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Peter Lynch: Use Your Edge

By Peter Lynch

What's the best way to invest \$1 million? Tip one: Don't buy stocks on tips alone. If your only reason for picking a stock is that an expert likes it, then what you really need is paid professional help. Mutual funds are a great idea (I ran one once) for folks who want this sort of assistance at a reasonable price.

Still, I'm not convinced that having 4,000 equity funds in this country is an entirely positive development. True, most of the cash flooding into these funds comes from retirement and pension contributions, where people can't pick their own stocks. But some of it also has to be pouring in from former stock pickers who failed to invest wisely on their own account and have given up trying.

When people find a profitable activity -- collecting stamps or rugs, buying old houses and fixing them up -- they tend to keep doing it. Had more individuals succeeded at individual investing, my guess is they'd still be doing it. We wouldn't see so many converts to managed investment care, especially not in the greatest bull market in U.S. history. Halley's comet may return ten times before we get another market like this.

If I'm right, then large numbers of investors must have lost money outright or badly trailed a market that's up eightfold since 1982. How did so many do so poorly? Maybe they traded a new stock every week. Maybe they bought stocks in companies they knew little about, companies with shaky prospects and bad balance sheets. Maybe they didn't follow these companies closely enough to get out when the news got worse. Maybe they stuck with their losers through thin and thinner, without checking the story. Maybe they bought stock options. Whatever the case, they failed at navigating their own course.

At the risk of repeating myself, I'm convinced that this type of failure is unnecessary -- that amateurs can not only succeed on their own but beat the Street by (a) taking advantage of the fact that they are amateurs and (b) taking advantage of their personal edge. Almost everyone has an edge. It's just a matter of identifying it.

While a fund manager is more or less forced into owning a long list of stocks, an individual has the luxury of owning just a few. That means you can afford to be choosy and invest only in outfits that you understand and that have a superior product or franchise with clear opportunities for expansion. You can wait until the company repeats its successful formula in several places or markets (same-store sales on the rise, earnings on the rise) before you buy the first share.

If you put together a portfolio of five to ten of these high achievers, there's a decent chance one of them will turn out to be a 10-, a 20-, or even a 50-bagger, where you can make 10, 20, or 50 times your investment. With your stake divided among a handful of issues, all it takes is a couple of gains of this magnitude in a lifetime to produce superior returns.

One of the oldest sayings on Wall Street is "Let your winners run, and cut your losers." It's easy to make a mistake and do the opposite, pulling out the flowers and watering the weeds. Warren Buffett quoted me on this point in one of his famous annual reports (as thrilling to me as getting invited to the White House). If you're lucky enough to have one golden egg in your portfolio, it may not matter if you have a couple of rotten ones in there with it. Let's say you have a portfolio of six stocks. Two of them are

average, two of them are below average, and one is a real loser. But you also have one stellar performer. Your Coca-Cola, your Gillette. A stock that reminds you why you invested in the first place. In other words, you don't have to be right all the time to do well in stocks. If you find one great growth company and own it long enough to let the profits run, the gains should more than offset mediocre results from other stocks in your portfolio.

A lot of people mistakenly think they must search far and wide to find a company with this sort of potential. In fact, many such companies are hard to ignore. They show up down the block or inside the house. They stare us in the face.

This is where it helps to have identified your personal investor's edge. What is it that you know a lot about? Maybe your edge comes from your profession or a hobby. Maybe it comes just from being a parent. An entire generation of Americans grew up on Gerber's baby food, and Gerber's stock was a 100-bagger. If you put your money where your baby's mouth was, you turned \$10,000 into \$1 million. Fifty-baggers like Home Depot, Wal-Mart, and Dunkin' Donuts were obvious success stories to large crowds of do-it-yourselfers, shoppers, and policemen. Mention any of these at a party, though, and you're likely to get the predictable reaction: "Chances like that don't come along anymore."

Ah, but they do. Take Microsoft -- I wish I had.

I avoided buying technology stocks if I didn't understand the technology, but I've begun to rethink that rule. You didn't need a Ph.D. in programming to recognize the way computers were becoming a bigger and bigger part of our lives, or to figure out that Microsoft owned the rights to MS-DOS, the operating system used in a vast majority of the world's PCs.

It's hard to believe the almighty Microsoft has been a public company for only 11 years. If you bought it during the initial public offering, at 78 cents a share (adjusted for splits), you've made 100 times your money. But Apple was the dominant company at the time, so maybe you waited until 1988, when Microsoft had had a chance to prove itself.

