20. I always considered this to be my first "profit center". Sometimes it is amazing how something small can make a big difference in you morale. I used that money to buy surprise gifts and things for myself

that I would not have bought out of the family budget. Purchasing a muni-bond fund is the first step of the Buy, Hold, and Collect strategy.

Muni-bond funds are a great place for your investment capital that is allocated for high-yield investing. The muni-bond funds tend to increase in value during panic times, which is a good time to sell a portion of them and buy a high-yield stock (likely selling for a lower than normal price).

Eventually, I desired more than the post tax 6.4% return of my comfortable, safe muni-bond fund. So I sold some of my muni-bond fund stocks and went to step two of the Buy, Hold, and Collect strategy.

What is a realistic excellent long-term annual return? Answer: 20%.

The best fund managers and the best investment newsletters seldom make more than 20% per year as a lifetime average. Very few even make 15% per year annualized over their careers. So any strategy that you can employ to make about 20% per year places you near the top of the investment world.

Select one of your candidate stocks that you feel comfortable with and purchase it (using about ¼ of your investment capital). Expect this stock price to fluctuate 50% up and 50% down, while you hold and collect. Most of the high-yield stocks pay dividends quarterly. Every quarter you will encounter Ex-Dividend. Ex-Dividend means that the owners of the stock the day before (on Pre Ex-Dividend) will be entitled to the quarterly dividend. On Ex-Dividend day the stock sells without the dividend. About two to six weeks later you will have funds deposited in your checking account or have a check in your mailbox for a substantial amount of money. Note that these dividends have a federal tax rate of only 15%.

If you have money going into an IRA, this is the long-term investment to make. Periodically, take your tax-deferred dividends and buy your best candidate stock. Your IRA account is now in Buy, Hold, and Collect mode. This is much better than the conventional buy, hold, and pray the market goes up before you retire strategy. With Buy, Hold, and Collect the market can go sideways or even slightly down and you will make a bundle.

You have now completed the second of four steps in the Buy, Hold, and Collect strategy.

Great Wealth Usually Comes from Concentrated Positions

Great wealth usually comes from concentrated positions. Henry Ford made his money with Ford Motor, Michael Dell with Dell computers, Bill Gates with Microsoft, John Rockefeller with Standard Oil, and Andrew Carnegie with U.S. Steel. Should the public investor do the same?

There are two important differences between the corporation owners and the public investor. The first is that the corporation owners are getting rich by *selling* stock. The public investor does not have that option. Public investors have the flip side of the bet. We are *buying* the stock.

The stock we buy is priced to sell for as much as the market will bear. The current valuation of the corporation plus considerable hope for the future is priced into the IPO (Initial Public Offering).

The time to buy is after the corporation has proved profitable and the price has settled down. When the corporation is paying a large yield, then there is some merit in purchasing the stock to increase your own wealth.

The second major difference between corporate owners and public investors is that corporate owners know if they have falsified accounting data. Public investors don't.

The Biggest Lie Ever Told

The biggest lie I have ever heard is that stocks beat bonds over the long term. The correct statement is that stock indexes have beaten bonds over the long term. People look at the Dow Jones Industrial Averages rise from 40.97 on May 26, 1896 to over 12,000 in the 21st century and misunderstand what they are seeing. They think that the index represents all stocks continuously throughout time. This is simply not so. The first Dow had 12 stocks, 11 of which are no longer listed.

There are three reasons that indexes do not represent stocks. The first is that the stock in the Dow and in other indexes (S&P500) are specially selected. These stocks are the “big fish who ate most of the little fish”. Secondly, indexes can be rigged to show whatever growth the index committee wants (see section on rigging an index) by controlling stock exit points. Third these indexes can vary radically from the overall market performance like in 1999 when the Dow went up 26% and 2/3 of the companies on the New York Stock Exchange lost share price.

That bonds beat stocks does make sense once you realize that share price is always a net loss for the investing public versus bonds where the public gets their initial investment (the principal) back at the end. It is just a question of time before a buy and hold strategy of low (or no) dividend stocks turns wealth into nothing. Again, corporations are like people, they all die in the end.

Once you grasp the concept that rising stock prices do not benefit public investors as a whole, the market takes on a different complexion. Too many stocks in the market are little more than glorified “chain letters”. There is an illusion of wealth being created by all the new corporations on the exchanges. Wealth for whom? Not for John or Jane Q. Public.

