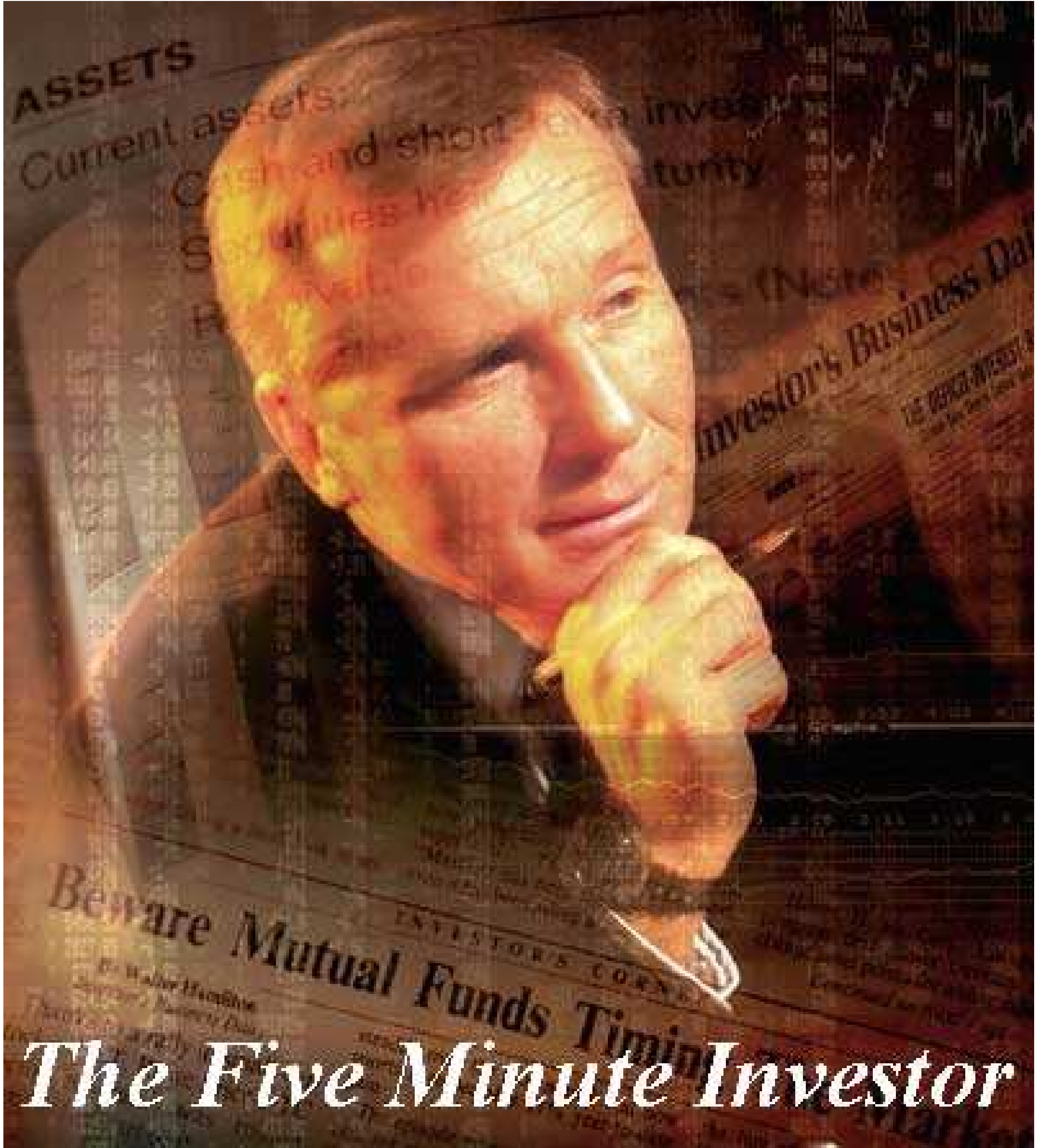
ASSETS
The Five Minute Investor

The Five Minute Investor Contents

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Chapter 1: Replacing Stock Market Myths

In the Introduction to Five Minute Investing, I mentioned that the ideas and approaches developed in this book would be unorthodox. In this chapter, I hope to point out and correct a few of the popular myths that abound in regard to stock investing. There are many more that exist, of course, but I've attempted to identify and address the most destructive ones. Please study this chapter carefully, and feel free to test any of the assertions I make in the laboratory of the market. Debunking these myths and replacing them with concepts that are closer to the truth is foundational to understanding the rest of the book.

Myth #1: The stock market is a form of gambling

Perhaps at the heart of many other stock market myths is the idea that investing in stocks is a form of gambling. Remarkably, I recently heard someone who was introduced as an "economist" say as much on a national radio news broadcast! As of this writing (1995), some of this myth has been dispelled by the relatively steady returns enjoye d by investors is recent years, versus the up and down markets experienced during the 1970s. Still, many folks consider stock investing to be fundamentally different than investing in bonds, certificates of deposit, and other more -predictable investments.

To understand why stock investing is inherently different than gambling, first we need to review what common stocks are. In the most basic terms, a share of common stock entitles the owner of that share to a fraction of what is left over after all other s takeholders in a business have been paid. So, the firm takes in revenue from customers in return for the firm's product, and with that revenue pays for raw materials, employee wages, energy, supplies, and pays interest on borrowed funds. Whatever is left o ver, if anything, belongs to the holders of the firm's stock, who are essentially the owners of the firm. Depending on business conditions and how well the company is managed, the amount left over for the shareholders can be very large, very small, or even negative.

It is obvious that the common shareholders see more variability (risk) in what they take home than bondholders, raw material suppliers, employees or anyone else involved in the operation of the firm. The common shareholder stands last in line t o be paid, and because of this additional risk the shareholder demands a higher expected return than does the bondholder. In the stock market, investors are constantly trying to assess what will be left over for the shareholders both now

and in the future. This is why stock prices fluctuate - because the outlook for business conditions are always changing, and what will be left over for the owners of a particular firm is always changing too. But, one thing is for sure: common shareholders expect their returns to be volatile, but they also expect them to be *positive* and *permanent* over the long run - and higher than the return on bonds, treasury bills, or other less risky investments. That is, the shareholders don't expect to give up all their gains - despite the fluctuations in value, the returns at some point become permanent. For as long as common stocks have existed (hundreds of years), this expectation has been met: Stocks have had their ups and downs, but have trended steadily higher in value over the years. And, they have increased in value at a faster pace, on average, than dollars invested in more predictable vehicles such as bonds or treasury bills.

It is this steady upward progression in the value of stocks that sets them apart from gambling in a major way. You could buy a set of stocks, and hold them for the rest of your life. Although they would fluctuate in value over your lifetime, chances are they would greatly increase in value during that period of time. However, no other person would have *lost* money simply because your portfolio of stocks gained in value. This is not true with gambling. In gambling, every dollar won is a dollar lost by someone else. It must be this way because gambling produces nothing, creates nothing, and therefore can only return to a winner what it took from a loser. The value of common stocks increases without taking wealth away from anyone; in fact when the stock prices increase, the amount of aggregate wealth increases for society as a whole. This is because common stockholders *do* produce something: They postpone the consumption of goods (ie, they save some portion of their income) in order to supply the seed capital needed to buy production equipment and produce goods. They get the ball rolling, so to speak, for firms wishing to produce goods.

Here is another fact which highlights the vast differences between gambling and stock investing: When gambling, the longer you stay at the gaming tables, the more likely you are to walk away a loser. In the stock market, the longer you stay at it the better chance you have of coming away a winner. In fact, if you buy and hold a well-diversified portfolio of stocks, you are virtually assured of making money eventually. Of course, many people do lose money in stocks, but only because they fritter their capital away with excessive or ill-founded trading strategies.

Every stock investor needs to know why investing and gambling are two totally different pursuits. Once you realize this, it will give you confidence in pursuing a long-term plan for investing and will make you less prone to the destructive forces of fear and greed.

So, the two facts to retain regarding myth #1 are as follows:
Gambling transfers wealth from a winner to a loser because it produces nothing. Investing increases overall wealth because the capital invested in stocks provides the initial funding for firms which exist for the purpose to producing goods and services.
The value of stocks trends steadily upward over time. They do not seesaw back and forth in the same range forever. In the aggregate, stock investors demand and receive a return that is *substantial* and *permanent*.

Myth #2: Stock Market Predictions are the Key to Successful Investing

One of the greatest popular myths about investing in stocks is that in order to be successful, you must be able to predict the stock market's movements. Why do people assume this? For some, it is because they do not understand that stocks give a positive and substantial return over time - they falsely assume that stocks bounce around in the same range forever, and they therefore conclude they must predict movements in order to be able to sell at the top of the range and buy at the bottom of the range. For others, the desire to predict is borne out of human nature, which puts a premium on certainty. We love to know what will happen in advance. Hence, it is usually assumed by the beginning investor that to be successful, one must first become an expert at forecasting future market trends. Experienced investors know, in fact, that nothing could be further from the truth.
Some icons of Wall Street love to advance the cause of market predicting, because they are paid to predict these movements. Others simply humor their clients who are looking for market projections because they know that it is easier to give them a projection than to try to correct the clients' thinking. For instance, nearly every retail brokerage firm has a chief economist or market strategist whose main responsibility is to predict the climate for stocks. A large number of books, advisory services, and such that are sold focus themselves almost exclusively on prediction of how the stock market in general will perform in the future. But in truth*, the best way to make money in the stock market is to avoid approaches that rely on market predictions.* This will most likely seem an odd or even a absurd statement to some, perhaps most. Yet, any serious review of the results of market gurus over a long period of time reveals a track record that is no better (usually worse than) a simple buy-and-hold strategy.

Don't misunderstand me: There is no doubt that if a person *could* accurately predict the short-term fluctuations of the stock market, that person could far exceed the return of someone who simply bought a basket of stocks and sat on them. However, the one fatal problem with this is that there has never been a single person who has figured out how to do it. Nearly all market advisors claim to be able to call the market's every turn, but in fact every credible study ever done on the subject has proven that these claims are invariably false. By far, most market prognosticators significantly under-perform the market, despite their universal claims to the contrary. Given the large number of market gurus that now exist, the laws of statistics dictate that **some** of them **must** beat the market, out of pure luck if nothing else. However, they lack the ability to repeat this performance from one time period to another, and the group of market beaters will usually be a different group every time period that is sampled. If you could predict which guru would be right for the next year, you would be in good shape. But, of course, it's just as hard to predict which guru (or which dart board) will be right for the coming year as it is to accurately predict market conditions. Finally, even if we are generous and assume that there is some market forecaster out there who has the holy grail of market prediction, our chances of being able to sort him out from those who simply got lucky are pretty slim.

As of this writing, the market prognosticators who are most successful over the past ten to fifteen years are those who have been perpetually bullish. Although we all get bearish once in a while, we do best when we keep our bearish feelings from affecting our actions. Therefore, I recommend that you feel free to have your opinions about where the market is heading, but always invest as though the market is going higher. Over the long run, you will be better off than if you had jumped in and out of the market. Of course, you have to exercise some caution in having an optimistic viewpoint; the best policy is to only invest money that you can afford to be patient with if the market stalls or backtracks. If you take out a huge mortgage on your home with the expectation of investing it for a quick payoff, you are tempting fate and your emotions of fear will almost certainly cause you to fail.

If results are any indication, the conclusion must be that market forecasting is prone to failure. One of the purposes of this book is to free you from the compulsion we all seem to have to predict future market trends.

An alternative mindset to the prediction game

If we are not going to spend our energies wondering where the market is going, then how can we succeed in the stock market?

The key is to develop a method which will react to events *as they occur*, and will ensure that our returns are as good or better than the returns on the general market, whatever those market returns may be in the future. We can essentially ignore what "the market" is doing - or especially what it is forecasted to do in the future. We own our particular set of stocks, not "the market." What we really need is a method which concentrates on how *our stocks* are actually doing, as opposed to how they will do in the future. We own our portfolio of stocks. The Reverse Scale Strategy is such a method and will be developed later in this book once its theoretical underpinnings are explained.

If you just can't help yourself...
As most investors eventually learn, market prognosticators are notoriously inaccurate. If you already know the futility of market forecasting but feel that you simply *must* predict the market, I will reveal at this time how **you** can be as good as the best market gurus in predicting the market: When you get up each and every morning for the rest of your life, make this astonishing prediction: "The market will be up today." If you make that your prediction every single day you will be as accurate as some of the best people in the field of economics, having achieved a long-run accuracy of about 60%. Despite people's fears of bear markets, the market spends most of its time advancing, not declining.
In the long run, a good investment strategy that doesn't rely on prediction will beat a market forecasting strategy.

Myth #3: What goes up must come down

The statement "what goes up must come down" is certainly true in the natural world, and it's often assumed to be true in the world of investing as well. I will attempt to convince you that this assumption will lead you to make some pretty significant strategic errors in your investing.
If you refer to the conclusion from Myth #1, you will see that in the aggregate, stocks trend upward over time and at some point, they advance to the point where they will never again return to their previous levels. As we have noted previously, stock investors demand a permanent return on their investments, just as investors in other types of assets demand a permanent return on theirs. A good high-profile example of this is the Dow Jones Industrial Average, which is now at about 5,000. In the 1930s, it was around 50. I do not expect to ever see it at 50 again. So, from here the Dow may dive to 3,000 or it may continue advancing, but there is a certain point below which it will

never again dip. So, certainly the gains enjoyed by shareholders up to Dow 2,000 or so may be considered "permanent." At some time in the future, the gains up to Dow 5,000 will also become permanent as the market will at some point dip to the 5,000 level for the last time. Naturally, there is no way to tell when that will occur.

