42™ Rules

of Sensible Investing

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“42 Rules for Sensible Investing” Book Excerpt

By Leon Shirman

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Intro

For obvious reasons, the topic of investing is a very popular one. Countless volumes are available on many investing aspects, such as thorough analysis of past market performance, psychology of investing, stock selection, etc. Why write another book?

In *42 Rules for Sensible Investing*, I compiled practical approaches and techniques that I used over the years into a number of concise and easy-to-follow rules. The rules themselves are not new, and I am sure many people have been and are using them, either consciously or subconsciously. Some of them I arrived at by personal trial and error, some I consider to be common sense, and some were inspired by strategies used by successful investors.

I like to think of this book as a condensation of valuable investment ideas—Cliffs Notes on investing, if you will. It is not a substitution for a textbook. You will not find detailed discussions and descriptions of various methodologies here. Instead, think of it as a checklist you can refer to when you make an investment decision.

Different people can have completely different investment approaches, and still be successful. I realize and understand that. The rules presented in this book work well for me, but I don't expect you to concur with every one of them. In fact, you will probably disagree with a few. Keep this in mind when you read through the book.

I am hopeful that flipping through these rules (which you don't need to do in order) will prompt you to think about your own rules and even to write them down. Please feel free to pass these rules to others and to start a discussion. After all, these are my rules. What are yours?

Preface

Just as I have completed the first draft of this book, the markets experienced their worst week ever (October 6–10, 2008), with the S&P 500 falling by 18%. The indices are down over 40% from their latest peak reached almost exactly one year ago. We are in the midst of the greatest financial crisis since the Great Depression. What a time to be writing a book on investing!

These are certainly very scary times. Banks, suffering from massive write-offs related to the collapse of mortgage-based securities, are hoarding their cash and are reluctant to lend. If banks don't lend, businesses can't finance their daily operations and could be forced to shut down. And this being a worldwide crisis, the economy of the whole world is in serious jeopardy. That is why governments across the world are taking action to inject trillions of dollars into the banking system to prevent an economic meltdown. It is not clear at this point how successful these actions will be.

Today's events are clearly unprecedented and terrifying. But let's take a look at the previous three major bear markets. From 2000 through 2002, the market fell 45%. This was the time when hundreds of high tech companies were going out of business, erasing trillions of market value. The events of 9/11 that happened during this period were also unprecedented and terrifying. No one was sure whether we would ever feel safe at home again.

On October 19, 1987, the market fell 23% in a single day. That was the worst day loss ever, both in point and percentage terms at the time, worse than the crash that marked the beginning of the Great Depression. That was unprecedented and terrifying, and there were many doomsday predictions of markets falling

much further. It didn't happen. In 1973–1974, the market fell 48%. We had double-digit inflation and unemployment rates, and our oil supply was choked off by the Arab embargo. That, also, was unprecedented and terrifying.

Each major bear market is unique and frightening in its own way, and it seems that the world is about to end…again. But the economy and the markets recovered from each of these setbacks, and proceeded their march to new highs. I have reason to believe that this will be the case this time, too.

When I was writing this book, I, like everybody else, did not imagine that we were about to witness these calamitous days. Other than adding examples, however, I am not planning to make modifications to the book. The investing principles presented here still apply in the current situation, perhaps even more so. The events of the last several weeks, as historic as they may have been, will not change my long-term investing philosophy and the Rules for Sensible Investing.

Leon Shirman

October 13, 2008

Rule

2 Compound Interest Is Good

It is amazing how each dollar invested compounds over time. The earlier you start, the more impressed you will be.

It is said that in 1609, the Dutch purchased the Manhattan Island from a native Indian tribe for an equivalent of $24 in beads and trinkets. Do you think that it was a good deal? It may certainly appear so, but yet, if they were to invest that $24 at 10% interest, after almost 400 years it would have grown to about 800 quadrillion dollars (one quadrillion is one thousand trillion, or one million billion). This should be more than enough to purchase all real estate property not only on Manhattan, but on the whole planet.