What is scary is that there are politicians who believe that capital gain in stock price will fund Americans’ retirements and pay their medical bills in old age. A few will get lucky, most won’t.

What have beaten bonds are the stock indexes. An index is a mathematical system that picks up stock when it is a huge winner, keeps it until it becomes a loser, and then dumps it well before the stock goes to zero. This highly successful stock picking system has theoretically made a bundle.

The Grand Delusion

The grand delusion of the investment world is "that capital gains will continue to rise forever, based on what the Dow has done". The implication is that if you bought and held stocks you would be rich and that if we all bought and held stocks we could all retire in style. Too bad it's not true.

I have a personal example that illustrates the fallacy. I inherited a small amount of K-Mart stock when my folks died. A few years before, K-Mart had been a longtime member of the Dow-Jones 30 selected stocks (those with very high capitalization). K-Mart's famous demise did little to phase the DJ average. It simply fell out of the index and was replaced by another stock. The fact that the stock dropped from its "fallout" price, down to three dollars and then down below ten cents was of no concern to the DJ average because K-Mart had long since ceased to be a member of the "club". This shows how the DJ index does little to accurately reflect capital losses over long periods of time.

The same principal applies to a DJ Index mutual fund. When a stock is no longer in the select 30, it is sold to a "public investor" to take the hit.

Some learned economic advisers suffer from the delusion that capital gains are on a permanent uphill ride. They fantasize about capitalizing on capital gains for the good of the country. Only the market crashes bring them back to a reality they don't understand.

The DJ Index is a reflection of market prices only so long as it has the exact same stocks in it. If no stocks were changed for several years, then the DJ Index gives an indication of relative stock prices for that several year period. However, once stocks are changed then comparing the DJ Index "then" and "now" is like comparing apples and oranges.

If the DJ Index is not an accurate measure of capital gains over a long-term period, then what is it and why does it rise so seductively?

The Dow is a "Trailing Stop"

The mantra of successful investors is "cut your losses and let your profits ride." Many investors do just the opposite. In an effort to be right they take early profits to validate winners and then ride their losers into financial ruin rather than admit a loss. The problem for successful investing systems is how to ride the profits without taking a big loss. This is done with a "trailing stop". Say for example that you purchased a stock for $80 and have a 5% trailing stop. Then the stock drops to $78, but you do not sell yet because the stock dropped only $2 and your system stop value of 5% would require a $4 loss before automatically selling. When the stock moves up to $100 you still don't sell because you are letting your profits ride. At $100 the new stop value is now up to $5. Suddenly the stock price plummets. You sell at $95 and take a $15 dollar profit ($95-$80=$15). Successful investing is not about exactly timing market highs and lows, rather it is about grabbing large profits while taking only small risks.

The Dow-Jones Index and its predecessor the original Dow are some of the oldest trailing stops in financial history. First they back the picks of investors by selecting top capitalized stocks of their era. Then they let their profits ride by keeping each stock in the index, until it no longer satisfies the criteria for being in the top 12 (for the original Dow) or the top 30 for the current Dow-Jones Index. Dropping a stock from the index is a form of "trailing stop".

What is the Dow-Jones Index for the long term? It is an apples-to-oranges comparison over long periods of time. Why does the DJ Index go up over long periods of times? The DJ Index is a great betting system with a highly effective trailing stop that easily beats the "real market" as its ever increasing numbers testify.

Would an index of 500 stocks be much different? There are thousands of stocks, so whether you pick the top 1% or the top 10% the same problems still exist. The "Index" essentially degenerates into a betting system with a trailing stop. The bigger pool will not capture much more of the capital losses. The index will still be an apples-to-oranges comparison over long time periods because the stocks in each time period will be different.

How to Rig an Index

Any index can be made to show huge annualized gains. Start by picking what Charles Dow referred to as “respectable stocks”. In today’s terms a respectable stock is one that has a large moat and is ready to make one bodacious bull run. Sit back and enjoy the ride, including the many stock splits. Ultimately, one by one, each of the original companies’ share prices starts to decline. The decline can be caused by many factors such as: excessive copy cat competition from US firms, overwhelming competition from Asian firms with super-cheap labor, newer products that take the place of the company’s main line of goods, a recession that lowers demand for company products, outdated equipment and procedures, excessive pension fund liabilities, inflexible management, etc. There is no mystery about when these economic supernovas are becoming dwarf stars. It can be seen by all.