Certainly, some individual stocks do go up rapidly, then give back the entire gain just as rapidly. All seasoned investors have had this disappointing experience. However disappointing it may be to have a good profit going and then see it evaporate, do not let this bitter experience lead you to believe in taking profits too quickly. If you do, it will cost you the really big gains, in the long run.

If you think about it, the fact that the entire stock market marches higher, often never to return, then there must of necessity be some individual stocks that also advance without returning to their previous lower price levels. In fact, this is the case more often than not. Even so, the average person commonly expresses the belief that when they have a profit going they should take the money and run - often leaving a lot of money on the table when they do.

Of course, the grain of truth in this myth is the fact that any stock trend consists of a series of advances and retreats, resulting in a net increase over time. So if you are going to believe the statement "what goes up must come down," then keep in mind that it often happens that a stock moves *way, way* up, and then comes down just a little. Think of it this way: If a stock increases tenfold in value and then undergoes a 20% correction, we are still ahead by eight-fold.

Given enough time, stocks of individual companies often make substantial price progress over time, and sometimes with no major pullbacks in price. As an example, following is a listing of stocks whose prices increased remarkably over a period of recent years:

Stock	**Price Move**	**Time Period**	**Percentage Gain**
Fastenal	$7/8 to $38	1987-95	4,242%
Linear Technology	$2 1/8 to $38	1989-95	1,688%
Jupiter National	$3 1/2 to $27	1991-93	671%
Mid-Atlantic Medical Services	$2 3/8 to $27	1991-94	1,078%
Micron Technology	$3 to $95	1992-95	3,066%

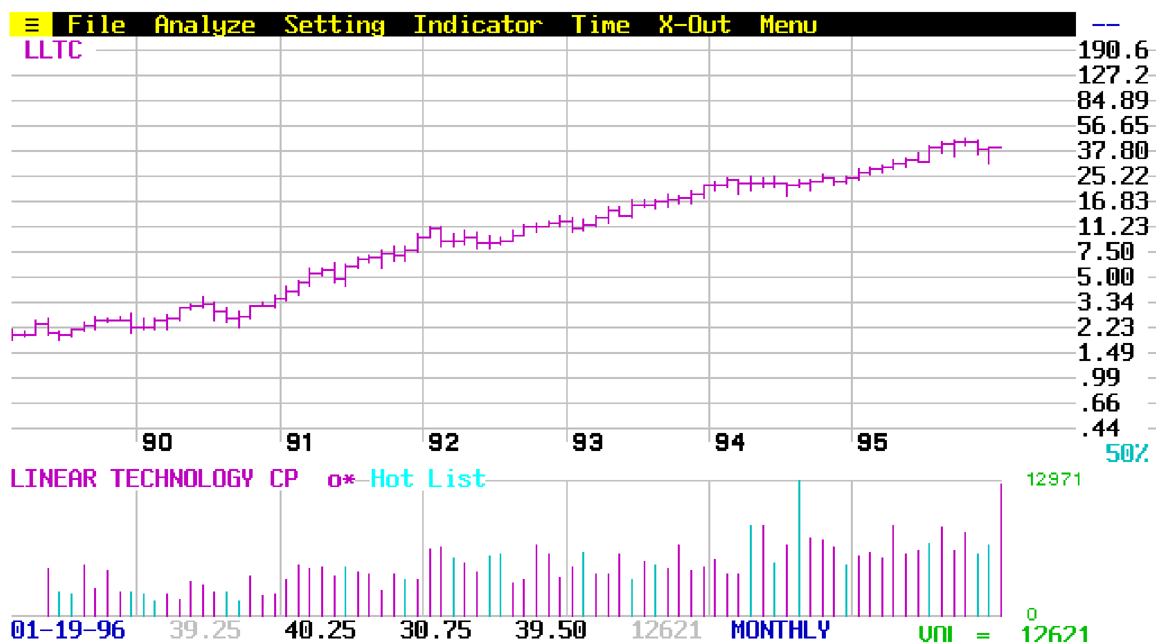
There are many, many others. Obviously, these are the types of stocks you want to find and hold onto. You won't find them often, naturally, but eventually you will find them if you use the stock selection criteria in Chapter 4.

It's educational to note that all the above listed stocks spent a lot of time on the daily new-highs list while they were increasing in value. The **new-highs list** is published daily in most financial newspapers. It is a list of stocks which traded above their previous high price for the past 52 weeks.

Linear Technology, as an example, hit a new 52-week high on 1/3/90, at $2 3/4. It topped out (so far as of this writing) at $45 5/8 on 11/9/95. There were 1,491 trading days between those two dates, during which Linear Tech appeared on the new-highs list 157 times, meaning it made it onto the new-highs list about once every two weeks, on average. During those 1,491 trading days, Linear Technology did not appear on the 52-week-lows list even once. Yet, incredibly, many people go to the new-lows list when prospecting for stocks! They ignore the new-highs list, assuming that the stocks listed there are "too high." In so doing, they decrease their chances of finding the next Linear Technology from pretty good to almost nonexistent.

Just because a stock has had a large increase in price does not mean it cannot increase further. Stocks which are hitting new highs often continue making additional new highs in price.

Following is a chart of Linear Technology's price trend from 1989 to 1995:



With this chart in front of you, it is an excellent time to rid yourself of another popular strategy often heard on financial talk-shows and in investment newsletters, namely: "Buy good stocks on pullbacks." As you can see from the chart of Linear Technology, many of the best-performing stocks do not have significant pullbacks while they are increasing in value. So, by waiting for a good stock to pull back, you will most likely doom yourself to sitting on the sidelines while a stock makes a tremendous move upward, without you. When it finally does

have the pullback you've been waiting for, that may be the beginning of the stock's demise.
Once a good performing stock has been identified, don't wait for a pullback in price before taking your position. In the long run, this will cost you more in profits than it saves in losses.

Myth #4: What goes down must come back up; or Buy low, sell high.

This myth is the granddaddy of them all. In the subject of investing, probably no more destructive misconception has ever been conceived than the idea of buying low and selling high. Whatever the reason for its appeal and widespread popularity, no myth is more pervasive among amateur investors. The emotional appeal of this myth leads investors to commit many of the most grievous errors listed in Chapter 2 on the most common investor mistakes.
Stocks make all price movements in trends. Sometimes these movements are small, sometimes huge. Given enough time, most stocks eventually have some large price trends which develop. Although most people know this, few take the time to realize the implications of it. As will be covered later in this book, one of the most common investor mistakes is to buy stocks that are "down" in price. The common assumption is that if a stock has gone from 40 to 10, it is somehow more likely to get to 40 again than is a stock that has gone from 4 to 10. They are both at 10, but the majority of novice investors assume the stock that is "down" in price will be a better bet than one that is trending upward. This is exactly the opposite of the truth!

If you are to succeed in the stock market, you simply must eradicate from your mind the appeal of buying declining stocks!

Think about this: If a stock is destined to go from 5 to 100, it of necessity must pass through 6, 7, 8, 9, 30, 50, 80 etc. to get there. It does not have to (necessarily) pass through 4, 3, 2 or 1 on its way to 100. This is why picking stocks that are trending upward in price gives you a better chance of finding timely, winning stocks than buying stocks in a declining phase. Why then, do most beginning investors tend to choose stocks that have declined in price, rather than choose ones that are at all-time highs? Simply put, because they "feel" safer buying a stock that once sold for a higher price. This false sense of security has led many investors to the poorhouse over the years.
Most investors will find it useful to study a long-term chart book in order to get a feel for how stocks make large price moves. Some good references for doing this are Long-term Values, published by William

O'Neill and Co, and the Value Line Investment Survey. As you study these long-term charts, note just how many stocks have made 300 - 1000% moves. You will find that such moves are not at all uncommon, and some of them happen in an almost uninterrupted manner. Sometimes, stocks will even make more stunning moves of 2000-3000% over longer periods of time. It is inevitable that any stock in an uptrend will have periods of correction (short-term pullbacks in price), but most often there are some long trends where pullbacks do not exceed 30% of the stock's peak price.
Study the price chart of a stock that has had a large (four to ten-fold) increase in price and note carefully just how many times this stock made a new all-time or at least a 52-week price high. From this you should learn that **someone who is afraid to buy (or hold onto) stocks making new highs would automatically *guarantee* that they will *never* reap the benefits of large price moves.** And yet, it is only by owning these very strong stocks that the true profit potential of stock investing is realized. By studying the way in which price trends occur, you will give yourself confidence to hold onto your winners rather than succumbing to the temptation to sell your winners to 'lock in' profits. This is why trading strategy (or the way you manage your stock picks) is just as important as which stocks you pick.

It is impossible to reap big profits from the stock market unless you are willing to buy and hold onto stocks that are making new all-time highs in price. Further, stocks that are at new price highs tend to do better than those making new price lows.
Eventually, everyone finds stocks that will ultimately turn out to be big winners - but not everyone ends up profiting from them. It is your *trading strategy* that will determine whether or not you reap the benefits of the winners you find.

Valuation measures

If you are to make really big money in the stock market, resign yourself to the fact that just about everything you buy, if you are buying stocks correctly, will seem too high priced by just about any traditional measure of valuation. This is because traditional measures of a stock's value generally are of little usefulness in circumstances where earnings are growing very quickly. Use of these measures as stock selection criteria often misleads investors into buying stocks that are declining in price. For instance, Price/Earnings (P/E) ratios are a commonly misused measure of a stock's attractiveness as an investment. Many investors try to buy stocks that are selling for very

low P/E ratios, meaning that the stock is selling for a low price relative to the previous year's earnings. They believe that if the stock is selling at a low P/E ratio, then the stock must increase in value. This approach to selecting stocks is flawed because it assumes all companies have roughly the same future earnings growth prospects. However, the reality is that companies have vastly different outlooks for growing earnings and that is why the market rightly assigns a low P/E ratio to some stocks and a high one to others. There are companies which grow earnings at 2 to 3% per year for years and years on end. There are also companies which grow earnings at 20 to 30% per year over many years. It is absurd to assume, as proponents of a low-P/E ratio strategy do, that a company which is positioned for high growth should be priced the same as a stodgy company in a shrinking industry.
Another popular but flawed concept which leads investors into buying stocks which are declining is the practice of purchasing stocks which are selling for a low price relative to "book value." Book value is calculated by taking the value of the assets owned by the firm and subtracting out any debts the firm may have. There are three problems associated with using this calculation as a investment screening parameter:

- Book values as calculated by accountants often bear no resemblance to the real value of assets on the balance sheet.
- Firms which are selling for a low price relative to book value are selling for a low price for a very good reason: these firms invariably are earning a very low return on their assets. After all, the value of a firm's assets really do not matter; what matters most is what the firm can earn on those assets for their shareholders. A person looking for low prices relative to book value forgets that most firms which are earning substandard amounts on their assets generally keep on earning low rates of return.
- Much of the earning power of a firm is determined not by physical or financial assets, but instead by the abilities of the people working for the firm (human capital) and by the position of the firm in the market it serves. Book values capture none of this and thus ignore completely the most critical assets which a firm possesses.

It is best to avoid stocks that are declining in price, even if they have financial measures which appear to make them good values.

Stocks that appear to be cheap by financial measures and are falling in price tend to keep falling, and what seems too expensive and is rising in price tends to keep on rising.

Chapter 2: Things to Avoid

Building upon the last chapter, we are now ready to explore and face the mistakes that nearly every beginning investor makes. Do not skip over this or any other part of the book because you need to be aware of these mistakes. Otherwise, you may spend years learning these lessons the hard way. Practicing these errors versus not practicing them makes a very large difference in your rate of return, not just a small difference. Generally, in fact, it will make the difference between a large positive rate of return and a large negative rate of return.
Obviously, there is a relationship between the investor myths of the last chapter and the errors reviewed here. Each of these mistakes is traceable to the myths. As was said earlier in the book, if you are to change your investment results, you must first change your thinking. If you have read and understood what's been written so far, you are well on your way to doing this.

Mistake #1: Not having an exit plan before buying

No matter how well or poorly founded, every stock selection strategy produces both losers and winners. In the case of both losers and winners, the reason for selling a stock is always the same: To preserve capital and allow you to re-deploy it to more profitable investments. The relevant question is, "how to determine the right time to sell?"
The time when you can think most clearly about why you would eventually sell a stock is **before** it is purchased. Before you buy anything, you have no emotional attachment to it, which means you can make totally rational decisions. Once you own something, you tend to get either greedy or scared. These emotions lead to a desire to preserve profits, leading to prematurely cutting off an ascending price trend.

How not having an exit plan hurts your performance

Big losses are one thing which destroys most investor's performance, and these are almost always a direct result of the investor failing to plan, before entering a trade, how he will exit it. Since the potential gains from a stock are always higher than the potential losses (100% loss potential versus unlimited upside potential), an even bigger source of under-performance is selling too soon when you do find a great winner.
An exit plan is one thing that experienced investors/traders always have before initiating a position. The reason is simple: you must have

a plan and stick to it, or else every decision you make will be emotional, not rational. Worse yet, the larger the position is, the less rational your decision-making will be. Therefore it is vital to make all decisions up front, before you are scared (if the position happens to go down), or greedy (if it soars). Emotional decisions almost always are poor ones, leading to large losses and small gains .

The pitfalls of trying to manage a stock portfolio without a plan are many and varied. The advice of friends, stockbrokers, market advisors, and the like are all likely to have a magnifying effect on the natural elements of fear and greed that are present in every investor. These influences can cause someone who does not have a well-thought-out plan to abandon profitable positions and hang on to losing ones. This is exactly why the majority of amateur investors under-perform the market: they do not have a plan. As the saying goes, "when you fail to plan, you plan to fail." This saying is as true in the stock market as it is in any other aspect of life.

