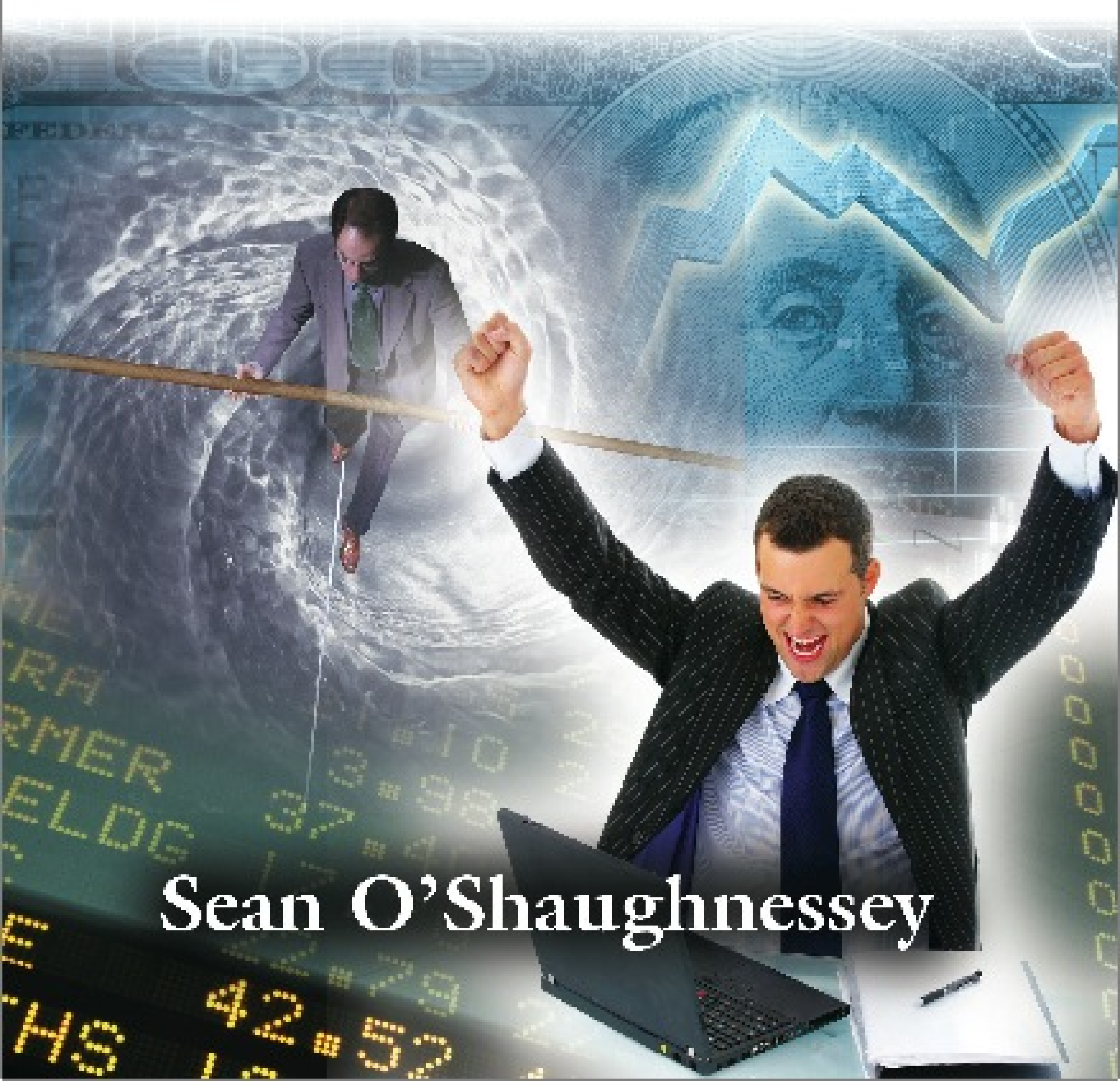
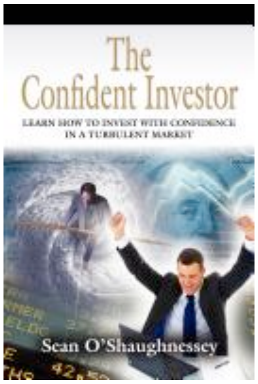
The Confident Investor