At this point the science of rigging the annualized gain is disguised by share splits. To the casual observer the fact that Big Stuff Inc. stock went into the index at $20 (in 1990) and left the index at $10 (in 2000) would seem to indicate that the index captured at least some of the stock price demise. However, consider that Big Stuff Inc. has had three stock splits (fewer than many giants in the index). That $10 share is really worth $80 in the “index computation” because three 2:1 share splits have turned one share into eight shares (2x2x2=8). Thus Big Stuff Inc. made a profit of $80 - $20 = $60 over a period of 10 years for an average profit of $6 per year (30% per year on the original $20) and an annualized gain of 14.87% per year. The annualized gain is what $20 would be worth after being invested at a 14.87% compounded interest rate for 10 years.

Suppose the index committee wanted to show their index with a more optimistic percentage growth. Say they desired to show the economy growing at a 20% rate! To do this they need to have Big Stuff Inc make a 10-year value of $123.83 per original share. No problem. $123.83 divided by 8 shares gives a price of $15.48 per share. They simply give Big Stuff the boot a little earlier (at $15.48 per share).

Suppose the committed decided that the index needed to show a more conservative growth of just 10%. No problem again. To do this they need to have Big Stuff Inc. exit the index with a value of $51.87 per share. $51.87 divided by 8 shares gives an exit price of $6.48 per share.

So for whatever percentage rate of Index growth the committee deems appropriate, index technicians can attain by altering the stock exit point. In the Big Stuff example we now have computed three options: 10% growth

with a stock exit price of $6.48; a 14.87% growth with an exit at $10; and lastly a whopping 20% growth with an exit price of $15.48. The committee can (within earthly limits) rig their index to show their desired growth number with pinpoint accuracy. Note that dropping the stock between share prices of $6.48 and $15.48 seems like a reasonable thing to do, since it is no longer selling for what it was a decade ago. We have become de-sensitized to this standard operating procedure for dumping stocks long before they hit bottom. This was originally done before computers to keep computations brief.

Any historical study of stocks using indexes as a basis for long-term conclusion needs to account for the Factor of Index Brevity (FIB). The index FIB makes many long-term stock studies suspect.

How many opportunities does the index committee have to perform the FIB bias? Quite a few! The most comprehensive study of a large index that I know of is a 46-year data marathon presented by Professor Jeremy J. Siegel in his fascinating book "The Future for Investors". The total number of new firms added to the S&P500 from 1957 through 2003 was 917! Only 125 of the original firms survived. Although there were 341 total descendants left (including spin-offs and mergers). On average there were about 20 changes per year.

This is a very heavy mortality for economic superstars. What became of the ordinary corporations? I would like to see a study done on corporate mortality. A tiny percentage of capital-gains superstars do not make a "restful night's sleep portfolio". Indexes truly portray things differently than they really are. Watch out!

For example, if the original portfolio at the start of an index has outperformed the index itself this could be partially caused by the committee hanging on to stocks a bit too long before pruning them from the index.

Now that we know about the index FIB we can take a closer look for a proper index that would be more useful in determining long-term conclusions. This would be an index that keeps all traded stocks in it until each stock goes to zero and then keeps the zero values in it to show the correct value of holding onto stocks.

When I say that corporations are like people, we all die in the end I have not accounted for the divergence in this statement. People are living longer and longer. However, our corporations are competing in a "future shock" world with an ever-accelerating pace of change including new

foreign competition. **I fear that we are more likely than ever to outlive the corporations we depend on for retirement income.**

The Real Value of Stock to the Public

The net value of a stock to the buying public is given by the following equation:
Net value = dividends – taxes – commissions – initial cost – interest lost– exercised stock options – principal owner's sale of their own stock not previously offered

The net value of stock for the pool of public investors is equal to what they get minus the stock costs. What stockholders receive are dividends on which they pay taxes. Costs paid by the investors are commissions to the brokerage house, the initial stock purchase price, the net value of stock options exercised by corporate officials, and the subsequent sale of the principal owner's stock that was not previously offered in the initial public sale. Additionally, for the time that the stock is owned, the public investor's money is not available to make interest.

Stocks need to pay more dividends than bond interest to offset the many costs and risks of stock ownership. Therefore a stock should be priced slightly lower than a bond fund when both are paying the same dividend.