With emotions running rampant from a loss or a large gain, it is virtually impossible to make a good decision. This is precisely the point at which most investors fail: They have no preconceived plan for exiting a stock before they buy it. As a result, when they hear a tip or rumor on a stock they get so excited that they forget to ask themselves what they will do if it turns sour, or if it soars, what will be their plan for letting the profit ride? If the investor who doesn't plan ahead also happens to believe some of the myths presented in Chapter 1 then his/her chances of making a good decision are almost nil. If you are a decision-maker of any kind, you no doubt realize that making decisions based on wrong assumptions renders your chances of success to be minuscule. For this reason, the need for an exit plan based on sound theory before a stock purchase cannot be overemphasized. Unfortunately, most investors don't want to think about planning ahead, (especially for adverse possibilities) when they are buying a stock - they put the selling criteria decision off until it is unavoidable, and usually too late.

An exit plan must be identified for every investment before the investment is made. This plan should cover all possible outcomes of the trade, both profit and loss.

Mistake #2: Plunging too much into a stock all at once

Another common error committed by many investors is *plunging*. This means that the investor makes two mistakes: First, they purchase entirely too large a position in a single stock. Secondly, they do it all at once. The real problem with doing this is that the investor puts

themselves in a perfect position for their emotional decision-making to run wild. Typically what happens is the following: First, the plunger takes a huge position. Then, his stock either begins declining or increasing. In either outcome, the emotions of plunging work against the poor investor. For if the stock declines, the plunger will either get scared and sell out with a loss that is a sickening percentage of his capital, or hold on in hopes of an increase in value (which may well never happen). If the stock increases in value, the investor will often have a large dollar gain that is hard to resist cashing in. In this latter case, the investor makes the mistake of cutting his winnings short. In short, plunging leads to cutting your potential gains short and letting your losses keep mounting...exactly the opposite of what you should be trying to accomplish.
Almost always, the plunger lacks an exit plan for the purchase before buying. If the plunger had thought about an exit plan beforehand, he probably would have realized the potential pitfalls and would have taken a more appropriately-sized position.
Plunging can work occasionally if one is fortunate enough to select a stock that immediately increases in value and never looks back. However, in most cases the plunger has such a large percentage of his capital riding on a single stock that the emotions of greed and fear work against him in a major way. The normal fluctuations of stock prices have an exaggerated effect on the plunger's emotions by virtue of the huge amount of capital represented by the position.

Taking too large of a position leads to emotional involvement which leads in turn to poor decisions. It also exposes you to the potential for lots of damage from one bad trade. Diversify - don't bet the farm.

Mistake 3: Failing to cut losses

A certain percentage of stocks you choose will show themselves to be losers. Count on this fact. These losers must be dealt with in some way in order to limit their impact on your overall performance. Once a stock starts to decline it can become a vicious cycle, leading to even more declines. As unbelievable as it seems to the novice investor, the more and longer a stock declines the more it is apt to continue declining, or continue going sideways.
Even if a stock does come back, it will likely take a long, long time to do so, and time is money. For this reason, it is important to stop the bleeding once it becomes apparent that you have chosen a loser. Here as elsewhere, the actions of most investors are opposite the logical course of action. Most hold on to their losers, hoping against hope that

the stock will someday pull itself together. Some also hold on because they can't face up to the fact that they made a mistake. They reason (poorly) that as long as they don't sell, then they haven't really lost anything. This is a error because the value of their stock is the current market price, not what they paid for it - but their rationalization helps them feel better about themselves. The driving force behind this type of thinking is dealt with in Chapter 3.

The other compelling reason for selling losers is the concept of *opportunity cost*, that is, the money you could have made by redeploying your capital to a more promising investment. Often, the opportunity cost of holding a losing stock is far greater than the loss on the stock itself. Let's say we have $10,000 invested in a particular issue and it declines to where it is worth only $8,000. There are two reasons to consider selling the stock in this example. First, the stock is clearly in a downtrend, and like most trends, the decline is most likely to continue. If it does, the decision to sell may save us as much as $8,000, the current market value of our stock.

The second reason for considering cutting our loss short is that by redeploying the $8,000 into a stock that is trending upward, we increase our chances of making up the $2,000 loss more quickly than if we'd continued to hold the losing stock, waiting for it to come back. The distinct possibility exists that we could make up the $2,000 loss and make an additional $8,000 profit by redeploying our capital from the declining stock to the ascending one. All the while, the original purchase may still be languishing far below where we dumped it. While there are no guarantees that the ascending stock will continue ascending, it is a much better bet statistically than the declining one. In the stock market, going with the long-term statistics is a key to long-term success.

Beware of the common compulsion to hold onto your losers. If you do succumb to this temptation, your portfolio may still be profitable (as long as you also do not sell your winners), but it will not be as profitable as it could be.

Mistake #4: Selling too soon

Another error that cuts seriously into many investors results is the error **of selling a winning stock too soon**. Though it might seem that this is a relatively minor problem, it actually is a very serious error because it robs you of your really big profits. **I believe it is a bigger mistake than failing to cut your losses, because in a properly diversified portfolio the potential profit from any one stock is far more than the potential loss.** That's simply another way of saying that the most you can lose on a single stock is 100% of

what is invested, but the potential gain from every stock is unlimited. If your objective is to make as much money as you can, then you *must* put yourself into a position to *hold onto* really big winners when they come your way. If you have a strategy that emphasizes taking the money and running every time you get a double or triple, then you are seriously shortchanging yourself.

Think big

I believe the reason most investors fail to hold onto winners long enough is that they simply do not realize how big a move can sometimes be realized. They wrongly assume that if a stock has doubled or tripled then that is about the best they can hope for. However, investors who take the time to study the history of stock trends know better. Sometimes a stock that has doubled will go on to make another tenfold increase from there. It can (usually does) take years for this type of move to occur, but over a several year time frame your chances of finding a huge upward trend is far better than you'd think. Again, the best way to convince yourself of this is to get a long-term stock chart publication and start studying it.

Price Objectives

Another insidious reason for investors selling too soon is the use of *price objectives*. This is when you buy a stock and set a price that you will sell at if and when the stock makes it to the target price. These target prices are usually arrived at as a certain percentage above the entry price, or else are based on some analyst's assessment of the 'value' of the stock.
However arrived at, I feel that the use of target selling prices is a seriously flawed practice. One of the enigmas of the stock market is the tendency for what seems overvalued to keep going higher still, and what seems reasonably valued or cheap to keep on retreating. The reason is that when a company's earnings are (or are about to start) growing rapidly, the price of the stock may be high relative to the current earnings, but only a few times the next year's *actual* earnings, if next year's earnings could be known. The stock may even be selling for many times the earnings *estimate* for next year, because it takes time for good trends to be recognized and assimilated by stock analysts. Thus, stock analysts' earnings estimates for coming years tend to lag when something good is brewing, just as they often lag when bad things are in the works. The thing to remember about this is that the aggregate consensus of all market participants (as reflected in

the stock's price trend) tends to be more accurate and more timely than published earnings estimates.

If you study stock trends I believe you will come to the conclusion that the trend of a stock is a more accurate indicator of when to sell than are calculated estimates of a stock's 'value.' Why then are price objectives used? The reason they are so popular is because of the need for retail brokerage houses and newsletter writers to give some sort of selling advice to large numbers of retail clients. Through the use of price objectives, the task of giving advice to large numbers of people is made manageable for the advice-giver. However, it seldom results in the best possible outcome for the client. This is a good reason to become your own investment advisor and portfolio manager.

The use of price selling targets mostly results in you capping your profits, as you cannot possibly make *more* of a profit than that which is reflected in the target price. Finally, it should be obvious to all that capping your profits is not a good thing. If you employ a strategy which cuts your losses but also caps your gains, by definition you'll be worse off than if you had bought your stocks and done nothing but sit on them forever.

Don't try to guess how far a stock can move up. If you do not give your stocks a lot of room to move upward, you will *guarantee* that your stock market profits will be below average.

Mistake #5: Choosing stocks that are in a downtrend

Buying stocks which are in a downward price spiral is the most common mistake among novice investors. In order to profit from such a strategy, you need to be right about two things at once : First, that the stock's slide will end (a surprising number never do until they become worthless), and secondly, the timing of when (and at what price) the stock's slide will end. Your chances of being right about both things are slim.

The typical scenario for this particular mistake is an inexperienced investor scouring the stock pages looking for stocks near their 52-week lows, since this information is readily available. The novice wrongly assumes that if a stock is near its low for the year then it must be "low" and therefore in an opportune position to be bought. As we have seen, the hapless bottom-fisher finds out after it is too late just how easy it is for such a stock to keep on making new (and even lower) 52-week lows.

As an aside, it's interesting to note that it's fairly common that a stock which is today making a new 52-week high has as its 52-week **low** a price that was a 52-week **high<** a year ago. That might seem like a

confusing statement but if you think about it, it will make a lot of sense. If the stock has been in an uptrend for a year or more, that price which was once a new high will now be listed as the lowest price for the past 52 weeks. Beginning investors usually do not even consider the possibility that this could be true, so they keep on buying dogs until their portfolio looks like a kennel.

Often, investors convince themselves that buying a stock from the 52 -week lows list is not a risky proposition because of that stock's low price relative to past earnings, book value, or some other measure of "value." But in reality buying a downtrending stock is always risky, as you are betting against the entire market's assessment of the company's earnings trend. If a stock is making a serious decline it is because market participants know some facts about the company's future earnings potential - facts that you may not be aware of no matter how well you research the company. Seldom is the entire market wrong about these matters. Sometimes the market is wrong, of course, but your chances of finding those exceptions are mighty slim because you are only one of thousands of people who are looking for such leads. It is very hard for one person to correctly second -guess the sum total wisdom of thousands of other investors. Try to keep in mind that your objective is to maximize profits, not to outsmart the market. The two objectives are vastly different.

Much of the problems associated with this strategy have already been dealt with in Chapter 1, under the section: Buy Low and Sell High. There is no need to rehash that section now. However, the practice of buying downtrending stocks is such a pervasive and major error that the importance of eliminating it from your bag of tricks cannot be overemphasized.

Listen to the signals of the market. If a stock is trending steadily downward, there is a good reason for it. Find greener pastures elsewhere.

Mistake #6: Adding to a losing position

Another strategic error commonly practiced by many amateur investors is adding more money to a losing position. The reasoning in the mind of the investor who does this goes something like this: "I bought the stock when it was $40. Now it is $20, so it's twice as good a deal as it was at $40. Besides, my average cost per share will come way down once I add to the position." Sometimes this is called **dollar cost averaging** - putting an certain dollar amount into a stock at specified time intervals or at specified price intervals when the stock drops in value.

When an investor adds to a position on equal time periods (i.e., $1,000 every quarter) independent of the price of the stock, I call it **Time-Based Dollar Cost Averaging**. When an investor invests an equal dollar amount each time a stock declines in price by a certain level (i.e., $1,000 with each 20% decline in price), it is called **Price-Based Dollar Cost Averaging** - (this practice is sometimes called Scale Trading and is discussed in Chapter 6). What you need to remember is that while Time-Based DCA can make sense if done in a controlled manner, Price-Based DCA makes no sense in any circumstances and is sure to bankrupt you if practiced consistently. The rest of this section I want to devote to explaining why you must never practice Price-Based DCA as a strategy, because it is the most destructive of all investor mistakes and represents in the extreme why you should never add to a losing position.

The fallacy of Price-Based DCA can best be illustrated by the following example. Let's assume we have the ability to anonymously observe a certain naive investor, Mr. Jones, who is going to pursue a Price-Based Dollar Cost Averaging strategy. Mr. Jones picks a portfolio of ten stocks and puts $10,000 into each stock, for a total investment of $100,000. Just for fun, let's also assume we know ahead of time that one of the stocks in Mr. Jones's portfolio is going to go bankrupt (that is, decline until it becomes worthless) sometime within the next year. (Of course Mr. Jones doesn't know this, and we aren't going to tell him, either). But, since he is a devout Price-Based DCA advocate, his trading rule is that whenever one of his stocks *declines* 50% in price from his purchase point, he will sell $5,000 worth of one of his better-performing stocks and use the proceeds to buy more shares in the declining stock. If the issue declines *another* 50% from his *second* purchase point, he will sell another $5,000 of one of his other stocks and again add to this declining stock. Can you guess what will happen to Mr. Jones over the next year as we watch him trade? It should be an agonizing thing to watch because, as you may have figured out by now, Mr. Jones's strategy will over the course of the next year *automatically allocate all of his capital to the stock that is to go bankrupt*. This is because there are an infinite number of sequential 50% declines that can occur between his initial purchase point and zero. He will lose his entire $100,000 unless he has the good sense at some point to realize what a bloody poor strategy he has.

If you pursue a Price-Based DCA strategy consistently, eventually you will encounter a Waterloo as Mr. Jones is about to. This is because inevitably you will someday get a stock in your portfolio that is bound for the scrap heap. When you do, cut the loss and don't even *think* about adding to the position! Otherwise, you may find yourself standing in bankruptcy court with Mr. Jones.

When you have a losing position, it means something is starting to go wrong. Never add to a losing position.

Mistake #7: Falling in love with a stock

It's a common mistake to have a good run with a stock and then decide that you will *never* sell it. Some folks have a hard time parting with something that has done so well for them, but again, what your emotions tell you to do and what you *should* do are two different things. Save the 'till death do us part' thing for your marriage, not for your stocks. Even a noted long-term investor like Warren Buffett takes profits occasionally. As of this writing (1995) many people are of the mindset that bull markets go on forever, but few remember that Buffett cashed out nearly completely in the late 1960s. Besides, few people have the skill to pick truly long-term investments the way Warren Buffett has. So for most of us the time comes when it makes sense to redeploy our assets to something more productive.