LEARN HOW TO INVEST WITH CONFIDENCE
IN A TURBULENT MARKET



Sean O'Shaughnessey



If you invested $10,000 in Apple in January 2006, you would have increased your profit an additional 10.8% by using the techniques in this book rather than "Buy and Hold." That is an additional $10,100. In the same time frame, you would have increased by 42% in Google and 135% in Buffalo Wild Wings. This book explains how to identify great companies, purchase stock at a discount in those companies, and accelerate wealth-building over time.

The Confident Investor

Learn How to Invest With Confidence in a Turbulent Market

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CHAPTER 1

The goals of this book

This is not a 'get rich quick' book. It doesn’t contain a ‘magic formula’ that will allow you to do the minimum of work and still make millions. If that is what you want, you should put this book back on the shelf and go to the fiction department! I do not believe there is a fast and easy way to get rich doing ANYTHING legal.

In this book, I will discuss the concepts that will enable you to become a Confident Investor. I will not teach you gimmicks and "get rich quick" tricks that are almost always guaranteed to fail. I won’t guarantee your success, as that in itself is a gimmick that the "tricksters" will pull on you when you watch infomercials on late-night TV.

I am going to teach you to accumulate wealth in the stock market. The key to success in the stock market is to Grow on Other People's Money (GOPM). The GOPM technique is designed to reduce your risk while not significantly minimizing your accumulation of wealth. As your investments in great companies earn profits, you want to keep that principle safe while letting your profit multiply.

Let me show you a quick example of how this works. (If the terms that I use are not clear to you right now, during the course of reading this book you should become comfortable with what I am describing here).

You buy 100 shares of a company at $40 with $10 in stock broker commission, so you have spent $4,010. Over the course of a few months, the stock rises to $44. Your investment is now worth $4,400. The technical indicators make you think that this great company will have a short-term pullback in its stock price, so you want to sit back while the market moves against the stock price. However, you still want your money to work for you at this great company. You sell just your initial investment ($4,010) plus the selling commission of $10. $4020 divided by $44 means 92 shares (or a net of $4,048). Your principle is safe (plus $28) and you have 8 shares of this great company. These 8 shares were bought with Other People's Money.

Eventually, the indicators confirm that you should buy in again. Perhaps this new position is $43. You reinvest your $4,048 minus $10 commission and buy 93 shares with $39 left over. You now own 101 shares for your original $4,000 investment with $39 left in your money market account. This $39 is earning interest in your money market account.

With this technique on a great company, over time your investment will increase dramatically and your downside risk will be minimized. However, it is important to remember that, with any investment, there will always be some degree of risk.

This is the just the first aspect of the techniques that are taught in this book. The real power lies in learning which companies are worthy of using GOPM. I also teach you how to recognize when to buy or sell the shares of a company.

I will also not require you to spend any more money than what you paid for this book. I will show you how to find the required information that is freely available on the

Internet. I will point you to websites that currently offer this information for free as part of their business model.

I will also point you to my own website for additional information. The basic information on my website is freely available to everyone who purchases this book. You may occasionally find other things for sale there that may interest you, but it's not necessary to buy anything more to follow the techniques that I describe in this book.

Why would I do all of this for free (after you purchase the book)? Simple: I have probably been in almost exactly the same position as you are now. I assume that you are just getting started in investing in stocks and are afraid of losing a large amount of money. You may have been experimenting in the stock market and not fulfilling your goals of profitability. If either of these situations is true, then I was just like you at one point.