At this point some investors may be screaming, "What about capital appreciation? Isn't the price of the stock supposed to go up and make me rich?" The sorry truth is that capital appreciation is less than a "zero-sum-game". Your ability to get capital appreciation is a function of your ability to "out-trade" another investor out of his or her money.

Unfortunately, corporations like people all die in the end. The equation for net capital appreciation for the investing public is:

Net capital appreciation = today's price – initial cost – exercised options – sale of principal owner's stock not previously offered

At the end of the corporations economic life: today's price = 0. This gives the following equation:

Net capital appreciation = – initial cost – exercised options – sale of principal owner's stock not previously offered

So net capital appreciation for public investors is a net loss. The amount of the loss is equal to the cost of initially buying the stock in the first place plus buying all the additional stock the corporate officers and principal owners could dump on the public.

You might think that the liquidated value of a corporation's assets might be of benefit to stockholders in the end. Don't count on it. If the corporation's assets had a lot of value, they wouldn't be going broke in the first place. Most likely office furniture and buildings will be sold to satisfy unpaid suppliers and other creditors. Valued workers will quickly line-up on competitor's doorsteps looking for a job to pay the family mortgage. There will be little of value left for the shareholders. Assets that might have gone to shareholders (like raw material holdings) will have likely been sold earlier in and effort to keep the company afloat.

Increases in capital appreciation are justified if the dividends go up. However, what goes up eventually comes down, so in the end even a long success streak of dividends will dry up as business turns sour. When the dividends go to zero and don't look like they are coming back anytime soon, then the value of the stock is near zero.

How would you price a stock? Multiply its current price by the ratio of its current yield divided by the interest rate from a bond mutual fund. This will give you an approximate upper limit for the stock price. For example, if a bond mutual fund is yielding 6%, then a stock selling for $100 and paying only 3% should be priced at about $50.

The rule I use for my major stock purchases is: "I only buy stock that puts money in my bank account now."

Capital Gain will be more Difficult in the Future

During the first half of the 21st Century capital gains will be more challenging to get than during the 20th Century. The reason is because of second generation system models.

For example, a technical indicator (like a moving 200-day average) may have been a winner over the last century, but may be of only marginal value in this century. This is because there is now testing of indicators on a real time basis to see which ones are performing and which are not. This way second generation models can "cherry pick" the times that the 200-day moving average is a more successful predictor and avoid those times when it isn't.

Additionally, with more people able to access technical indicators, the indicators will tend to already be "priced into the market".

Value investing and fundamental investing will become more common place, computerized, refined, and disseminated. This will tend to more accurately price stocks so that finding a stock that is likely to grow above the "owner's take" will be increasingly difficult. With easy access to a wide variety of analyst opinions more stocks will be more correctly priced at their potential. This will leave few than might break the "owner's take" barrier.

I have some personal experience that illustrates this challenge. In college I was taking a statistics class that required a research project. A brand new racetrack had just opened up, so I selected a quarter horse race for analysis. I got hooked on racing. I read five books on it that summer and actually made money at the track. I made money because the new bettors, new tout sheets, and new odds-makers were incompetent enough that there were profits to be had above the "20% take". After graduation I tried the following season and studied over 30 books in all. I ran thousands of dollars through the betting windows and lost less than 1% of it. But I could no longer make money. I was astonished at how fast the crowd "came up to speed". The odds-makers were a lot sharper and could handicap accurately enough so that there were very few opportunities above the 20% take. Essentially, I was 19% better than the public, but since the state took out 20% I ended up losing about 1% of the amount bet. When the public began following the increasingly competent odds-makers, there were very few

races with much opportunity for profit. Sometimes I would sit through an entire 12-race card and only bet one race. This made for a very long day.

The same thing is going to happen to stock pickers. As more techniques are learned by more investors, the less value can be extracted from rising stock prices by anyone. This is the reason that we should focus our attention on getting dividends from the company rather than trying to outwit other investors for an increasingly small slice of capital gains.

The one system that will be the least subject to having its picks overvalued will be Index funds. While much ballyhoo is made about a stock about to go into an index, this causes only a minor price rise. Once a stock is in an index and in Index funds, the stock can enjoy a run for several decades. All buying after a stock is in the index simply boosts the stock price. Because of the very long time period that most stocks are in an index, the index funds are almost immune to the "priced into" fate suffered by other systems.