Every gardener knows that the fruit of even the best-growing plants eventually needs to be picked before it turns overripe and finally, rotten. Likewise, even the stocks that grew so well in their season eventually need to be sold. Some plants are annuals, lasting but a single outstanding season and then dying. Others are like apple trees, bearing fruit year after year, but eventually they decline in productivity and die or produce substandard fruit. A stock can have a phenomenal rise that lasts many years, but most will eventually start lagging and break down. In the most extreme case, they may go from star to oblivion and bankruptcy. Therefore we must reap, but we need to make sure that our reaping is not done prematurely but allows for long-term growth. The perfect system would be one which tells us the exact top, but that is impossible in reality. We must instead find a balance between selling too soon and selling too late. It must not be done based on guesswork but instead on the actual performance of the stocks in your portfolio. There is no doubt that our chances of making really big money on a stock increases commensurate with the length of time we hold it. As you will see later, the Reverse Scale Strategy sets its parameters so that we do not engage in short-term trading.

Try to remain emotionally unattached to a stock so that you are not blinded to what the market is telling you about it.

Mistake #8: Trying to "Get Even" with a Stock

One of the big investor mistakes I've observed is that some investors, once they've taken a loss on a stock, keep looking for an opportunity

to buy that same stock. Without realizing it, they become enamored of the stock simply because it has "done them wrong." Like an adolescent ratios been beaten up, they are looking to "get even." "I'll show that stock," they say to themselves. By so doing they lose focus of what they are trying to do: Make money, not save face. There are thousands of companies available for them to invest in , s o why do they keep coming back to a proven loser? The answer is, of course, ego. Ego is one of the most destructive forces that you can unleash on your investment performance, and we will take a close look at how it manifests itself in the next chapter, so you can recognize it. It crops up in everyone now and then, but when it does, you must resist it and think logically.

If you are fishing and a fish slips off your hook, do you refuse to pull in any fish other than the one that got away, from then on? Of course not - you throw your line back into the water in hopes of catching "a fish," not "*the* fish." It seems obvious when fishing, but unfortunately, many people's common sense goes out the window when it comes to the stock market. They keep gunning for th at one particular stock, ignoring the other rich targets which abound around them. Thus, one mistake begets another.

Sometimes, people also return to a stock because they had such a good experience with it. They made some good money off this stock and so they have warm, fuzzy feelings for it. Again, this is not logical thinking unless the stock has recovered and is showing itself still to be one of the stronger stocks in the market.

Once you have sold a stock, forget it, whether it was sold for a profit or a loss.

Chapter 3: Know Yourself

As you have probably seen by now, the emotions and predisposition's we are all imbued with tend to work against us in the world of aggressive investing. Often to succeed in this business we need to develop the ability to do exactly the opposite of what our emotions are telling us. To do this effectively, it is necessary to ferret out the real reasons why we are investing in the first place. While 'to make money' is likely the obvious reason, in reality there are myriad reasons why we try our hand at stocks. These range all the way from the money objective, to wanting to feel good about ourselves, to garnering the respect of others. These are at least as strong as the money factor, and when you think about it, money is usually the means for achieving something else - like respect, etc. Only misers want money alone. From a practical standpoint, we are all a mixture of these reasons and more. Therefore, if we are to succeed, it may be helpful to know what our own true motivations are. Whatever your reasons for wanting to succeed at stocks, you simply *must learn* to keep your ego in check because it is the one thing that will lead you to make the wrong moves. I cannot psychoanalyze you, but I offer this chapter as a means for you to psychoanalyze yourself.

My way of illustrating the motivations of investors will be to study the two basic types of investors. One of these is an extremely humble fellow, who does not care much about whether he is viewed as smart or ignorant by his acquaintances, but he does what he needs to do in order to optimize his investment results. The other is a proud person who cares primarily about his image in his own mind and in the minds of others. Swallowing his pride to increase his investment results is out of the question for him.

There is a little bit of both persons in each and every one of us. Before you embark on any investment approach it is best to search yourself to see which elements are present in yourself and attempt to root out the attributes of the ego-driven investor and bolster the characteristics of the results-oriented investor.

The ego-driven Investor

The ego-driven investor sees investing as something exciting. He mostly does it as a way to garner the admiration of others. He may also see it as entertainment. He is constantly talking about this or that great deal, imagining that others will stand in awe of his prowess and immense wisdom. In reality, he most likely does not really make too

much money in the stock market, a fact which he hides from the outside world by any means possible.

Worst of all for the ego-driven type, he never gets any better at his investing. To admit he has been doing something wrong, even to himself, is more than his sensitive ego can take. Since the aura of being an investment wizard is simply a way for him to gain affirmation from others, he really doesn't care too much whether the results are there as long as he can still stay in the game and keep talking about his smart deals at cocktail parties. Of course, he conveniently forgets the bad ones and keeps turning over in his mind his best deals and how smart he must be. He certainly never does a post-mortem on any of his losing trades to figure out just why they were losers. He simply blames the loss on his broker, the company's management, or stock manipulators. He can't ask anyone what he may have done wrong, since to admit he's made a mistake to someone else goes directly against the grain of his objectives - to appear wise to others.

One way in which our friend Mr. Ego deals with losses is by stubbornly holding on to his losing trades, no matter how bad they get. He reasons that until he sells, he hasn't really lost anything, so why sell? Never mind that his broker sends him statements every month telling him that his account value has dwindled - he really *has* lost money - whether or not he admits it or not. In this way he assures himself that he can never really redeploy what's left of his capital into something more promising.

The ego-driven investor doesn't enjoy buying a stock that has already doubled in value, even if it could increase another 1,000% from there. The idea that someone else was "smarter" than him and bought at a lower price is more than he can bear thinking about. On the other hand, he dearly loves to buy stocks that are in a downtrend because there is a chance that he will be the one who will buy the stock at its low for the year. Imagine what bragging rights that would give him! Of course, most of the time he buys these types of stocks and they just keep going down, down, down. But that's OK, as these deals are unknown to anyone in his circle of friends. The prospect of that unlikely but alluring "buying the bottom" scenario keeps him coming back for more - losses, that is.

Even when he does get lucky and happens to stumble into a winner, Mr. Ego is his own worst enemy. He waits until the stock hits a new high for the year and then promptly sells out to lock in his profit. Of course, this stock was in an uptrend and keeps right on sailing far above where he exited. That's OK by Mr. Ego, though: he now has a profit that can be exaggerated the next time he sees his friends. Will they ever be impressed!

Thus, the ego-driven investor's strategy is complete: he always holds onto his losing stocks and when something starts to go right, he bails out faithfully. He has plenty to talk about at parties, but there is no way he can ever make a decent profit. The real tragedy is owed to the fact that since he blames others for all of his problems, he will never get any better.

The results-oriented Investor

The results-oriented investor seldom talks with others about his investment results. Really, he is too busy trying to make his results better. He is never too proud to buy a stock that is making new highs, realizing that those who are buying the stock most likely know far more than he does - and a winning company is more likely to keep on winning than a losing company is. The fact that someone else was smarter and bought at a lower price does not worry him; it is against his nature even to have such a thought occur to him. He is far too focused on trying to pick stocks that are performing well to entertain these types of thoughts. He compares his performance against others' performance only as a means of learning and getting better.
When the results-oriented investor finds himself with a stock that is zooming ahead, he holds on, letting the stock continue to do well for him. Conversely, when a stock stumbles badly enough that his predetermined plan says it is time to exit, he acts in an unhesitating manner. He follows his plan for buying and selling whether that means selling at a gain or at a loss. He also never sells a stock as it is making a new high, since his concern is not in selling the top but rather in letting his winning positions run their course. He does not mind selling a stock after it has retreated 50% in value, if being patient through price corrections is what allows him to capture the occasional 1000% gain.
One big difference between the results-oriented investor and the egoist is what he does with losses. While Mr. Ego blames others and learns nothing, the results-oriented chap studies in great detail how his loss occurred, and eventually figures out the fallacies in his thinking and/or system. Therefore he always gets better and better at what he is doing. He even keeps a notebook on each loss and records what he could have done better.

Don't forget why you are investing: *To make money*. If you have any other reason for investing, find another pastime.

Chapter 4: Stock Picking

Stock investing is something that has been made out to be far more complicated than it needs to be. There are far more complicated approaches to stock-picking than those presented in this chapter, but the guidelines presented here will result in 95% of the results of those approaches with only 5% of the time, effort, and confusion. Since the name of this book is Five Minute Investing, I have chosen to build these guidelines in such a way as to minimize your time commitment while helping you avoid the investor mistakes outlined in previous sections.

1) Look for positive price momentum

Most investors search diligently for companies where some good situation is developing - and rightfully so. They do this by asking brokers, looking for stories in the press, etc., but few stop to realize that the stock market itself gives them a list of such companies every day in the form of the new 52-week highs list. Most likely it's because they have believed some of the misconceptions dealt with in Chapter 1 and wrongly felt that if something appeared on the new-highs list, it's too late to buy. Actually, nothing could be further from the truth.

The simplest, best way to assemble a list of potential high performers is to refer to this new 52-week highs list included in just about every financial newspaper. I highly advocate that investors begin their stock picking expeditions by referring to this list. Remember that companies on the new-highs list do *not* get there because a certain financial reporter likes them, or because the government thinks they are good for society, or because a brokerage firm will get a hefty commission if the stock appears there. Stock market investors themselves who are knowledgeable about the company in question put them on the list by voting with their own hard-earned dollars, bidding the price up to new highs. Stocks do not appear on it unless there is something **in fact** really good and tangible happening with the company's prospects. Furthermore, few good situations develop in one day; they develop over many weeks, months, or years. So, many of the uptrends evidenced in the new highs list will most probably continue on for some time. Not all will, but as long as our strategy allows for weeding out those stocks that do not continue increasing in price we will probably be all right. This part will be dealt with later in the book.

Ask yourself the following two questions:

> How often does a company make a new price high when something good isn't happening?
>
> How often does a company where something really good is happening fail to trade close to or at a new high price?

I believe the answer to both of these questions is *seldom*. All trends eventually come to an end and stocks can go from making new highs to making new lows with breathtaking rapidity. But even in that extreme case, if you utilize the Reverse Scale Strategy introduced in Chapter 7, you may be able to react before major damage is done to your portfolio value. If something very good or bad starts to happen to a company's earnings trend, it will most likely start to show up in the trend of the stock long before you will read about it in the press - or hear about it from your broker. But the stocks that show positive momentum by appearing on the new-highs list have a excellent chance of continuing their trends. In a nutshell, the new-highs list technique isn't infallible, but then neither is the stock-picking advice of your broker.

I believe you are almost always better off picking your own investment ideas because you will know why you picked them. Also, you will be more aware of what is happening in the market since you won't have delegated responsibility for your money to someone else - someone who most likely has hundreds of individual accounts to oversee. It is your money and the more personal attention you can give to it, the better off you will be. Certainly, unless you are very wealthy, you can give more attention to your portfolio than can a broker or advisor. However, it may be best to let your advisor manage the majority of your money, while you try the strategies in this book with your true risk capital.

Finally, if you do not believe that the stocks on the new-highs list tend to outperform others, pick a group of ten stocks from the new highs list and a group from the new-lows list. Track how each group performs over the next few months. Unless you happened to pick a very unusual time period, you will see that the new-highs as a group seriously outpace the new-lows group. If you are into instant gratification, you could also go to the library and pick a random list from a year or two ago and see how they have done since then. If you do, be sure you account for stock splits that may have occurred in the last year, since there may well be some where that has happened - especially among the stocks which appeared on the new-highs list. I highly encourage anyone to perform this simple and unambiguous experiment.

Your performance can be further enhanced by not only choosing stocks making new 52-week highs, but better yet pick stocks that

are at *all time* new highs in price. This will take a little more work for you because you will not find such a list in the newspaper. The best way to distinguish between issues making new 52-week and those making new all time highs is by looking at a long-term chart book. Obviously, any stock making a new all-time high will also be on the new 52-week high list, so begin your search with the 52-week high list.

2) Diversify between industry groups

Because stocks within an industry tend to move more or less in lockstep, make an attempt to diversify your portfolio between at least three industry groups. This will help to reduce some of the risk in your portfolio and having your money spread over several industries will help even out more of the ups and downs in your account value than if you had everything in one industry. Whether you are investing in stocks, fine art, certificates of deposit, bonds, or whatever, the first rule of investing is : Diversify.

3) Beware of stodgy stocks

When selecting stocks, beware of picking those stocks that move very little whether the market is good or bad. These are generally referred to as "defensive" stocks because they are held by those wanting to defend themselves against the possibility of a bear market. These conservative picks tend to underperform the market over the long run, making them a poor substitute for issues with real growth potential. Especially during market downturns, defensive issues hold up well, giving the illusion that there are good things happening to their underlying businesses. In reality, they hold up well mostly because investors flock to them for safety. When the market turns better, these types of companies tend to simply sit still while the rest of the market charges ahead.
So, it is best to avoid defensive stocks lest you get left behind when a bull market appears. Issues considered to be defensive include utility companies, gold stocks, food companies, oils, real estate investment trusts, and closed-end mutual funds. Closed-end mutual funds are mutual funds which have a fixed number of shares outstanding and trade just like a stock on an exchange. While they can sometimes post large increases in price, for the most part they sputter along and do not often have the potential for large increases in price.
While there have been times when each of these groups has done very well, for the most part they are a waste of time for those who

are willing to take a little more risk in order to make a lot more money. So it is best to exclude defensive stocks, at least from the aggressive portion of your portfolio.