I am not a stockbroker. I am not a professional investor. I am not a Wall Street financier. I am not filthy rich from an inheritance. I am a guy with an engineering degree and a family who has been investing for over two decades and has lost as well as made a great deal of money in the stock market.

Since I have gone through the "school of hard knocks" in investing, I have quite a bit of knowledge to share. I have learned a few techniques that work well to find opportunities to invest in good companies. I have also learned the right time to buy or sell that stock. I learned these techniques by noting what made money and what lost money for me.

I use these techniques every day in my portfolio of investments. I am constantly going down this same path with you. I evaluate companies as to their investment merit, and then decide if I should buy today or wait until the market is a bit better.

Because I have a family, I need to be as confident as I can that my hard-earned money is in the right investment at the right time. My job provides for the basic needs of my family, but I want my money to work for me so that I can provide my family with the extras in life that we enjoy. I also want to build an investment portfolio to give me a retirement that I can enjoy.

I have a regular job (hopefully, just like you), but I know that "working for the man" will not provide me with the extra comforts in life that I enjoy. It is only when my money works for me that this will be available to me.

So here is my first piece of advice. You've hopefully read this far while still in the bookstore, because if you cannot follow this first piece of advice, this book may not be for you. My first advice to you is to get a job. Not just any job, but one that you do not hate. I tell you this because you will need that job to keep you and your family safe, healthy, and clothed while your investment portfolio grows. Some day that portfolio will provide you the extras in life.

If you cannot follow that advice, please place the book back on the shelf. If you are not able to hold a satisfying and rewarding job, then you should not invest in stocks. Do not think of the stock market as a way to replace your daily income; it is a way to augment it. That does not mean that someday your investments will not pay for everything that you need. It does mean, though, that your investments will not do it if you are just now starting out.

If you have a rewarding job, I can give you the second piece of advice: save some of that money. My old sixth grade teacher advised the following formula:

- 10% after taxes to charity.
- 10% after taxes to savings.
- 80% after taxes to live on.

You're likely to have heard of a similar rule. I doubt my old teacher invented that sage advice. It is great advice and the order is just as important as the numbers.

First, you should give ten percent of your money to those less fortunate than you. That can be via the church or synagogue if you prefer. It can be via United Way or any other charity that you choose. The key point here is that you should take care of your fellow man first before you take care of yourself.

Second, you need to put ten percent of your earnings into a savings account at the bank immediately, preferably before you even touch your wages. Most employers now offer automatic deposit of your check into as many bank accounts as you wish. Set up your direct deposit so that ten percent of your earnings goes into a different account to that in which you normally keep your money. Do not touch that account to pay the bills unless calamity has beset you or your family. This is the cushion to keep you financially secure.

Your federally insured savings account needs to build up to the equivalent of six months of your after-savings and after charity donation income. This 6-month cushion is designed to help you in case life deals you a tough hand, such as:

- If you lose your job.
- If someone in your family is diagnosed with a medical condition.
- If some catastrophe happens to you.

You will need those 6 months of income to give you a soft landing.

If you have nothing saved right now, simple math tells you that it will take you 48 months to save up this cushion. The interest does not count here since the interest on a savings account will barely keep up with inflation. If you have not started saving yet, you should put this book down and start building your savings. Once you have accomplished that minimum goal, then you can begin to invest.

> ***Note:*** *You can verify this math yourself on the web by going to www.Confident-Investor.com/ emergency_savings. You will need to be a registered user to access this page but you can register easily and for free by following the instructions on the site.*

If you are still reading, then I assume that, due to luck or good habits, you have built up a six-month nest egg. You are now in a position to use the 10% savings per month and begin to invest in the stock market. You do not want to invest your six-month cushion in the stock market. That cushion must be in a federally insured savings account with little risk of drastically reducing in value. After the cushion is there, you can start to deposit the 10% savings income into a different bank account. Instead of a bank, you may want to consider an easily accessible money-market account at a brokerage house (more on this later in the book).