Are index funds a good bet for the future? Under current low-yield conditions index funds are only good to about 2010. By 2012 Indexes will give up massive gains unless Congress comes to the rescue with public investor veto power over sleazy dividend-robbing share repurchase schemes.

Wealth building traps

Picture a large corporation that employs thousands of highly trained workers producing a quality product that everyone admires. See how satisfied their customers are (including yourself) and what nice things the corporation owners do for society. Note that their annual report to stock holders shows ever increasing earnings with even more earnings forecast for a rosy future. You feel proud to be a part of this company and even boast that you are a stockholder. Note how the wise corporate leaders are plowing back all the earnings into research, expansion, and salaries to attract the best employees. "Growth for the future" and "investing for the future" are their messages, with the promise of even better things to come. Now picture yourself reaching for your telephone and calling your broker. After some minor pleasantries are exchanged you tell your broker in a loud firm voice, "Dump that Dividend Deadbeat!"

I hope that this company stays in business and the workers keep their jobs. I appreciate quality products and may well be using this firm's product myself. I wish them well in the future. But don't buy their lousy stock. As soon as its investors figure out that "the emperor has no clothes", this stock is heading downhill fast. In this all to familiar story millions of investors are being conned out of a reasonable dividend. The rosy promise for the future is for the owner's rosy future, not for the investors' future. Next year the investors will again be asked to forgo a reasonable dividend by management giving any "song and dance" that it thinks the public investors will buy. For an established corporation not to share earnings is a strong sign of unethical management. Why would corporation owners not want to share dividends with their public shareholders?

I learned about this scam during my college days, when interest rates were around 5%. If you could put together some kind of company that would net $1,000,000, then you could use that earning power as justification to go public and sell $20,000,000 worth of stock. When I heard this I thought why would anyone want the bother of being accountable to the public and lose control of your own million dollar golden goose? Well first off you didn't lose control because you only sold 10% of the shares. You kept the other 90% of the shares for yourself! This is legal. Secondly I wondered what would the company be doing with the new $20,000,000 in cash from the initial public offering? Taking a huge cut off the top for principal owners and expanding the business with what was left were the answers. Expanding the business would likely increase earnings. The

public would then bid up the price of the stock believing it would be sharing the spoils of business victory. At this point the owner of the firm begins to dump some of his shares (the 90% not sold at the initial public offering) and makes a killing. No longer are the firm's profits the owner's goal. The owner's new goal is to sell his stock for as much as the market will bear.

The next key to increase stock sale profits is to get the investing public to buy into the notion of P/E ratios. Price/Earnings ratios are based on the price of the stock divided by the after tax income the corporation has earned. Theoretically all of the earnings can be returned to the stockholders in the form of stock dividends. When earnings are not given out as dividends, there is the promise (either stated or implied) that the investor will get even bigger dividends in the future. When that promise is broken year after year management is lying to its shareholders.

P/E ratios are an excellent way to screen out bad stocks, but a good P/E ratio does not mean that the stock is good. A P/E ratio that is too high because of poor earnings or an over inflated stock price indicates that the stock in question should not be purchased based on its current performance. However, the company with a good P/E ratio that won't pay dividends is no better from the public investors' standpoint than the company that can't pay dividends. If a company's CEO has the means, but not the will to payout at least 80% of the profits as dividends, don't buy the stock. It you own a Scrooge-Stock (low yield) or a Dividend-Deadbeat dump it now!

Brokers and other financial advisors like to recommend stocks with good P/E ratios. While we wouldn't want recommendations to buy on stocks with bad P/E ratios, the notion of paying dividends starts getting lost in the process. Capital appreciation is touted as the main reason for buying stocks. Clients want financial advice that will help them make a killing when the price of their newly purchased stock zooms upward.

For the unscrupulous corporation owner the process is: go public; hold back 90% of the stock for himself and cronies, increase earnings which causes a brainwashed public to bid up the stock, sell as much of the owner's stock as the market will bear, deny dividends for more growth, public bids the stock even higher, owner sells even more stock at the new higher price, etc.

Stock splits and advertising also play a part in this. Stock is split to bring the price per share down to the $20 to $30 dollar range that the public likes to buy in. This is done to enable the owner to dump more shares at an attractive price. If the stock were priced at $150 per share it would get fewer takers. On the low side, a stock that is priced too low (say under $10) may

make some investors think that stock is not a “serious contender” or that the corporation is about to go bust.