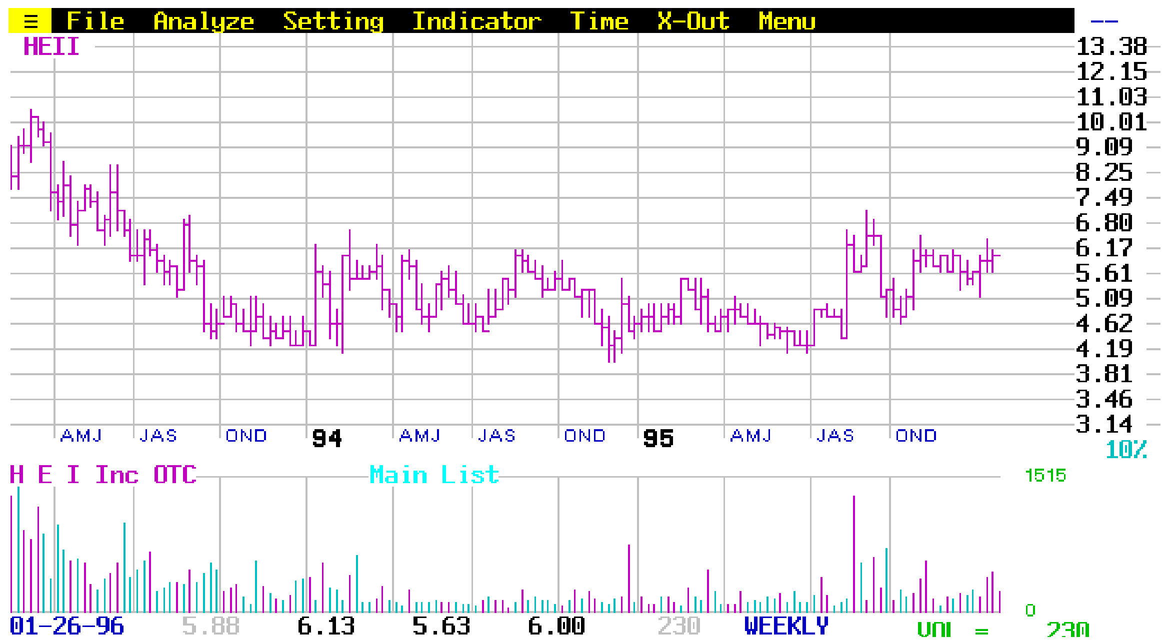
4) Weed out takeover situations

I would generally recommend that you look over recent news items around a company before you make a final decision to buy its stock. The reason I say this is that some of the stocks on the new-highs list are stocks of companies which are involved in real or rumored merger or buyout situations. They are generally a small minority of the stocks on the new-highs list, but be aware that this possibility exists. Takeovers and buyouts are unnatural, all-at-once events which are highly speculative and thus do not lend themselves to prudent investing. Once a firm is known to be a potential takeover target the price is dominated not by the company's market position or products, but rather by the development of the buyout offer. Also, most of the potential for further price advances is gone once the initial "pop" from the buyout has occurred.

For purposes of this book, try to avoid buying stocks which have become known to be the target of a buyout. Buyouts, when they occur, are big news and are generally well-known. The easiest way I have found to spot companies where a takeover has occurred is by looking at the price chart. Takeovers are almost always evidenced by a one-day increase in the price of the target company's stock of between 20% and 100%. If you see that type of pattern, dig deeper. There is an excellent chance that this company is in a buyout situation and should therefore be avoided.

5) Check out the Chart

Before you buy a stock, take a look at its price chart for the past year or two. This will give you a snapshot of the stock's personality from a volatility standpoint. I like to avoid stocks which have high week-to-week volatility and instead prefer ones which have a tendency for a cleaner trend. If a stock has a very volatile price pattern, then it generally means the company has no clear advantage in the marketplace for its product, services, etc., versus the competition. Since there are many companies out there which do have a clear, sustainable advantage in their particular market, I generally opt to purchase these instead. As an extreme example, following is a chart of a stock which has shown a very volatile price pattern in the past year:



I would probably not buy HEI Inc. at this point due to its highly erratic price pattern with no clear, discernible trend. The stock is also a long way from hitting a new all-time high, although it's not too far from making a 52-week high. Because of its poor trend in combination with the degree of up and down fluctuation in its price, I would definitely avoid this issue at this time.
As an example of a stock which shows an excellent trend pattern and low volatility, study this chart of Amgen, Inc. As you can see, the stock is making a new all-time high combined and is moving more steadily upward than many other stocks. I would tend to favor a stock with this type of price chart.

As a rule of thumb, the lower-priced a stock is, the more tendency it has to be volatile in its trend pattern. This is a good reason to avoid low-priced stocks and is one of the main reasons I insist on buying stocks that are above $15 per share.
In addition to volatility, the chart can also give you a clue to other important facts about the stock, such as if it's in the midst of a takeover situation (characterized by a large one-day move and a relatively stable price pattern thereafter), or whether it's a new issue. New issues sometimes appear on the 52-week highs list not because they are particularly strong stocks, but simply because they do not have much trading history behind them. It is best to know about these things and I can think of no faster way of finding out than by looking at the stock's chart.
There are several ways to obtain a chart of a company's recent price history. By far the best and cheapest way these days is by

computer, but there are many published chart services as well. Mansfield Charts and Daily Graphs are good choices. Standard and Poor's also publishes a compact book of stock charts which give two years' price history on many stocks.

Keep in mind that no matter how you get your chart information, you only need it when initially selecting a stock for purchase with Five Minute Investing. As you will see later in the book, you do not need to lug a computer or chart book around with you in order to manage your portfolio. Charts are only useful for getting a quick feel for the stock's trend, volatility, and as a tip-off for weeding out takeovers and new issues. In Five Minute Investing, they are not necessary for day-to-day management of your portfolio.

6) Other Criteria

Other than what's already been mentioned, are there other criteria which are simple but can help you narrow your stock picks down to a more succinct list? Yes, and I will try to give a brief overview of them here. You can then choose how many of these criteria you would like to use. No matter how few you choose to use, as long as you apply the first four sections of this chapter you will not go too far wrong. These items should be considered "finesse points" that can be used to narrow your choices down to a select few.

Earnings Growth.

One way to further narrow your list of potential stocks is to

focus on those that are reporting high rates of earnings growth. Do not think that because a company is presently generating rapid earnings growth that it cannot continue to do so well into the future. It often takes years or even decades for competition to nullify such a company's competitive edge in the products or services it provides, and it is this competitive edge that allows the rapid growth in sales and earnings. So, pay close attention to the earnings trend of your potential stock selections. Where can you get this information? It can be gotten from any number of publications including Standard and Poor's and also the Value Line Investment Survey. So far, though, the easiest place to find summary information on earnings growth is Investor's Business Daily. IBD has earnings per share rankings for every stock in the market, every day. For this reason, it is superior to the other sources of information because all the information can be found in one place, and in a similar format so that each company's earnings growth number can be directly compared to every other company. IBD categorizes earnings growth on a percentile basis, called the Earnings Per Share ranking. This number ranges between 1 and 99, with 99 being the most positive. All else being equal, try to pick issues which have the highest earnings growth, because these are the companies which have a demonstrated edge in their particular market.

Market Capitalization.

Market capitalization is another thing you will want to pay attention to. Market capitalization is simply the total market value of all the company's outstanding shares, or total shares multiplied by the price per share of the company's stock. I generally like to avoid the very biggest capitalization stocks, say those with capitalization's over $5 billion (in 1995 dollars) or so. This number will change over time, since the definition of a "big" company is constantly increasing.
Why take market capitalization into account when picking stocks? The larger the base of earnings a company is working from, the less likely they are to be able to grow earnings at a sustainable clip of 30% or more - and the less likely we are to be rewarded with a windfall profit. So, try to stick with the smaller-company stocks appearing on the new-highs list.

Buy the Price Performers.

Try to choose stocks that have performed well versus other stocks in the market, from a price standpoint. Simply put, choose the stocks that have run up most in value. This approach goes directly against human nature, but by adding this to your list of criteria you will greatly increase your chances of finding a phenomenal winner. You can determine how well a stock is doing by looking at it's current price versus its 52-week low (not high). The higher it is in percentage terms versus its low point, the better. Or, an easier way is to use Investor's Business Daily because it provides Relative Strength rankings on every stock, every day. If you are using Investor's Business Daily, also try to choose stocks with a relative strength ranking that is high. Like the EPS ranking mentioned earlier, this runs from 1 to 99, with 99 being the most favorable and meaning that the stock is moving upward in price better than 99% of the stocks in the market. I like to focus on stocks exhibiting a relative strength ranking of 90 or better. If you do not have a subscription to IBD, make sure you at least pick up a newsstand issue whenever you are picking new stocks to invest in, as by now you can see how much time and effort it can save you in gathering information. I consider this publication to be well worth the price of an annual subscription.

Share Price.

Finally, try to limit your purchases to stocks sporting a share price at or above $15/share. By so doing you will enhance your chances of investing in stocks with good trending potential. Low-price stocks tend to have very choppy trading patterns and are much more subject to false trend reversals. I actually prefer to invest in stocks priced in the $30 to $50 price range, as I find they are often well-established enough to have a high success rate, but if they are smaller capitalization issues they also are small enough to have nice growth potential.

Short-term timing

Many investors let short-term timing considerations overwhelm their choice of which stocks to buy. I believe this is an error, and also greatly complicates their stock-picking criteria. People become so confused by what is happening with short-term oscillators, moving averages, chart formations, and other mumbo-jumbo that these things begin to dominate all other considerations. In this book I want to totally de-emphasize short-term timing and focus on the big picture: Long-term results.

The simple reason for my philosophy is, I would rather buy a stock that is overextended and may have a relatively small short-term pullback in price but on its way to a 1,000% gain than one that is not at all extended but on its way to only a 50% gain. In fact, on weekends I often look at the largest percentage price gainers for the week and I strongly consider those stocks for purchase. I am not afraid to buy a stock just because it is moving decisively upward. I believe that if you use the Reverse Scale Strategy as developed later in this book, you will accumulate your positions gradually enough that you will not need to worry about whether a stock is overextended, underextended, or other short-term timing concepts. Therefore, you can keep your stock-picking techniques as simple as what is presented in this chapter.

Fundamental Analysis

You may have noticed that there is nothing in this chapter regarding how to perform fundamental analysis of industries, companies within that industry, financial analysis of earnings statements and balance sheets, etc. Perhaps you expected any book on stock picking to include these topics, but Five Minute Investing does not. The simple reason for this is that if the market is saying that a certain company's earnings are expected to grow (evidenced by an accelerating upward stock trend), why should we find reason to dispute what the market is saying? As long as we have a loss-cutting mechanism in place, we do not need to use fundamental analysis to validate what the market already has told us about the future earnings of the company. The opinion of the aggregate marketplace has far more credibility in my eyes than does the opinion of any fundamental analyst, no matter how good. So I will always go with the opinion of the market, as opposed to anyone else's opinion, including my own. To me, anyone who tells me that a stock which is moving up shouldn't be moving up, has by definition missed something in his analysis.

To make my point on the futility of fundamental analysis for the average investor, think of how you would determine if the grass in your lawn was growing quickly. Wouldn't you just measure the grass today, wait a few days, then measure it again and subtract? If you did this and discovered that the grass was growing quickly, would you then go out and conduct a survey of the temperature, rainfall and hours of sunlight per day to validate that the conditions for growing grass are indeed good? *Of course not!* You would rightly conclude that the conditions for grass growth are good based solely on the fact that the grass is growing. Even if you did cook up some formula to predict grass growth based on environmental conditions, would you trust your formula more than your direct measurement of the grass's actual growth? If your formula said that grass shouldn't be growing and yet it was growing, would you stop mowing your lawn? Again, to do so would be preposterous. You would have to conclude that something is wrong with your formula.
Unfortunately, common sense of this sort does not get applied in the stock market by many people. Even though we can directly measure through a stock's price trend what the company's growth prospects must be, there is always someone there to try to make us lose sight of that simple fact by pointing to his "analysis." You can be sure that for every fantastically bullish trend, there is some analyst somewhere saying why it shouldn't be happening all along the way. The best you can do is to not listen to such opinions, and, again, go back to the market as your one source of advice.

A final word: Buy Quality

Whether you are investing in stocks, art, coins, or real estate, it is my opinion that it is always best to buy the highest quality you can possibly afford. Any review of the return on rare coins or masterpieces of fine art will quickly reveal that the best returns on investment have been enjoyed by those who bought the rarest and highest-priced items. The same principle is true in stock investing. Do not be afraid to pay a high price relative to earnings, book value, or sales. In fact, I would ignore such items. I recommend that you buy the stocks which are moving up persistently in price, and don't concern yourself that these stocks tend to cost a little bit more than some more boring issues. History shows that the premium paid for high-quality items of any kind is generally worth the extra money.

When picking stocks for investment, apply these criteria:

Restrict your stock-picking to stocks making new 52-week highs.

Diversify between at least three different industry groups.

Weed out defensive stocks and those involved in buyout situations.

Don't be afraid to pay up for quality.

Chapter 5: How to Evaluate a Trading Strategy

Characteristics to look for in any investing system

Obviously, there are many strategies that can be used in stock investing, but there are certain characteristics to look for in *any* plan for investing. Before we can develop a strategy for investing, we need to have a set of criteria by which to judge if it is a good plan or not. Building upon our previous discussions about common investor mistakes and stock-market myths, I offer the following eight criteria as the means by which to judge an investment plan - *any* investment plan. The degree to which a strategy stacks up well against these criteria determines its desirability. The very best strategies will satisfy the following eight requirements:

1) Lets gains run their course, cuts losses short.

