Chapter 1

Three Basic Rules

There is an infinite number of different investment strategies available to investors. Some books advocate specific investment strategies that promise greater riches than they can deliver. But the reader finds out the goals are unattainable long after the books are purchased. There was a book published in 1987 that forecasted the depression of 1990. It sold 400,000 copies in 1987. The author was completely wrong and earned well over $1,000,000 prior to 1990. If he had been correct he would have earned many millions more.

The primary objectives of this book are to recommend some basic investment strategies and to give some insights as to the characteristics of different investment securities. It is assumed the investors are interested in keeping the probability of winning at a relatively high level but are willing to accept some risk. Some expected return is given up in order to keep the risk at an acceptable level. The basic investment recommendations are conservative. This is not the desired objective of all investors, and if the investor's objectives are different all is not lost. Enroute to our specific recommendations we will point out alternative strategies for different objectives. We will not recommend that an investor follow a strategy that has a small probability of a very large gain and a large probability of a large loss, but we will describe such a strategy.

We can not describe a strategy that is certain to lead to very large gains and little risk relative to alternatives because such a strategy does not exist. If we did have such a magical strategy we would sell it. The investors employing the strategy would drive the price of the securities involved up and their return down to a normal return.

Different investors have different attitudes towards risk and they will accept different amounts of risk and will aim for different expected returns. There is no one investment strategy that is correct for all investors.

When a strategy is recommended in the following pages the reason for the recommendation will be explained so that the reader may judge the reasonableness of the suggestion. No sure-fire rules for achieving large riches with no risk will be offered because these rules do not exist. The best we can offer is a strategy leading to a small probability of large losses. Unfortunately, a probability of losing does exist. There are no securities in the U.S. that guarantee that you will be better off at the end of the period compared to investing in alternative securities.

Three Basic Rules

The chapter title promises three basic rules for investing. They are:

1. Diversify;
2. Take the tax implications of your investment decisions into consideration; and
3. Market turns occur but they are difficult to predict.

The book will expand on each rule but let us consider the rule that one should diversify. If the investor's objective is to earn a higher return than all other investors, then the investor should not diversify. The best strategy to beat the performance of a large number of other investors is to invest in one common stock security (or better yet buy call options; a call option is a derivative to buy the security). This strategy is very risky, but offers a probability of beating the other investors. For most of us, the investment objective is to earn a reasonable return with a reasonable probability (a sensible amount of risk). A diversified portfolio is the best way to achieve this objective.

Three Real Life Stories

One title considered for this book was "An Investment Strategy for One's Heir." It is a title with considerable merit. If we consider a strategy to be used by our heir, then we bypass the problems associated with the fact that we think that we know how to beat the market, but we would not want our heirs to follow the same strategy because we know they cannot beat the market without considerable risk.

Bad investment strategies are found in a variety of forms. Consider the senior business officer of a major corporation who died ten years after

retirement. At time of death her medium-sized estate consisted of the normal real assets (house, car, etc.) a large bank account, and many shares of the common stock of the company for which she had worked. She should have diversified her stock holdings to reduce risk.

A second story involves a nice elderly woman in her eighties barely surviving on a stock portfolio left to her by her reasonably successful husband. The portfolio was the result of a series of hunches of her husband and included 20 different securities including many of the faddish growth stocks popular during boom periods. Some of the stocks were paying zero or very low dividends. She needs to switch from growth stocks to dividend paying stocks so that she can pay her bills.

In both the situations described the strategies suggested in this book would lead to drastic changes in the portfolios. Do the strategies of this book always lead to improved results? Unfortunately, we cannot claim that degree of perfection, but they tend to improve the results.

The third story involves an executive not employing the strategies of this book who took all his savings and bought common stock of the firm that employed him. The company was a very small oil exploration company that then proceeded to be very successful in a string of drillings. The manager became a millionaire many times over. A careful reading of this book and following its advice is likely to have significantly reduced his winnings. Following the advice offered in this book will not necessarily lead to the best decisions, but it is very likely to beat the worst feasible decisions.