CHAPTER 4

Improving the "Buy and Hold" strategy

Much of what you read and hear from "experts" is that you should "Buy and Hold" stocks and have a fixed investment schedule. They recommend that you find a quality company (or mutual fund), buy fixed amounts of stock out of your paycheck every month, and hold that stock for quite some time (maybe even decades).

The "Buy and Hold" and "invest regularly" philosophy seems easy. It also shows commitment to your favorite stocks, but it's not the philosophy that the "experts" use when they buy a stock!

> ***EXAMPLE****: Warren Buffet is considered to be one of the smartest buyers of companies ever. In a two-week span at the end of September 2008, Mr. Buffet bought stock in General Electric (NYSE:GE) and Goldman Sachs (NYSE:GS). He did not buy just a little bit; he invested billions of dollars in each company in return for a large percentage of those companies. If GE and GS were such great investments, why did not he just put a regular installment system in place to buy the stock? Of course, they made him a special deal for the investment, but that only proves that when the price is right, you need to act.*

> ***EXAMPLE****: Microsoft Corporation (NASDAQ:MSFT) acquired all of the stock of Skype in 2011. This acquisition did not happen slowly by Microsoft investing in the Skype stock every month until they owned it all.*

> *Rather, Microsoft went to Skype investors and offered to pay them more than the current market price of the company. They did this because they saw value in total ownership of the company immediately. Microsoft executives evidently felt that Microsoft would be more profitable by buying all of Skype at one time.*

The pages of the *Wall Street Journal* and *Investor's Business Daily* have stories almost every day of individuals and corporations buying substantial portions of a company. These are some of the brightest investors on the planet. They show by their actions that the prudent way to purchase stock is to find a company that is priced right and invest their cash in that company. So why should you listen to experts say to "buy and hold" on a regular basis, when many experienced investors make substantial investments?

If you bought a stock on VJ day

Let's say you were around on VJ day, September 2, 1945, which was the day that Japan formally surrendered at the end of World War II. For the month of September 1945, the Dow Jones Industrial Average was at $180. Sixty years later in September 2005, the DJIA was $4,789. That is an increase of over 2600% over 60 years.

The problem is that the increase in the DJIA was not a straight line; it went up and down the entire time. If you could not wait for 60 years but only had 40 years, the price in September 1985 was $1,329, which is only a bit better than 700% for the four decades. If you only could wait 20 years, the price in September 1965 was $931, which was a bit better than a 500% increase.

How does this compare to interest earned in a bank? If you put $180 into a bank account and it earns 8.22%

compounded daily for 20 years, then you will have about $931 (the same value as the DJIA that year). For 40 years, the $180 invested at 5% would result in your $1,329. The 60 year mark would turn your $180 into $4792 at 5.47%. This shows that the timing of your buying and selling can have a dramatic impact on the return of that investment.

"Buy and hold" may be good, but it does not necessarily mean that the longer you hold your investment, the wealthier you will become! This is due to the erratic nature of the stock market. You need a system that can maximize the return during the peaks and minimize the risk on the valleys. Five to eight percent returns seem quite small, especially for something as high-risk as the stock market.

Five to eight percent returns are probably adequate for a bank, but this is not a safe, FDIC-insured bank. This is a highly-volatile holding that can decline in value quite rapidly. Conservative banks can pay a lower interest rate because the saver can be assured that the rate of return is safe. In the stock market, your only stability comes from your understanding of what is happening to your investment.

You need a system that allows you to evaluate companies, buy into those companies that are good investments, and then transfer that money to other companies when the investment is better elsewhere. That system is described later in this book.