I would like to think that most advertising is designed to sell company products. By increasing sales there would likely be more money for potential dividends. However, some advertising is little more than getting the company’s name before the stock buying public. It is the stock that company moguls want to push, products are almost incidental. Too much corporate advertising is about publicity, not sales.

There you have it. The dirty secrets are exposed. All too many company owners are making a lot more money fleecing investors than by satisfying customers. Capital gains have a net benefit only for the company owners and the highest level of management.

Worker, Consumer, Citizen, and Investor

The chapter title has four roles that we all play. Sometimes roles can get confused in our brain. What's required to do the best job in one role doesn't necessarily even do a good job in another role. As a worker we want top wages, nice conditions, stable employment, growing company with a chance for advancement, and stock options if we can get them. As a consumer we want a product at a low price, with market sizzle and sex appeal, brand names with high status, the latest thing, and something that won't drive us crazy. As a citizen we want the good jobs, tax revenue, and charitable contributions that the corporation provides our community.

Notice that none of these things has anything to do with an investor getting large dividends. When you do investing, think like an investor. Do not get caught back in your other roles. What's good for those other roles doesn't help you much. True we want to invest in companies with satisfied customers, happy workers, and that are models of integrity and generosity. We can afford all of these if we are being compensated. Investors gotta get paid too!

However, if there is nothing left for you as an investor, it is time to move on. If the company is not paying large yields, sell and move your money where it will get the respect it deserves.

Getting paid in one form or another is what we insist on when we are in the other roles. As a worker I liked a biweekly check. If it wasn't there then I would contact the finance department. As a consumer I want my money's worth. If the product doesn't work I usually send it back. If a service isn't adequately provided, I call and find out what is going on. As a citizen, I want something for my tax dollar. I expect government to provide certain protections. As an investor I want you to expect your corporation to pay dividends.

Reading this book will help remold your investor self-image to an investor who is supposed to get paid and will get paid.

The Asset Myth

Businesses are not as healthy as people think. The reason is that sale of common stock does not appear as a liability on the balance sheet!

Think about this statement. I have never seen it in print.

If you or I buy a house, a car, a small business or any other asset with borrowed money, then our individual balance sheets show the asset with a corresponding liability i.e. the loan we have to pay back. However in today's climate, the money corporations and their owners receive from sale of stock is free from payback. They are awash in capital with no apparent strings attached. Corporations are not forced to repay their stockholders, or to even give them a dividend. This money was from consenting adults who are supposed to be familiar with the buyer-beware concept (as well as the "never give a sucker and even break" concept).

It is only when a corporation files for bankruptcy that common stock holders have any rights to sale of assets. Unfortunately, common stock is at the wrong end of the line and all other creditors must be satisfied first. Usually, common stock holders get nothing when a corporation goes bankrupt.

When I was younger I used to hate the depressing Chinese proverb of "See the glass already broken." But now that I am older and have seen some "corporate glasses" broken I understand the application of the idea to investing. Basically, most business assets will reach a point of such diminished return that there is no reason for the corporation to use or maintain them. Even at Electronic Ego Inc. the whiz kids whose corporate culture is "don't trust anyone *over* 30" will eventually have gray hair and a motto of "don't trust anyone *under* 30". The pace of change is accelerating. This means that the machines, employees, business procedures, and other assets that made the company look so attractive to investors at the onset are becoming obsolete. **The only value of business assets to investors are the dividends they generated before the assets become obsolete.** That these assets were once of considerable value and could have been sold with capital returning to stockholders is of no meaning if it didn't happen. If the stock price reflects the "if it were broken up and sold" asset worth of the corporation, then the corporate owners and some public share holders made

money on the upside while even more public stockholders lost on the downside.

Too many stocks are marketed to investors based on the "worth" of the company, with the worth being defined as the "assets under management". While inflation helps the value of these assets, changes in productivity do not. As other competitors get more efficient or introduce new competing products, your corporation may be left behind and your stock price decline. Are assets under management a good estimate of the value of the company? No!