Unfortunately, we don't have four centuries to invest, but compound interest can work wonders even in our short lifetimes. The 10% rate mentioned above is a historical average return of S&P 500—the most popular benchmark for the performance of the U.S. stock market—as measured from the early 1900's. That's on average; there were and will be big up years, and well as down years. But if you have a reasonably long investment horizon, time is on your side.

Now, let's consider a more realistic example. Let's say you take $5,000 of your savings and invest it in the stock market. In 30 years, it will grow to over $87,000. This certainly beats having that money under the mattress, or in a bank savings account. Even if you don't have that $5,000 to start, maybe you can spare $200 each month from your paycheck. If you do that for 30 years, you will have about $452,000. Again, time is on your side.

Even though I have seen results like these many times, I am continually impressed. Can it be right that one can amass over $450,000 just by putting in $200 per month? Witness the power of compounding. Albert Einstein is said to have called it the most powerful principle he ever witnessed. That is a rather strong endorsement from Einstein, as he did discover a few other powerful principles as well.

The table below shows how a single investment of $10,000 grows at various rates of return compounded annually. Two percent is what you can typically get from a savings account (if you are lucky), 5% is typical CD (certificate of deposit) rate, and 10%, as discussed before, is the historical stock market average.

Year	2%	5%	10%	15%	20%
0	$10,000	$10,000	$10,000	$10,000	$10,000
5	$11,040	$12,762	$16,105	$20,113	$24,883
10	$12,189	$16,288	$25,937	$40,455	$61,917
20	$14,859	$26,532	$67,275	$163,665	$383,376
30	$18,113	$43,219	$174,494	$662,117	$2,373,763

The difference in results over long periods of time over just a few percentage points is huge; it is stunning. This is the miracle of compounding. When your investment returns start to earn money, and these returns, too, start to earn—this is putting money to work, and the single most important reason to start investing right away.

A comparison similar to the following often appears in various 401(k) and IRA brochures, but is nevertheless worth repeating. Let's say Alice graduates from high school and reads this book and decides to invest in the stock market. From age 20 to 30, she saves $2,000 per year and invests it. That's less than $170 per month, approximately the cost of an espresso drink per day. After she reaches 30, she stops her contributions and just leaves her balance in the brokerage account.

Her friend Bob, however, does not have Alice's foresight. He spends all of his paychecks in the early years and, by the age 45, realizes that he too has to plan for retirement. He puts away $15,000 per year for 20 years. By the time they are 65, Alice will have $896,000 and Bob will $859,000—despite the fact that she contributed a grand total of $20,000 compared to $300,000 for Bob.

The bottom line is, the earlier you start, the better. Time is on your side.

Rule

3 Invest for the Long Term

Over the long term, stocks have outperformed bonds and treasury bills with less risk.

Over the long term, staying out of the stock market is more risky than being fully invested.

This statement is certainly going to cause some controversy. How can I say that? At the time of this writing, in September 2008, the Nasdaq is still below 50% of the level it reached eight years ago, in 2000. We are also in the midst of a credit crisis of historic proportions with a number of venerable financial firms failing practically overnight. It is accompanied by a bear market with all major averages down over 30% from their highs several months ago. If that's not risky, what is?

The key to this claim lies in definition of what exactly constitutes "long term" and how you define "risk." Let's take these concepts one by one.

Since 1900, the stock market returned an average of nearly 10% annually. The traditional competition to stocks, bonds and treasury bills, only returned about 4% during the same period. One dollar, invested in the stock market in 1900, would have grown to over $20,000 today. That same $1 invested into bonds would be worth only $60. Rule 2 states that compound interest is good. Indeed.

The domination of the stock market has been rather consistent over shorter periods as well. As explained in *Stocks for the Long Run* by Jeremy Siegel, over any 5-year period, stocks outperformed other investment types over 70% of the time. For 10-year periods, this number rises to

80%. Over 20 years, it goes to 95%. Finally, over 30-year intervals, stocks have always outperformed other investment types. I would say that this defines the first element in my claim, namely that long-term should mean over 20 years or more.

You may wonder whether a holding period of 20, or even 30, years applies to your situation. After all, chances are that you are not planning to hold a particular stock or a mutual fund that long. However, I am talking about the holding period of the entire portfolio, regardless of the number of changes you may make in it. And this holding period, in most cases, will run for several decades.