The above discussion also highlights another important idea: lost opportunity costs. This is a crucial concept. If you put your money into one investment that earns 3% rather than another investment that earns 6%, then you have actually lost 3% of unrealized potential. This assumes that the risk of the investment is similar between the two investments, which should also be understood. For instance:

> *Is it better to receive a guaranteed 7% return on your investment or a security that may yield anywhere from 5% to 9%? In most cases, the safer 7% is a better investment if you are unable to control the circumstances in which you need to take the profit. If you cannot wait for the investment to bounce back up from the 5%, then you will have a real possibility of losing profit or principle.*

Too many people misinterpret "buy and hold" as "buy and hold no matter what." A better phrase would be "buy to hold," as this reflects the true intention of long-term investing. When you buy to hold, you hold the investment for as long as it makes sense to do so. You should consider each investment as a new investment for that day. Do not own an asset that does not make sense.

If something changes in the investment, market, or your goals, "bought and sold" is the way to go. As an investment strategy, "sell" is not a four-letter word.

If you make a mistake in your business analysis, or if the company moves in a different direction than you expected, you sell. In addition, if the reaction of the market agrees with your analysis, and the stock that was once a good deal with plenty of benefits is now just a solid stock that probably will not drop, you should divest your initial investment to let your earnings grow on their own.

Your goal should be to sell as infrequently as possible and only to minimize the inevitable drops in the market. Ultimately, "buy to hold" simply means you need to do your homework, find a great business to own for a while, and check it regularly to re-balance and re-evaluate.

A safe investment that you should consider

While on the subject of opportunity costs, it is appropriate to have one short side conversation. The money that you invest in stocks needs to be money that you do not need immediately. This does not mean that it is not money that you will not need for 20-30 years. If you have money that you are confident you will not require for decades, you should probably invest that money in your own home. Follow the old Benjamin Franklin saying, "A penny saved is a penny earned."

If you currently pay 7% interest on your home loan, any extra money that you apply to your mortgage will immediately give you a 7% return for the balance of your mortgage term. Therefore, if you pay a one-time extra $1,000 on a 7% mortgage that has 23 years left on it, then it will result in $5,002.04 that you did not have to pay over the course of the 23 years. This is a guaranteed return: over the course of 23 years you will be more than $5,000 wealthier due to that one-time investment.

Your home mortgage is the safest "buy and hold" investment that you can make! You already know that you pay a certain percentage. If you pay the loan off early, you effectively get that loan percentage as an investment return.

The same logic also applies to your auto loan and credit cards. This is typically more short-term debt than your home but it is also debt that you are being charged a higher interest rate. Quick payoff on any short-term debt will guarantee you the quickest and best investment strategy. You are not spending those pennies, you are saving them. Benjamin Franklin will be proud of your efforts to pay off your short-term and long-term debt quickly and efficiently.

A better strategy

Since some "buy and hold" rationale makes sense, you need to have a strategy that takes the good from "buy and hold" but still gives you the flexibility to achieve an even better investment, as well as reduces your risk if the price starts to reduce too quickly.

In the stock market, it is incredibly rare for a stock to have no value. Yes, companies occasionally go out of business. However, most companies will be bought up by other companies long before they cease to exist. Your risk of losing everything on a stock is relatively small (especially if you utilize the tools discussed later in this book).

While the risk of losing everything is not that extreme, the risk of the loss of all of your profit is quite high when you are investing in stocks. Stocks have a tendency to increase in price for a while and then decrease in price for a while. If you look at any given stock chart covering two or three years, you will see a series of mountains and valleys. The system that I describe in this book encourages you to lock in your profits when the market starts to move against you. You then re-invest your original investment when the market is recovered. This uses both your original investment and your original profits to grow your portfolio.

This is a much improved version of "buy and hold" as it allows you to participate in the market with your profit and save your initial investment funds for future investment choices that present themselves to you. I call this method GOPM, "Grow on Other People's Money."

GOPM is designed to take advantage of the historical fact that stocks rarely drop to zero but are subject to wild swings. Even leading companies with excellent managers will sometimes see their stock price drop rapidly. Often, they are simply a victim of the forces that drive the market. We need to escape the market when this occurs.