After the company found the oil, we know that the manager was correct in buying the firm's common stock. Before finding the oil it was far from obvious that the decision to buy a large amount of common stock in one very risky firm, where the manager was employed, was wise. The employees of Enron whose savings were invested in Enron common stock were not happy in December 2001.

Investment objectives change as one gets older. A young person might want to accumulate wealth. An old person might want the cash flow to sustain a lifestyle.

What are Our Objectives?

We want to define the nature of different securities and how to mix different securities into a portfolio that is consistent with the investor's objectives.

We will start with a basic discussion of the relevant factors to be considered and then discuss how to manipulate these factors to achieve the objectives.

The basic investment approach to be recommended in this book will strike many investors as being excessively conservative. This creates no great problem, if you object to any specific recommendations, hang in there and continue to read. You will be told how to invent your own strategy.

Throughout the book runs the conclusion that consistent with past history common stocks are a good investment, independent of the current level of the stock market. While the situation could change in the future, it is unlikely that there will be a time when the investor should ever be completely out of stocks. A mix of stocks and other securities is likely to be the suggested solution.

Some Basic Assumptions

There will be one very important assumption made throughout the book. We will assume that investors prefer higher returns to lower returns and less risk to more risk. This means that if two investments have the same risk it will be assumed that an investor will prefer the investment with the higher expected return. In like manner, if two investments have the same expected return, we will assume the investor will prefer the investment with the smaller amount of risk. We will call this type of behavior "risk aversion for the investor."

There are many real world examples, which contradict the risk aversion assumption. People do pay for the privilege of losing at the race tracks, do engage in state lotteries, and do play games at gambling casinos. Some people prefer more risk to less in these recreational situations, but we will stick with the assumption that people require a higher expected return before they willingly shift to a security with more risk.

A Fable

Many years ago in a far away country a wise old teacher was in trouble with his King. The King sentenced the teacher to death, but listened to the teacher's appeal.

The teacher pleaded for the King to give him five years in which to teach the King's horse to talk. The King liked to own unusual things and

a talking horse would certainly be unusual and after considerable thought said “yes”.

A friend of the teacher said to the teacher “Why did you make such a rash promise? You know no one has ever taught a horse to talk.” The teacher said in reply: “Sometime before the end of five years:

1. The King might change his mind and pardon me.
2. The King might forget that he sentenced me to death.
3. The King might die. I might die.
4. I might teach the horse to talk.

In any event, I gain five years.”

Note he did not promise to teach the horse to talk by next week. Why do I claim to know that the stock market is not too high from a long-term perspective? In order to prove that the market is too high from a long-term perspective you are going to need the earnings on stock over the next five, ten, 20, or more years. The financial history of the U.S. shows that common stocks have been a good long-term investment over the past 90 years. Of course, this does not prove they will be a good investment (compared to alternatives) in the future. That is why diversification is recommended.

Summary

This book will tell you how to make a reasonable return (per dollar of investment) over a long period of time with acceptable risk. If you want to earn vastly large earnings from investments in a relatively short time period, you should have an extremely large investment fund, or alternatively not follow the advice of this book.

To become vastly rich you will have to work hard, be lucky (e.g., strike oil) or marry well (financially as well as in other ways). If you have modest wealth, the strategies recommended in this book are not likely to lead to vast wealth as a result of your investment strategy, but they should help avoid poverty, and are likely to lead to reasonable wealth.

Questions

1. How does an investor diversify?
2. What activity leads to a lower expected return and considerable risk?
3. Assume a stock selling for $100 pays a $8 dividend. How much will the owner of one share net if:
    a. A zero tax rate
    b. A 0.35 tax rate
    c. A 0.65 tax rate
    d. A 0.15 tax rate
4. Name an investment that has zero risk.