Now, let's take a look at risk. Traditionally, many people think of risk as the possibility of losing a substantial part of their investment. Looking again at performance of stocks vs. bonds and treasury bills, over any period of 10 years or longer, the maximum loss suffered by stocks was less than that suffered by bonds and treasury bills. Even in the worst 5-year period, the maximum loss from stocks was only one percentage point higher than that from bonds.

In mathematical terms, risk is often defined as the standard deviation of average annual returns. Standard deviation measures how widely spread the values are from the average. Using this formal definition, again, over any period longer than 20 years, stocks carried less risk than competing investment types.

The superior performance of stocks does come with a price of short-term volatility. Back in the 1800's, Mark Twain said: "October is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February." Over a few months or even years, no one can argue that this danger is all too real. However, history shows that over longer terms, stocks are in fact less risky, if one sees risk as lost opportunity. In the long term, the risk of investing in "safe" securities and realizing subpar returns is far greater than the risk of short-term fluctuations in the stock market.

Rule

10 Stay Invested at All Times

Jumping in and out of the market jeopardizes your returns. Stay the course instead.

If you accept that it is impossible to time the market on a consistent basis, as discussed in Rule 9, then logically it follows that you should always stay invested in the market. This conclusion is certain to raise some controversy. The power of hindsight is just too great, and you do hear stories of other investors who had the foresight of not only avoiding bear markets, but also of hedging or even going short during the slide.

You can spend a lot of time looking at the charts that show past performance but today, now, no one can say for sure which direction the market will turn tomorrow. Various studies have shown that past movements cannot reliably predict future results. In one test, eight charts were given to a number of traders who used technical analysis. Four of them were charts of actual stock performance, and the other four were randomly generated by a computer. The traders were not able to distinguish between the real and simulated charts.

Staying out of the market, you are also likely to miss some big up days. If you invested $10,000 in 1997, it would have grown to $22,000 by 2006. Missing ten best days during that time would have reduced the return to $14,000. Missing 20 best days would reduce it further to $9,600—below your original investment. Granted, it could take some talent to specifically miss the best days, but nevertheless I think that this illustrates the point.

Staying fully invested doesn't mean that you have to keep holding the stocks that you already have. In fact, it is necessary to keep re-evaluating your portfolio and make sure you are holding the best selections you can possibly choose (see Rule 25). In any kind of market, one can always find stocks with good current prospects.

What about hedging? Hedging is essentially an insurance against market declines. Note: many, but not all, hedge funds practice hedging; see Rule 6.

One of the most common hedging techniques is a purchase of put options, for example, on a market index such as the S&P 500. Hedging, however, could be quite expensive and, used constantly, may cost you many percentage points in decreased overall performance. While hedging could prevent you from suffering big losses during market declines, its constant high expense in the long term, during flat or rising markets, could drive your overall returns significantly lower—very possibly lower than if you did not have any hedging to begin with.

I started my investing career in 1987, after the big correction that year, and stayed fully invested ever since. Yes, I do admit that this was true even in 2000. Moreover, I had very high exposure to tech stocks, since I have a technical background and was actively involved in that industry then. I did have the foresight, however, of not buying into dot com enterprises with no revenues. But, as you know, even solid tech stocks with real earnings fared very poorly during that bear market. In late 2000 and 2001, I re-evaluated my portfolio and sold many tech stocks and replaced them with other equities, while staying fully invested. My portfolio originally suffered together with the rest of the market, but fully recovered to its year 2000 highs in about four years. Granted, it would have been nice to sell out at the top in 2000, but according to many analysts, markets were already overpriced back in 1995. Remember "irrational exuberance?" Should you have sold then?

Today, in September 2008, as in 2000, we are in bear market territory. The market may continue to go down, but it may also turn up tomorrow. No one knows for sure. I do believe that it is prudent to stay the course rather than tempt fate by jumping in and out.