GOPM simply means that we are going to allow our investment to grow until we see the market turn. At that point, we will sell enough shares to recover our original investment, but we will leave the proceeds (Other People's Money) in the form of stock. This profit may be reduced during the upcoming market reversal, but it will not be eliminated — it is locked in. When the market recovers, we will reinvest and have even more shares in the company and our money and other people's money will grow and increase our profit.

Let's look at GOPM in a fictionalized example using real-world data from NYSE:IBM. It is late February 2007. Some of your friends are discussing IBM. The company is doing great. They think everyone should get in. One of your friends, Alex, decides to buy on March 6, 2007 for $93.80. Alex has enough money to buy 100 shares. The broker he uses charges him $10 for the transaction; therefore, he paid $9,390.

The stock does not do too much for a few weeks. Alex starts to question his investment. It goes up and down a little but everyone assures him to "buy and hold." He is excited to see that the stock takes off in April 2007. The stock price goes up and down a little, but he is okay with that and is bragging about his choice of stock picks.

By July 2008, he thinks that he is the master of all investors. IBM has increased in value to 129.88. Alex' investment of $9,390 has increased in value to $12,988, an increase of $3,598!

Then October 2008 hits. This was a terrible month for many investments. Many investors took huge losses. Over-extended investors saw mammoth losses. By November 21, 2008, Alex has given up and sells his 100 shares for $7,488. That price (minus the $10 broker fee) equaled $7,478 to put back into his savings account. He vows never to buy individual stocks again. In his mind, a loss of more than $1,600 on an investment of $9,390 (almost 18%) only proves that the stock market is for gamblers.

Another friend in your group, Bruce, subscribes to the practice of regular investments in a stock. This common philosophy tries to even out the highs and lows of the market by buying more shares when the price is low and fewer shares at a higher price.

Instead of a purchase of one big allotment, Bruce decides that he will put $2,000 into IBM every three months. He sets this up with his bank and broker so that he will not fail to do this. Bruce thinks this will give him the cost-averaging that everyone tells him is the best investment strategy.

Bruce makes his first purchase a few days earlier than Alex. He buys on the first trading day of March 2007. Every three months, he makes an automated purchase of up to $2,000 plus he pays a $10 commission fee for each purchase.

By September 2008, he has purchased 121 shares of IBM stock. He has paid $13,468.24 for these shares for an effective share price of $111.31. If he sold all of the shares on September 2, 2008, he would have a profit of $7.10 per share, or $849.10 after commission fees. A satisfying profit, but not as robust as Alex' profit on September 2, which would be $2,451.

Table 4.1 - Imaginary purchases of IBM stock

Purchase date	Share price	Number of shares	Amount invested
3/01/07	$92.27	21	$1,947.67
6/01/07	$106.54	18	$1,927.72
9/04/07	$118.19	16	$1,901.04
12/03/07	$105.83	18	$1,914.94
3/03/08	$114.23	17	$1,951.91
6/02/08	$127.36	15	$1,920.40
9/02/08	$118.41	16	$1,904.56

However, just like Alex, Bruce is shocked when the floor falls out of the market in November 2008. If he chose to sell on the same day as Alex for $74.88, he would lose $36.43 per share. He must now make a tough decision – should he continue to make regular investments, should he just hold tight, or should he sell? Regardless, he has an ulcer as he worries about all of the money he just lost.

Now let's say you read this book first, and followed its recommendations on trade timing (some of which is described later in this book, so read on for more details). You are not sure that IBM is as strong as your buddies think. The company does not register as a Good company on the Confident Investor Rating scale, but you decide to take your buddies' advice and buy the stock.

In this scenario, you notice that the stock price indicators show that it will not grow in price anytime soon. You follow the stock until you think it is about to make a move. You know that you do not lose money by leaving your investment in money market fund at your brokerage.