This is a necessary element for any good plan of investing, especially the part about letting gains run to their full potential. As long as a portfolio is well-diversified, you can probably afford to make the mistake of holding onto your losers, but you absolutely *must not* make the error of prematurely cashing in your winners. Since we expect our gains over long periods of time to exceed 100% of our initial investment, the amount of damage that can be done by cutting our winning stocks short far surpasses the damage we can do by failing to cut losses. However, for optimal performance it is best to both cut losses and ride winners as long as possible.

2) Much has been written about what the ideal point is for cutting losses.

Some say it is 10%, that is, that you should never lose more than 10% on a stock trade. Others say you should never lose more than 8%. I have found that cutting losses this short leads to excessive trading and excessive losses, and does not allow a good stock enough room for normal day-to-day fluctuations. When cutting losses to 8% or 10%, it is extremely easy to get bumped out of a stock only to have it recover and begin soaring again without your being on board.

For this reason I prefer to take a radically different view of loss-cutting**. I aim never to lose more than 3 % of my total account value on a single stock trade**. As an example, I might set my stop-loss point back 30% from my purchase point and invest no more than 10% of my account's assets into a single stock. Therefore, I will not sell the stock unless it gets into serious trouble and falls 30%. If the worst happens and the stock does lose 30% of its value, I will have lost only 3% of my account's assets on the trade since I only invested 10% of my accounts assets into the stock. So, 10% times 30% equals 3%. I believe that this approach to loss-cutting is far superior to arbitrary rules which require cutting losses too short. If you can aim to lose no more than 3% of your cash on any one trade, it will take a long string of uninterrupted losers in order to seriously deplete your trading capital. Of course, there is nothing magical about the 3% number, but the point is to keep your possible losses from any one trade to a very small amount. Even in a market dip, it is improbable that *all* of your positions will drop to your sell point.

3) *Gradual entry into major positions, as long as the position continues to be profitable*.

It is inevitable that any system which attempts to let gains run will eventually build some large positions in a few stocks as the stocks grow in value. That is the good way to develop a large position. Also, it is OK to build a position by adding to the position as it advances in value; in fact, most professionals continually add to their stock holdings as the price moves in their favor. In this way, they maximize the potential reward for holding a particular stock or basket of stocks.

However, some approaches cause an investor to plunge a large amount of his capital into and out of the market all at one time. This is the type of approach which must be avoided at all costs. It is risky to enter *any* market all at once because it maximizes your ability to lose a lot of money in a hurry. One poor timing decision can result in a loss of a large percentage of your capital, and these drawdowns in capital really hurt you. A 33% loss of your capital requires a 50% gain on the *remaining* capital just to get to the break-even point. It is also unnecessary to take such daredevil risks because most trends last long enough that there is plenty of time to get on board and a lot of money can still be made by entering a trend in several installments as it is developing.

4) Minimal chance of a large loss from any one position.

This is an adjunct to #2, as the gradual entry into a position is a means for minimizing the chance of loss from a single bad decision. Again, it cannot be emphasized too much that massive drawdowns in your capital are to be avoided at all costs. Any plan of attack should score well in the area of keeping our eggs in many baskets as opposed to one; and we should not have a large percentage of our assets in a single stock unless *our average purchase price is far below the current market price*. If we do well at that, we can sustain a large one-day drop in the price of a stock without losing much, if any, of our original investment.

5) Clear, predetermined criteria for initiating, adding to, or liquidating a position.

In the heat of battle when you are dealing with your hard-earned money, the instructions from your system must be as clear as crystal. If not, you will find yourself making judgment calls that relieve your short-term stress, and yet are poor long-term decisions. Precise and unambiguous signals and marching orders are the best way to head off the effects of euphoria and fear. You may still feel these emotions, but as long as your system is sound and you adhere to it fastidiously, everything will turn out well.

6) Sells a stock once it begins to under-perform.

While we want to make sure we have a means for riding a stock's trend for as long as it can go, when it becomes clear that the trend is beginning to profoundly weaken or even reverse, we need to have a system which allows for selling the stock so we can redeploy capital to greener pastures.

7) Maximum dollars invested in biggest winners.

If a strategy allows us to build a large position in an issue that is lagging or even losing money for us, there is something seriously wrong with that strategy. The common complaint one hears from many stock market participants is that they wish they hadn't invested so *much* in XYZ Company and they wish they had invested *more* in ABC Co. This mis-allocation of assets is usually accomplished via some of the common investor mistakes in Chapter 2, especially the mistakes of adding to a losing position, or

plunging. A successful system needs to ensure that our biggest investments are in our best stocks, not in our worst.

8) Minimum dollars invested in losers/underperformers.

This is the converse of #7. It is interesting to note that the only ways you can accomplish having too much invested in a loser is to either plunge into it all at once and fail to cut your loss, or add to a losing position once it is established as a loser. Both of these are deadly mistakes and any system we develop must preclude us from committing these sins.

9) Not time consuming to maintain.

This is important because throughout this book I assume that the reader's time is his most valuable asset, and probably in short supply as well.

When an investment plan is not *really* a plan

Occasionally, one will hear statements such as "sell a stock once its earnings growth slows," or "hold a stock as long as its product looks good." Often, these types of statements are hawked as rules for investment. I want to make a point that these types of statements are not really plans at all, in and of themselves. They are far too subjective for the very tangible world of the stock market, where stocks are given a specific price every minute of every trading day. In order to be useful for decision-making by us mere mortals, the system used must tell the investor *exactly* when to buy or sell, and how much to buy or sell. How can you spot that precise moment when a company's product turns from good to bad, or when a company's earnings have "slowed?" Chances are, you can't. Since a stock's price generally reflects such events long before they actually happen, these subjective sorts of approaches tend to be a day late and a dollar short unless you are incredibly well-connected to the company in question. Even if you were well-connected, then you could be trading on inside information, which is against Federal law.
It is conceivable that if you could develop some non-subjective criteria about how to tell when a firm's product or earnings are losing their edge, you might possibly be able to develop a true (non-subjective) system around it. Even if you could do it, it would be different for every industry, making it very time-consuming to implement. Therefore, this type of approach is not very practical for the average person and definitely violates our requirement that our strategy not be

time-consuming to maintain. There is a difference between subjective rules of thumb for trading, and a non-subjective system for trading. Learn to recognize the difference and you will be several steps ahead of the majority of investors.

Chapter 6: The World's *Worst* Trading Strategy

The next step down our road to investment success involves briefly reviewing the **worst** stock trading strategy I can imagine, a simple strategy known as **Scale Trading**. Why would we want to learn about the worst strategy? Because once we know the worst possible strategy, one that is destined to maximize losses over the long run, then we can reverse its ideas to craft a strategy which does just the opposite - it will be destined to produce some tremendous long-term gains. This is precisely how I came to develop the Reverse Scale Strategy introduced in the next chapter, which has served me very well and will also serve you well if you adhere to it. I want you to not only know what the strategy is but also to understand how it was developed and why it works.

I want to mention that the comments in this chapter focus on scale trading as applied to **stocks only**. Scale trading **can** be a viable strategy when applied to commodity futures, mostly because commodities have inherent value meaning that they cannot decline to zero value. But even then, it requires a lot of capital and advance planning to be successful. Individual stocks can and do become worthless on occasion, which is one of the main reasons why scale trading is such an unfit approach for stock investing.

Scale Trading

Other than the fact that it is simple, this strategy has no redeeming value. It is the manifestation of all the most devastating investor mistakes. While it can produce small profits over short periods of time, eventually it *always* leads to the poorhouse when applied to individual stocks. Scale trading is not a very popular or widespread strategy except among extreme neophytes, as anyone using it will not last very long in the stock market. I like to think of it as the financial equivalent of bungee-jumping: It's exciting, risky, takes a lot of guts, and occasionally, the cord snaps! Nevertheless it is useful to study this method because often much can be learned by studying a *truly bad* approach to anything and then reversing its concepts.

Scale trading can be applied to a single stock, or a portfolio of stocks with equally disastrous results.

It is accomplished by taking an initial position and then adding to it in predetermined increments as the position declines in value, and selling those purchases as they increase in value. For instance, the investor might buy 20 shares of stock at $50/share (for $1,000) and decide to buy another $1,000 worth of stock if the price declines by 20%. If the price increases from $50 before declining to $40, he will sell his 20 shares (purchased at $50) for $60/share, for a profit of $200 less

commissions. So, another 25 shares are added at $40 with the idea of selling those acquired at $40 if the price then increases to $50, and so on. The purchase and sale levels for this particular situation are shown in the following table:

Scale Trade from 50, 20% declining purchase increments.

Price Level	Amount Invested This Purchase	Shares bought This Purchase	Cumulative $ Invested	Cumulative Shares Owned	Cumulative Value of Shares	Cumulative Cost/Share	Total Profit/(loss)
50	$1,000	20	$1,000	20	$1,000	$50.00	$0
40	$1,000	25	$2,000	45	$1,800	$44.44	($200)
32	$992	31	$2,992	76	$2,432	$39.37	($560)
25 5/8	$998	39	$3,990	115	$2,944	$34.70	($1,046)
20 1/2	$1,004	49	$4,994	164	$3,359	$30.45	($1,635)
16 3/8	$999	61	$5,993	225	$3,686	$26.64	($2,307)
13 1/8	$996	76	$6,989	301	$3,945	$23.22	($3,044)
10 1/2	$996	95	$7,986	396	$4,152	$20.17	($3,833)
8 3/8	$998	119	$8,984	515	$4,320	$17.44	($4,664)
6 3/4	$1,000	149	$9,984	664	$4,456	$15.04	($5,528)
5 3/8	$999	186	$10,982	850	$4,563	$12.92	($6,419)
4 1/4	$1,001	233	$11,983	1083	$4,651	$11.06	($7,332)

The scale trader is hoping to profit by, for example, selling any shares acquired at 32 on a subsequent rise to 40, any shares purchased at 20 1/2 would be sold at 25 5/8, and so on until the stock advances to 60, at which point the scale trader sells off the last of his shares - those purchased at 50.

There is no limit to the amount of times that a stock can oscillate between any two or more of the price levels. Each time this happens the trader pockets another $200 profit, excluding the effect of commissions.

It seems like a foolproof approach to the neophyte trader, but let's trace what happens with this trading method through a hypothetical situation. As indicated, our trader makes up the chart as shown above, and takes his position of 20 shares purchased at a price of $50/share. Let's say the price then slips to $40, and a subsequent 25 shares are purchased at that price. From there, the price increases to $55, meaning that the 25 shares acquired at 40 are sold when the price reaches $50, netting a profit before commissions of $200. At this point, 20 shares acquired at $50 are still in his inventory. However, he doesn't get to sell those shares, as the price drops from $55 all the way down to $30 - so 25 shares are purchased at $40, and another 31 shares at $32 before increasing again to $40. The shares purchased at $32 are sold for $40 for another $200 profit. Fantastic: He has so far generated a $400 realized profit and never had more than $3,000 invested at any point. The only negative so far is that it took four months to do this, but $400 profit on a $3,000 investment over four months is not bad. So far, so good.

From $40, the price then takes another dive down to $15. Shares are purchased at $32, $25 5/8, $20 1/2, and $16 3/8. Then the price runs up to $30 before retreating back to 25 5/8. Quite a windfall for our trader as he sells the shares acquired at $16 3/8 for $20 1/2, and the ones scooped up at $20 1/2 for $25 5/8. From this, he nets out another $400, bringing his total trading profits to $800. True, he has a $1,046 unrealized loss bringing his net profit to a negative $246, but he reasons that when the price goes back up to $60 he will have

completed his trade and sold out every single position for a profit. At this time, though, he narrowly misses selling his shares acquired for $25 5/8 at 32, since the price topped out this time at $30.

Next, the unexpected happens. The company that our scale-trading friend is trading reports that it is under Federal investigation concerning false financial reporting. The next day, the stock opens a few points lower and just keeps on dropping until it hits $10 3/8, its closing price for the day. Though shaken by the news, our friend is disciplined about his system and buys slugs of the stock right on schedule at $25 5/8, $20 1/2, $16 3/8, $13 1/8, and $10 1/2. He is getting a little worried because he is eight months into this trade and he has an $800 realized gain and a $3,833 unrealized loss so far. He also is realizing that so far he has nothing to show for his nearly $8,000 investment except a net loss. He starts to wake up at night wondering what will happen to his position, since although he realized that this could happen, he never thought that it actually *would* happen.

Unfortunately for our friend, in the following months the investigation reveals that the company does actually have some fraudulent practices. This requires that the balance sheet and income statements for some previous years are revised to reflect the effects of the management misstatement and cover-up. The experienced (though crooked) management of the company is ousted for their sins and replaced. So the price of the stock works its way lower and eventually levels out between $4 and $5 per share, and it languishes in the low single digits for the next *five years*. Our scale trading friend has a $6,000 to $7,000 unrealized loss in addition to his $800 trading gain, and ten or eleven thousand dollars invested in the stock he still holds. Once in a while over the next few years he may get a $200 trading gain as the stock bounces around, but these pale in relation to what he has invested and what he could have earned even from a passbook savings account. On top of this, he also has to live with the *worry* for the next five years that the stock will further decline, causing him to either give up his strategy completely or invest even more money. Now he realizes that so much time has passed that even if the stock rises back up to $60 someday, his annual rate of return for the amount invested will be minuscule.