Appendix

A

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Appendix

B Internet Resources

1. http://finance.yahoo.com/
   Market news, detailed information on stocks, quotes, etc.
2. http://www.fool.com/
   News, tutorials on investment topics, stock recommendations
3. http://www.j3sg.com/
   Information on insider activity
4. http://www.888options.com/
   Good summaries of various options strategies

Appendix

C Glossary

Accredited (Qualified) Investor A high net worth individual or entity that can invest into hedge funds. Needs to have at least $1million in net worth, or have an annual income of $200K if single or $300K jointly if married.

Bear Market A declining market that drops at least 20% from peak to trough.

Bond A promissory note issued by a company or government to repay the principal plus interest for a specified period of time.

Bull Market An advancing market.

Call Option A contract that gives the buyer the right, but not the obligation, to buy an underlying security at the strike price before or on the expiration date.

Capital Gain (Loss) Profit (loss) from sale of an investment.

Compound Interest A way interest accrues over time.

Correction A drop of at least 10% in the market from peak to trough.

Covered Call Strategy A strategy to sell call options while owning the underlying stock.

Diversification Spreading investments among different securities or different investment types.

EBITDA — Earnings before interest, taxes, depreciation, and amortization.

Exercise — An act of an option buyer to use his right to buy or sell an underlying stock at the strike price.

Expense Ratio — A percentage of invested assets that a mutual fund charges for its services.

Expiration Date — The date an option ceases to exist.

Fundamental Research — Analysis of companies based on financial metrics, such as sales, earnings, assets, etc.

Hedge Fund — A type of mutual fund that is not regulated by the SEC and is usually available only to accredited investors.

Hedging — A technique that acts as an insurance against possible market losses.

In the Money — Option contract where the strike price is above the current stock market price for calls, and below the market price for puts.

IRA — Individual Retirement Account.

Leverage — Ability to control a certain amount of investments by committing only a fraction of the funds required to purchase these investments.

Limit Order — An order to buy or sell a security at a specified price.

Load — A charge, expressed in percentage of invested assets, that a mutual fund may charge for buying (front load) or selling (back load) its shares.

Lock In Period — A time interval, imposed by some hedge funds, when an investor is unable to sell his position in the fund.

Margin Account — An account type that permits the account holder to borrow funds from the brokerage with existing securities and cash as collateral for the loan.

Margin Call	A demand upon an account holder to deposit additional cash or securities to maintain margin requirements.
Market Capitalization	Total market value of a security, calculated by multiplying stock price by the number of shares outstanding.
Market Order	An order to buy or sell a security at the current price.
Mutual Fund	An investment company that pools together investors' funds and makes investment decisions on their behalf.
Option Premium	Cost of options contract.
Out of the Money	Option contract where the strike price is below the current stock market price for calls, and above the market price for puts.
P/E Ratio (Price to Earnings Ratio)	Price of stock divided by earnings per share over a one-year period.
PEG Ratio	P/E Ratio divided by stock earnings growth rate.
Penny Stocks	Low priced issues, usually below $1, very often highly speculative.
Put Option	A contract that gives the buyer the right, but not the obligation, to sell an underlying security at the strike price before or on the expiration date.
P/S Ratio (Price to Sales Ratio)	Price of stock divided by sales per share over a one-year period.
Qualified Investor	*See* **Accredited Investor**.
SEC	Securities and Exchange Commission.
Short Selling	Transactions where one borrows a security from a broker and immediately sells it, hoping it will go down in price so that one can profit by buying it back at a lower price and returning it to the broker.

Stop Loss Order — An order to sell a stock if it drops below a specified price.

Strike Price — A price at which an option can be exercised.

Technical Analysis — Analysis of markets and stocks based on past price movements, charts, trends, etc.

Treasury Bill — A short-term bond issued by the U.S. government.

About the Author

Leon Shirman earned his Ph.D. in Applied Mathematics from the University of California at Berkeley in 1990. He turned his attention to investing in 1987, after a market crash that year. In 2002 Shirman founded his investment fund, Etalon Investments, where he is the Managing Partner, as well as a major shareholder.

Prior to launching his investment career, Shirman worked in prominent high-tech companies, such as Sun Microsystems and Microsoft, and in start-ups, including one he founded. His research has yielded a number of publications in scientific magazines, as well as numerous U.S. patents.

Shirman lives in Redwood City, California with his wife and two daughters.

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