The indicators become favorable in early April. You buy at $95.21 on April 2, 2007 and invest a total of $9,531 (including $10 commission fees). You now own a piece IBM!

In May 2007, your indicators tell you that the run may be over. You sell on May 16 for $105.87. You do not sell everything though; you only sell enough to cover your initial investment. You let your earnings to continue to grow. You protect your initial investment to take advantage of another market move. You are also prepared for a different investment that has a higher potential return. This means that you sell 91 shares to cover your initial investment, allow 9 shares to increase, and return $93.17 back into your money market account.

The 9 shares are free. The proceeds from your trade have paid for them. They did not cost you any money and were paid for by Other People's Money (OPM). You own them for free so you can let them grow. Your original investment will Grow on Other People's Money (GOPM). It is highly unlikely that these shares will ever be worthless. You have secured your initial investment and reduced your risk substantially.

In June, you see that the indicators are once again favorable. You buy another 100 shares on June 19. These shares are sold on July 30. This allows you to increase the number of free shares from 9 to 16 plus reinvest $154.15 in your money market account. You now have 16 free shares of IBM. You have now experienced GOPM since even your 9 free shares have grown and added 1 of those 7 free shares!

You repeat this scenario again. You buy on August 28 and sell on September 17. This time you add 4 more shares to your free holdings and return $9.07 back into your money market account.

These three managed and timed investments have increased your net worth by 20 shares of IBM stock plus $256.39 in cash. As of the market price on September 17, 2007, your net worth has increased by $2,546.79.

You continue this practice for a total of 9 transactions; the last occurs on August 11, 2008. Not every trade is profitable, but in the end you have accumulated 32 shares of stock and have spent only $231.06 doing it. This means you have acquired these shares at the low sale prices of $7.22 per share!

> ***Note:*** *You can look at these trades by going to www.Confident-Investor.com/ sampletrade. You will need to be a registered user to access this page, but you can register easily and for free by following the instructions on the site.*

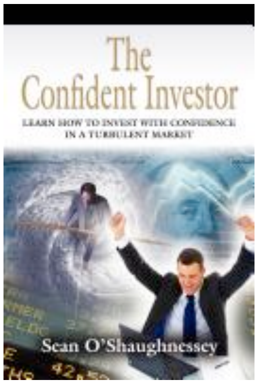
On September 2, you compare notes with your friends, Alex and Bruce. You are not in the market, but they still are. You do not think that IBM has enough potential upside compared to the downside. At September 2 prices, you have secured a current profit of $3,558.12 (larger than your friends). You are not interested in selling since you think that IBM is a respectable company. You have all of your initial investment in your money market account. You can invest that money in IBM at the right time or another company that may be a better investment.

In November, your friends are bemoaning their woeful portfolios. You have also taken a loss from your highest profit, but your loss is not nearly as damaging to your net worth. You have 100% of your initial investment. You still own 32 shares of a company you consider well-run. When the market starts to recover, you may decide to invest again in IBM. You could divest your shares in IBM on the worst day in November 2008 and still make a profit - you only paid $7.22 per share and the stock price was well above that level!

This can continue to go on forever. You buy when the market is moving in the right direction, and you sell when it gets flat or drops. You will notice that you miss the ultimate highs and the ultimate lows, but you get close enough. You keep your initial investment and hold on to your profits within the well-run company. You let that profit grow.

This is a much improved version of "buy and hold" as it allows you to participate in the market with your earnings and protect your initial investment funds for future investment choices that present themselves to you. This is the basis of the method I call GOPM, Grow on Other People's Money.

It is also relevant to note that GOPM is set up to take advantage of the historical fact that stocks rarely drop to zero, but are subject to wild swings. Even admired companies with strong managers will sometimes see their stock price drop rapidly. This is often not because they did anything wrong, but rather because they are just a victim of the forces that drive the market.



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