By then, you would have realized that IBM and all its clones were using Microsoft's operating system, MS-DOS. IBM and the clones could fight it out for market share, but Microsoft would prosper regardless of who won. This is the old combat theory of investing: When there's a war going on, don't buy the companies that are doing the fighting; buy the companies that sell the bullets. In this case, Microsoft was selling the bullets. The stock has risen 25-fold since 1988.

The next time Microsoft might have got your attention was 1992, when Windows 3.1 made its debut. Three million copies were sold in six weeks. If you bought the stock on the strength of that product, you've quadrupled your money to date. Then, at the end of 1995, Windows 95 was released, with more than 7 million copies sold in three months and 40 million copies as of this writing. If you bought the stock on the Windows 95 debut, you've doubled your money.

Many parents with children in college or high school (I'm one of them) have had to step around the wiring crews as they installed the newfangled campuswide computer networks. Much of this work is being done by Cisco Systems, a company that recently wired two campuses my daughters have attended. Cisco is another opportunity a lot of people had a chance to notice. Its earnings have been growing at a rapid rate, and the stock is a 100-bagger already. No matter who ends up winning the battle of the Internet, Cisco is selling its bullets to various combatants.

Computer buyers who can't tell a microchip from a potato chip still could have spotted the intel inside label on every machine being carried out of the computer stores. Not surprisingly, Intel has been a 25-bagger to date: The company makes the dominant product in the industry.

Early on, it was obvious Intel had a huge lead on its competitors. The Pentium scare of 1994 gave you a chance to pick up a bargain. If you bought at the low in 1994, you've more than quintupled your investment, and if you bought at the high, you've more than quadrupled it.

Physicians, nurses, candy strippers, patients with heart problems -- a huge potential audience could have noticed the brisk business done by medical-device manufacturers Medtronic, a 20-bagger, and Saint Jude Medical, a 30-bagger.

There are two ways investors can fake themselves out of the big returns that come from great growth companies.

The first is waiting to buy the stock when it looks cheap. Throughout its 27-year rise from a split-adjusted 1.6 cents to \$23, Wal-Mart never looked cheap compared with the overall market. Its price-to-earnings ratio rarely dropped below 20, but Wal-Mart's earnings were growing at 25 to 30 percent a year. A key point to remember is that a p/e of 20 is not too much to pay for a company that's growing at 25 percent. Any business that can manage to keep up a 20 to 25 percent growth rate for 20 years will reward shareholders with a massive return even if the stock market overall is lower after 20 years.

The second mistake is underestimating how long a great growth company can keep up the pace. In the 1970s I got interested in McDonald's. A chorus of colleagues said golden arches were everywhere and McDonald's had seen its best days. I checked for myself and found that even in California, where McDonald's originated, there were fewer McDonald's outlets than there were branches of the Bank of America. McDonald's has been a 50-bagger since.

These "nowhere to grow" stories come up quite often and should be viewed skeptically. Don't believe them until you check for yourself. Look carefully at where the company does business and at how much growing room is left. I can't predict the future of Cisco Systems, but it doesn't suffer from a lack of potential customers: Only 10 to 20 percent of the schools have been wired into networks, and don't forget about office buildings, hospitals, and government agencies nationwide. Petsmart is hardly at the end of its rope -- its 320 stores are in only 34 states.

Whether or not a company has growing room may have nothing to do with its age. A good example is Consolidated Products, the parent of the Steak & Shake chain that's been flipping burgers since 1934. Steak & Shake has 210 outlets in only 12 states; 78 of the outlets are in St. Louis and Indianapolis. Obviously, the company has a lot of expansion ahead of it. With 160 continuous quarters of increased earnings over 40 years, Consolidated has been a steady grower and a terrific investment, even in a lousy market for fast food in general.

The best companies often thrive even as their competitors struggle to survive. Until recently, the airline sector has been a terrible place to put money, but if you had invested \$1,000 in Southwest Airlines in 1973, you would have had \$460,000 after 20 years. Big Steel has disappointed investors for years, but Nucor has generated terrific returns. Circuit City

has done well as other electronics retailers have suffered. While the Baby Bells have toddled, a new competitor, WorldCom, has been a 20-bagger in seven years.

Depressed industries, such as broadcasting and cable television, telecommunications, retail, and restaurants, are likely places to start a research list of potential bargains. If business improves from lousy to mediocre, investors are often rewarded, and they're rewarded again when mediocre turns to good and good turns to excellent. Oil drillers are in the middle of such a recovery, with some stocks delivering tenfold returns in the past 18 months. Yet it took a decade of lousy before they even got to mediocre. Readers of my column in *Worth* learned of the potential in this long-suffering sector in February 1995.