It is scary to realize what can happen when you get caught up into a flawed strategy such as scale trading. This little story might sound extreme, but I assure you that every single day someone gets the bright idea to do exactly what our poor friend in the story did. Thinking they have discovered a money machine, they begin scale trading and the rest is simply a matter of time. The trader in the story was disciplined - he held to his system against all odds, but he still got

mired into a terrible mess. The lesson to be learned is that to be successful, you not only have to be disciplined, but the theory on which your system or method is based must be correct as well. A bad theory well implemented still results in a loss.
Of course, not every scale trade results in a disaster, in fact most of them probably result in a profit sooner or later. But the potential for profit is small considering the time, worry, and capital invested. The typical pattern with scale trades is a series of small profits followed by one gigantic and inevitable loss.
Some folks even apply the scale trading technique to several different stocks at the same time. This does nothing but compress the amount of time it takes to lock on to a stock that just keeps declining and declining in value - it may even become totally worthless and enter bankruptcy proceedings. Or, almost as bad, it may decline from $50 all the way down to $10/share and sit there for a long time. Perhaps it will sit there for years or even decades while the poor trader sits trapped in his losing position earning little or nothing on his money. You can rest assured that anyone who uses this approach consistently in the stock market will meet this demise fairly early -on in the process. The fatal assumption made by the scale-trading theory is "what goes down must come up," and as we have discussed earlier, this simply is not the case with stocks.
In the example above, if the price of the stock declines to slightly above $1/share, the hapless scale-trader will own stock with a market value of $4,900 in which he has $17,900 invested - a loss of $13,000. If the company goes bankrupt, the numbers would be worthless stock and at a sickening loss of at *least* $17,900 (if he had sense enough to stop buying once the stock fell below $1/share). This is after starting with only $1,000, and the usual case is that the neophyte feels his strategy is so foolproof that he starts with $5,000 or some other large amount. The only saving grace is that people tend to pursue this strategy when they are young, foolish, and have little money to lose. So if our novice scale trader started with a $10,000 initial position at $50/share instead of the $1,000 position in the example, he likely won't lose the entire $170,900 we might expect him to lose. This is because unless he inherited his money, he probably won't have that much to lose.

The positives of scale trading are:

- It is simple and not subjective.
- It can generate lots of small gains in choppy market conditions.

The negatives of scale trading are:

1) When applied to a portfolio of stocks, the stocks which do worst suck up the most capital as more and more purchases are made while it declines. All capital is automatically allocated to the worst-performing stocks in the portfolio while the best stocks are sold off. The result is at best a disastrous underperformance versus the market or at the worst a total loss of capital. If a scale trader uses margin (borrows money from the broker to buy even more stock), the trader may, under the right conditions, creatively find a way to lose even more money than he has. The biggest problem is that scale trading cuts the trader's gains and lets his losses run, just the opposite of what you want to do.
2) It is impossible to plan how much capital it will take to execute the strategy since you never know how far down a stock will go before it recovers - if it does recover. There are an infinite number of 50% declines between any positive number and zero, therefore an infinite number of purchases you would need to make to fully execute the strategy. Few people I know have unlimited capital.
3) Eventually, everyone who practices scale trading encounters a stock that declines precipitously and then goes bankrupt. The losses from such an occurrence are huge. There have been a plethora of seemingly rock-solid companies over the years that have ended up in bankruptcy court.
4) The scale trader **never** gets the full benefit of a favorable trend since he is always selling his winners and buying more of his losers.
5) Even when a scale trade is successful, the amount of profit to be had is very small relative to the amount invested and especially relative to the risk of catastrophic loss.
6) When a scale-trader finds himself locked into a large losing position, he can't even get the tax benefit of a write-off, since his strategy makes no provision for him to sell out his position. Of course, if a bankruptcy should occur, then he can write off the entire amount!

Obviously, scale trading is not a strategy to pursue unless you want to guarantee yourself substandard returns peppered with an occasional financial disaster. In the next chapter we will take this lemon of a method and make lemonade. By reversing the scale trader's tactics, we will construct the Reverse Scale Strategy, which will give us some moderately large gains, some small losses, and some *huge* gains which will make it all worthwhile. Better yet, the rules of this strategy will be as forthright and unambiguous as in the scale trading method.

Chapter 7: The Reverse Scale Strategy

I want to emphasize that perhaps the best strategy of all, for most people, is to simply apply the stock picking criteria in the past chapters, then buy and hold their selected stocks without *ever* selling them. Of course, you will need to select a substantial number of stocks to achieve an adequate level of diversification, but for results versus risk and time expended, it is hard to beat a buy-and-hold strategy. I recommend the simple buy-and-hold approach for the vast majority of people.

This chapter, and following chapters, are written only for those who are willing to take more risk of loss and expend more time in order to have a chance at winning big. However, keep in mind that you can always lose big whenever you employ any type of trading strategy!

In the previous chapter, we studied the worst of all trading strategies. It systematically snowballs your losses and jettisons your best stocks just as they start to become winners. Practiced consistently, the scale-trading approach is a surefire ticket to the soup line. The Reverse Scale Strategy, on the other hand, is developed by *inverting* the Scale Trading approach, and in the right market conditions may deliver large profits over time. Before we get into the details of the Reverse Scale Strategy, though, let's take a side trip to examine how all portfolios inevitably act over time.

The one inevitable characteristic of all stock portfolios.

To begin with, let's think about a portfolio of ten stocks held over a period of time, say, five years. For now, let's not worry about which stocks are in the portfolio. The only thing we know about the portfolio is that it is composed of ten stocks. Now let me ask the question, "what can we predict about the portfolio five years from now?" In other words, what is certain to happen over the next five years?

First of all we *can't* predict what the total return on the portfolio will be, because that will depend on market conditions over the next five years, and also will depend on how well our ten companies individually perform over that period of time. Stocks have historically returned *on average* about 9% per year, but over any five year period this can range from a negative number to a very positive number of 20% per year or more. It also varies considerably from company to company. So obviously we can't accurately predict what each individual stock in the portfolio will return, either.

It may be disheartening to you to realize how little we actually can foretell about the future performance of our portfolio. However there is only one thing that we can fairly confidently predict about any basket of stocks, and it is this:

At the end of the five year holding period, some stocks in the portfolio will have performed vastly better than others.

For the sake of reference, I will call this the **Variability Concept**.
This is not exactly a revelation. We could expect that one or two of the stocks will have tremendously outperformed the market averages, which might mean a move of two, four, or maybe even ten or more times our entry price, depending on market conditions. Some will have proven to be dogs, perhaps declining marginally, or in the extreme case, gone out of business in the meantime. A large portion of the stocks will have performed pretty much in line with the market. If you've chosen your stocks randomly, there's also a very good chance that your ten-stock portfolio will have returned something close to what the market averages returned over the five years. Since every portfolio of stocks contains future winners and future losers, we are left with this:

The challenge of investing is to make sure that when you get to the end of your holding period, you find that most of your money was invested in the stocks which performed the best, and relatively little was invested in the stocks which did the worst.

To realize how this concept can be useful to us, we also have to add to it another fact we've already discussed in great length about the stock market:

Stocks make large moves in continuous trends which almost always take months or years to develop.

Let's call this the **Trend Concept**.
Large price movements are gradual incremental events, not all-at-once step functions. They are evolutionary, not revolutionary. Whether the move is up or down, a really big move does not normally happen overnight unless there is a merger announcement, bankruptcy filing, or something of that sort. Even then, the actual announcement has often been preceded by an uptrend (in the case of a pending buyout) or a downtrend (in the case of a pending bankruptcy filing). The reason for this is that there are always some folks who know about

these pending announcements before they happen, even if they are not supposed to know. Their buying or selling leading up to the announcement moves the stock while the public is still clueless as to why it is moving.

Putting the Trend and Variability concepts together, it becomes apparent that there will most likely be a **wide gap in the returns between the best-performing and worst-performing stock in your ten-stock portfolio**. It is equally apparent **that this condition will develop slowly,** with the gap in total returns between the best and worst stock growing steadily as the holding period lengthens. The union of these two inevitable events should lead logically to this conclusion:

If only we could find a way to *gradually* allocate our investment dollars to the best-performing stocks in our portfolio *as they are becoming* the best-performing stocks, then we'd have a tremendous chance of greatly increasing our investment returns above and beyond what would be achieved by simply choosing those same ten stocks and holding them in equal dollar amounts.

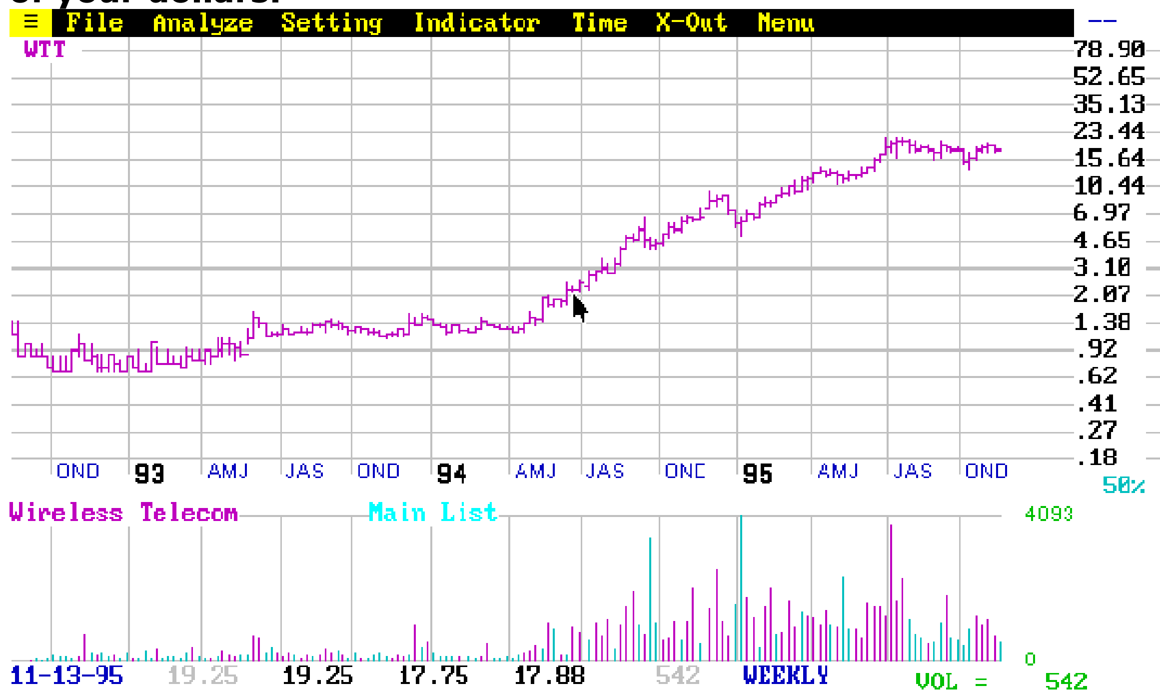
Reversing the Scale Trading example

What we need, then, is to develop a system that will accomplish this allocation of capital to our strongest and best-performing stocks. As it turns out, we can do this by simply reversing the scale trading approach learned about in the last chapter. So in other words, we *add equal dollar amounts to our stock positions as they move **up** in price*, instead of when they move down in price. This is what I call the **Reverse Scale Strategy**. In the rest of this chapter, you will see how the mathematics of this approach work greatly in our favor.

Since one picture is worth a thousand words, take a look at the following chart. It is a price chart of Wireless Telecom, a stock which I began buying in early 1994, and still own as of this writing. **I purchased the stock after it had already more than doubled in value, at slightly above $2/share** (marked by the arrow). I added an equal ***dollar*** position (not an equal number of shares) with every 50% increase in price from the previous purchase level, represented by the horizontal lines in the chart below. That is, each successive purchase was for less shares than the previous purchase.

Pursuing the Reverse Scale Strategy I purchased positions at approximately $2.07 (all prices are adjusted for stock splits which occurred during the stock's rise), $3.10, $4.65, $6.97, $10.44, and $15.64. The price has not yet reached $23.44 or I would have

purchased an equal dollar amount there, too. For the sake of an example, let's say I put $2,000 into the stock at each of those price levels, and every time I did make a new purchase, I moved my stop-loss order (if you are not familiar with stop-loss orders, they are explained in Chapter 8) up to the price of the previous purchase. Hence, my sell point was constantly rising during this time, most recently at a price of $10.44. Obviously, I owned other stocks in mid-1994 when I first bought a position in Wireless Telecom, but at that time I had no idea this particular stock would increase as much as it did in value versus the other stocks. I didn't need to know, because my strategy guaranteed that if it made an exceptional move, I would have a disproportionate amount of money invested in it. As I said earlier in the book**, it is best to avoid prediction altogether, and rather rely on a strategy which can guarantee a good allocation of your dollars.**



If you followed the Scale Trading example as presented in the last chapter, you saw how no matter what happened, the scale-trader's poor strategy allocated most of his capital to the worst-performing stocks gradually, with a large loss being the inevitable result. Like a snowball rolling downhill, the tendency for a declining stock to keep on declining, in combination with the scale trader's foolish trading rules required the poor trader to buy more and more while his position became worth less and less. Once you have really grasped how foolish the scale trading strategy is, it becomes much easier to see how wise it is to follow the Reverse Scale Strategy. To give you a flavor for the

advantages of adding to a position as it moves up in price, following is a brief contrast of Scale Trading versus the Reverse Scale Strategy:
Scale TradingReverse Scale Strategy Positions added only if stock declines.Positions added only if stock increases.Your average cost per share is always above the current market price after second purchase. Your average cost per share is always below the current market price after second purchase.Sacrifices large long-term gains for small short-term gains.Sacrifices small short-term gains in order to realize large long-term gains.Unlimited potential for loss.Unlimited potential for gain.Makes no attempt to cut losses. Adds to losing positions.Cuts losses. Does not add to losing positions.In a portfolio, automatically allocates majority of capital to worst-performing issues.In a portfolio, automatically allocates majority of capital to best-performing issues.