Imagine that you are a farmer during tough times. You double the size of your land (and double your mortgage debt), and hire more workers. You make just enough to break even. This corporation is good for the workers who now have jobs and good for the consumers who now have more to eat, but what about the investors (yourself in this case). What is the value of a "break even" corporation to the investors? Zero! A company that doesn't make money (or one that won't pay money) is worth zero to investors. If you are rich enough to fund such charitable works, then keep the stock. **The value of a company is not their assets. The value of a company is how much money they make from their assets and distribute to you.**

Stay away from companies that are "asset rich and dividend poor". Avoid the trap of thinking that things will get better for this sector of the economy, because the "better off" scenario is likely already priced into the stock. As a successful investor you should focus on the your net (return), not their gross (sales, assets under management, book value, etc.).

Book value is a comforting feeling when your stock's share price has dropped near it. It makes you feel like the bottom is near and that happier days are just around the corner. <u>The problem with book value is that it is determined by what assets cost if you were to buy them today, not what they will produce tomorrow.</u>

Asset-rich, dividend-poor companies are prisoners of their own devices. They are trapped into performing a service for everyone else in the world but their investors. Growth companies are caught in this trap. The investors of growth companies pay for the building of huge infrastructure while the company renders a new service to the public. Much of the progress of humanity is made by such corporations. As a rule, these corporations seldom return much to their investors. These corporations are good for creating jobs, paying taxes, serving their public customers, making wonderful life enhancing products, etc. Just remember, as a successful

investor it is your job to be able to afford the wonderful items made by growth companies, not to subsidize them.

Avoid asset-rich, dividend-poor companies.

Quiz Questions:

Given that businessman Bob sells 10,000 shares at $100 per share to the public for a total of $1,000,000 and that Bob buys an asset that does not produce cashflow.

What is the worth of the corporation's stock to the public investor? Zero!

What is the worth of public investor shares if the company is taken over and assets sold with proceeds distributed to all investors? This is tricky because we don't know how much stock Bob held back and how much he has had time to sell to the public. Say Bob held back 90% of the stock and will now exercise his pre-IPO options. Then Bob will pocket $900,000 and the public's portion of $100,000 will be divided among 10,000 shares for a per share value of only $10.

Let's change the given to Bob makes $500,000 per year with this asset, but chooses not to pay dividends.
What is the worth of the corporation's stock to the public investor? Zero!
"Wait a minute!" you say. "Isn't Bob growing the corporation?" Yes, Bob is growing the corporation. He is paying himself a bigger salary, has bought a company jet, and holds stockholder annual meetings at world-class resorts. He is also holding back any money he can't figure out how to spend, so he can repurchase shares to keep their price up (while he dumps part of his 90% on the market).

Again, **avoid asset-rich, dividend-poor companies.**

Getting Rich Slowly

Looking back, the best advice for those nearing retirement age would have been to buy index funds when you were young, convert to annuities as you got older, and payoff your house in-between. Even this hindsight strategy was fraught with pitfalls. The index moved nowhere during the 1970's, while houses went out of sight in the late 1970's and early 1980's, and finally converting to an annuity with rapidly falling interest rates near 2000 was an unpleasant end.

Accumulating wealth over a lifetime is the only hope most middle class citizens have of getting a retirement. I hope the Buy, Hold, and Collect system aids you in your quest. Here are some of my thoughts on saving.

Apply the Random Walk to retirement planning! For example, you don't know if you will even be alive then. Both my wife and I are grateful we spent in our youth, when we were healthy enough to enjoy it. If you have a career you enjoy, consider working longer and spending more while you are younger. I have lived long enough to know people who didn't make it to the golden years.

While some bonds and CD's produced significant interest, they weren't much fun. You can make saving fun it you redirect a portion of the interest into your "fun money". Use the "fun money" to buy something that is "showy" and or lasting. This way you reinforce your saving. Having a CD directed into your checking account will do this. I always hated "hung money". Hung money is money you pay taxes on (like a CD), but can't touch it without a big penalty (I got hit for over $2,200 one time). It felt like I was watering a tree where the fruit was hung so high I couldn't get to it. What was the point in taking care of the tree? Saving with some interest going into your "adult allowance" will preserve your capital.

Getting over 40% off the BHC system in your IRA is the fastest way for a middle class person to become wealthy. Having the covered calls and dividends not be taxed will compound your investment rapidly. In just 10 years a $50,000 IRA nest egg can be multiplied over 28 times to over 1.4 million dollars. This is enough to pay taxes and buy a lifetime supply of annuities (that will give you about $6,000 per month for the rest of your

life). Managing your account intensively for 10 years is work, but there is light ahead at the end of the tunnel.

Make over 40% on your investments. Avoid investing pitfalls.

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