Retail and restaurants are two of the worst-performing industries in recent memory, and both are among my favorite research areas. I've taken a beating in a number of retail stocks (some of which I still like and have continued to buy), but the general decline hasn't stopped Staples, Borders, Petsmart, Finish Line, and Pier 1 Imports from rewarding shareholders. Two of my daughters and my wife, Carolyn, have continued to shop at Pier 1, reminding me of its popularity. The stock has doubled in the past 18 months.

A glut in casual-dining outlets didn't hurt Outback Steakhouse, and a surplus of pizza parlors didn't bother Papa John's, whose stock was a double last year. CKE Restaurants -- whose operations include the Carl's Jr. restaurants -- has been a profitable turnaround play in California.

So far, we've been talking about growth companies on the move, but even in this so-called extravagant market, there are plenty of bargains among the laggards. Of the nearly 4,000 IPOs in the past five years, several hundred have missed the rally on Wall Street. From the class of 1995, 37 percent, or 202 companies, are selling below their IPO price. From the class of 1996, 33 percent, or 285, now trade below their offering price. So much for the average investor's never having a chance to profit from an offering. In more than half the cases, you can wait a few months and buy these stocks cheaper than the institutions that were cut in on the original deals.

As the Dow has hit new records week after week, many small companies have been ignored. In 1995 and 1996, the Standard & Poor's 500 Stock Index was up 69 percent, but the Russell 2000 index of smaller issues was up only 44 percent. And while the Nasdaq market rose 25 percent in 1996, a lot of this gain can be attributed to just three stocks: Intel, Microsoft, and Oracle. Half the stocks on the Nasdaq were up less than 6.9 percent during 1996.

That's not to say owning these laggards will protect you if the bottom drops out of the market. If that happens, the stocks that didn't go up will go down just as hard and fast as the stocks that did. I learned that lesson in the 1971–73 bear market. Before the selling was over, companies that looked cheap by any measure got much cheaper. McDonald's dropped from \$15 a share to \$4. I thought Kaiser Industries was a steal at \$13, but it also fell to \$4. At that point, this asset-rich conglomerate, with holdings in aluminum, steel, real estate, cement, fiberglass, and broadcasting, was trading at a market value equal to the price of four airplanes.

Should we all exit the market to avoid the correction? Some people did that when the Dow hit 3000, 4000, 5000, and 6000. A confirmed stock picker sticks with stocks until he or she can't find a single issue worth buying. The only time I took a big position in bonds was in 1982, when inflation was running at double digits and long-term U.S. Treasuries were yielding 13 to 14 percent. I didn't buy bonds for

defensive purposes. I bought them because 13 to 14 percent was a better return than the 10 to 11 percent stocks have returned historically. I have since followed this rule: When yields on long-term government bonds exceed the dividend yield on the S&P; 500 by 6 percent or more, sell stocks and buy bonds. As I write this, the yield on the S&P; is about 2 percent and long-term government bonds pay 6.8 percent, so we're only 1.2 percent away from the danger zone. Stay tuned.

So, what advice would I give to someone with \$1 million to invest? The same I'd give to any investor: Find your edge and put it to work by adhering to the following rules:

With every stock you own, keep track of its story in a logbook. Note any new developments and pay close attention to earnings. Is this a growth play, a cyclical play, or a value play? Stocks do well for a reason and do poorly for a reason. Make sure you know the reasons.

Pay attention to facts, not forecasts.

Ask yourself: What will I make if I'm right, and what could I lose if I'm wrong? Look for a risk-reward ratio of three to one or better.

Before you invest, check the balance sheet to see if the company is financially sound.

Don't buy options, and don't invest on margin. With options, time works against you, and if you're on margin, a drop in the market can wipe you out.

When several insiders are buying the company's stock at the same time, it's a positive.

Average investors should be able to monitor five to ten companies at a time, but nobody is forcing you to own any of them. If you like seven, buy seven. If you like three, buy three. If you like zero, buy zero.

Be patient. The stocks that have been most rewarding to me have made their greatest gains in the third or fourth year I owned them. A few took ten years.

Enter early -- but not too early. I often think of investing in growth companies in terms of baseball. Try to join the game in the third inning, because a company has proved itself by then. If you buy before the lineup is announced, you're taking an unnecessary risk. There's plenty of time (10 to 15 years in some cases) between the third and the seventh innings, which is where the 10- to 50-baggers are made. If you buy in the late innings, you may be too late.

Don't buy "cheap" stocks just because they're cheap. Buy them because the fundamentals are improving.

Buy small companies after they've had a chance to prove they can make a profit.

Long shots usually backfire or become "no shots."

If you buy a stock for the dividend, make sure the company can comfortably afford to pay the dividend out of its earnings, even in an economic slump.

Investigate ten companies and you're likely to find one with bright prospects that aren't reflected in the price. Investigate 50 and you're likely to find 5.