The Snowball Effect

To help you envision the principle of the Reverse Scale Strategy, I'd like to offer the following illustration. Imagine you are standing at the top of a large hill. You have made five snowballs, all equal in size, and you give each of them a equal push to start them rolling downhill. One of the snowballs starts out okay but doesn't get very far, as it hits a rock that was hiding below the surface of the snow, exploding the snowball into smithereens. Two others make it about halfway down the hill, but then stall out because they became large and happened to be on a part of the hill that was not as steep as some other areas. Still another makes it a bit further than those two, but then hits a wet area and gets bogged down. One of the snowballs, however, happens to have just the right type of snow and a nice steep incline, and its quick start, momentum, and after a while, sheer size make it unstoppable. It goes several times the distance of any of the other snowballs.
The analogy between snowball-rolling and a portfolio of stocks is a good one. Obviously, the snowball that rolls the farthest gets the biggest and picks up more snow gradually as it goes. The size of the snowball can represent either losses or gains, depending on whether you are using the Scale Trading approach (snowballing losses) or the Reverse Scale Strategy (snowballing gains). Really, both the Scale Trading approach and the Reverse Scale Strategy cause a snowballing effect. You have to choose which strategy you would prefer: One which snowballs losses or profits. Tough choice, huh?
With snowballs, as in the stock market, there are things you can control and things you cannot control about the stocks you are investing in. You can control how big you make each snowball initially, and you can control how much of a shove you give each. From then on, many of the factors are out of your control or unpredictable. Even

though we can't predict which snowball will roll the farthest, the hill still gives more snow to the one that eventually does go the furthest, because it adds snow to it gradually as it progresses. Hence, the beauty of the Reverse Scale Strategy is that just as the hill and gravity make sure the snowball that goes the furthest gets the most snow, our strategy will make sure that the stock which advances the furthest gets most of our capital.

Trading rules for the Reverse Scale Strategy: an example.

To learn how to implement the Reverse Scale Strategy, let's run through an example for one single stock. Although we will be using the Reverse Scale Strategy in a portfolio of several or more stocks, it is much easier to illustrate the concept using just one stock.

First, we construct a chart similar to what the scale trader in the last chapter constructed, only our chart begins at the initial purchase price and goes *up*, each succeeding decision point being 50% *higher* than the previous one, (instead of 50% lower, as with scale trading). The trading rule is:

We will invest an additional designated number of dollars at each price level as that level is reached - and only if it is reached.

As you can see, we will be adding an equal dollar amount at each price level. This dollar amount is the same as our initial position in dollars, but a reduced number of shares due to the higher price paid for each successive purchase. For a stock where our initial purchase was at $20 per share, our decision chart would look as follows (the initial entry position is highlighted):

Reverse Scale Strategy, 50% purchase increments

Decision Point	**Price Level**	**Amount Invested this Purchase ***	**Shares bought**	**Cumulative $ Invested**	**Cumulative Shares Owned**	**Current Value of Shares**	**Cumulative Cost per Share**	**Total $ Profit/(Loss)**
Loss-cutting point	13 1/4	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Initial entry point	**20**	**$1,000**	**50**	**$1,000**	**50**	**$1,000**	**$20.00**	**$0**
Decision point 1	30	$990	33	$1,990	83	$2,490	$23.98	$500
Decision point 2	45	$990	22	$2,980	105	$4,725	$28.38	$1,745
Decision point 3	67 1/2	$1,013	15	$3,993	120	$8,100	$33.27	$4,108
Decision point 4	101 1/4	$1,013	10	$5,005	130	$13,163	$38.50	$8,158

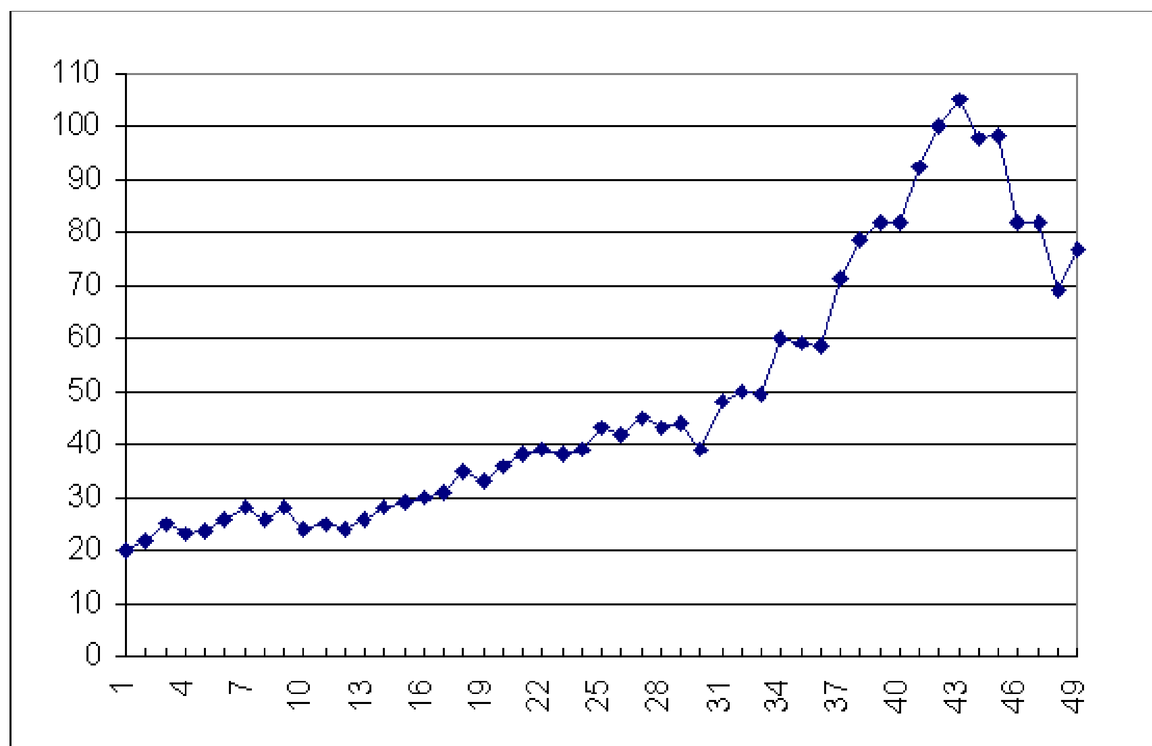
***** Since shares can only be bought in increments of one, this number does not always equal $1,000 for each purchase, but the cost of the closest increment of one share that can be purchased with $1,000.

Again, each successive Decision Point is arrived at by multiplying the previous one by 1.5. So the first decision point is calculated by multiplying the $20 initial entry price by 1.5, which yields $30; $30 times 1.5 results in $45, and so on for as far as you need to go.

Our other trading rule is:

Whenever our stock increases to reach a decision point and then *retreats all the way back to a previous decision point*, we will *sell out our entire position* in the stock.

Why do we have this trading rule? Simply because if a sto ck retreats enough to make it all the way back to a previous decision point, then it's a good bet it's lost enough momentum that it will have a hard time becoming a market leader once again. In other words, its up -trend may be ending or about to go dormant for a long, long time. So, it's best to trade it in and start over with another more promising issue. As we have discussed in earlier chapters, we need to give a market - leading stock plenty of room for normal retreats off its highs in order to be able to ride the long trends when they develop. However, we have to draw the line at some point. Given that our decision points are 50% apart, the prospect of "whipsaw" losses or prematurely bailing out of a stock are limited with this approach.
To illustrate, let's assume we took our initial position at $20/share as indicated in Chart #1. Over the next year, the stock increases in value gradually to $105/share, as graphically illustrated in Chart #2. We would have picked up shares at $30, $45, $67 1/2, and $101 1 /4, for a total of 130 shares owned, referring once again to Chart #1. Because the stock reached the Decision Point #4 at 101 1/4, our sell point would have ratcheted up to 67 1/2.



Let's say then that the stock retreats back to the $67 range. Since the stock has at that point violated our sell Decision Point #3 by falling below $67 1/2, we unhesitatingly enter a market order to sell the entire 130 shares. For the sake of simplicity, let's assume we were able to sell our shares at exactly $67 1/2. We could then compute our profit from the trade as follows:

Summary of Purchases and Sale

	Shares Purchased	**Price per Share**	**Total Cost**	**Commission**	**Net Cost**
Purchase #1	50	$20	$1000	$25	**$1025**
Purchase #2	33	$30	$990	$25	**$1015**
Purchase #3	22	$45	$990	$25	**$1015**
Purchase #4	15	$67 1/2	$1013	$25	**$1038**
Purchase #5	10	$101 1/4	$1013	$25	**$1038**

Total cost of all the purchases: $5,131.
Total shares purchased: 130
Proceeds from 130 shares sold at $67 1/2 = $8,775. Minus $ 25 commission = $8,750.
Net Profit = $8,750 minus $5,131 or **$3,619**.

Just to illustrate the previously made point about the Reverse Scale Strategy making it hard to get shaken out of a stock prematurely, please note what our sell decision point would have been had the price topped out at only $100 instead of at 101 1/4 or higher. In that case, the price would have had to retreat from $100 all the way down to $45/share in order to trigger a sellout of the position, since it never reached the $101 1/4 level and therefore $67 1/2 never became our sellout point. Now, I know emotionally it might seem disheartening to you to have to sit idly by while a stock sinks from a peak of $100 down to $45. But believe me, there are plenty of times where this discipline of being able to ride out the occasional temporary steep correction will be the ***very thing*** that allows you to sometimes go on to make a huge gain of 1,000% or more. Keep in mind that gains of 1,000% happen much more often than you'd think if you are using the stock-picking criteria presented in Chapter 4. It is also much easier to ride a stock down temporarily if it is only one of many stocks you own, so make sure you diversify!

For the sake of covering all the bases in the last example, what would have happened if our stock had turned out to be a loser instead of a winner? If after we took our initial position at $20 per share, the stock declined to 13 1/4 or lower ($20 divided by 1.5), we would have sold the initial position and started looking for a new stock to start over with. We would have incurred a loss of $337.50 plus two $25.00 commissions, for a total loss of $387.50. We then would go prospecting for a new stock to trade. Remember, we do *not* want to keep gunning for the same stock once we've been bumped out of it by our system.

Risk and Reward

While you might or might not be impressed with a profit of $3,619, keep in mind that we never exposed ourselves to a loss of more than $400 or so in this trade. So, the potential for profit here is unlimited (limited only by the performance of the stock being traded), while the potential for loss is quite limited.

The real power of the Reverse Scale Strategy lies in using it to harness the power of margin borrowing. So in the Chapter 8 we will explore how the Reverse Scale Strategy can go hand in glove with the controlled use of borrowing to enhance the return on your portfolio. Chapters 9 and 10 will cover implementation details and trading rules. When we are done we will have the perfect blend of limited loss, limited personal cash investment, and unlimited profit potential. However, keep in mind that anytime you use margin borrowing to buy stocks, you are taking a larger risk of loss than if you didn't. There is still no free lunch.

Chapter 8: Margin Power

As long as money has existed, risk-takers have multiplied their efforts through the use of other people's money. There is probably no place where the use of other people's money can be used to such advantage (if you have a well-thought out plan) or to court disaster (if you don't have a plan) than the stock market. In real estate, for instance, you can borrow money, but there will be a banker there to make sure you don't make too bad a deal and thus put the bank's loan in jeopardy. In the stock market there are few such safeguards. You are free to lose all of your money (and more) if you are not judicious in the use of debt leverage.

In the stock market, it is possible to easily borrow money, using the value of the stocks you own as collateral. As of this writing, current margin rules allow a person to borrow in order **to buy up to twice as much stock** as you have cash in your account. By using margin, you now magically have the same number of dollars in your account, but more stock than you had before. This practice is called *trading on margin*. Does it sound risky? You had better believe that it is, if it's done in an uncontrolled fashion. When using margin, the need to have an airtight plan and the discipline to follow that plan is doubly important. Even then, people can and do lose money trading on margin, because you can never tell what will happen in the stock market. However, if you do have a reasonable plan and discipline, you can obviously make a lot more money in stocks than you can by trading from a 100% cash position. If you try trading on margin, you can *lose* a lot more money than you could on a cash-only basis. So, be aware of the risks of margin as well as the potential.

The Reverse Scale Strategy that we just introduced can be used with margin leverage while keeping the risk to a manageable level. To effectively use margin, the first, most important rule is that you *never* borrow money in order to add more shares to a losing position. If you are carrying a losing position on anything, it is by definition trending downward at least from your entry point. As you have seen, in the Reverse Scale Strategy we only add to positions as they are trending in our favor, upward. We already concluded that we didn't want to buy into downtrending stocks even when trading from a cash position. We certainly don't want to *add* to any losing position, and with the ability of margin to magnify gains and losses we must be especially careful not to add to a losing position when we are borrowing to do it.

The other thing to keep in mind with the use of margin is that while current regulations allow us to finance up to 50% of the value of the stocks we own, such a level of leverage is almost never a wise move.

For instance, if you have a $20,000 account you can borrow from your broker to purchase up to $40,000 worth of stock. The use of *that much* leverage means you are paying a huge amount of interest relative to the cash in your account, which will deplete your capital rapidly with each passing day if your stocks happen to sit idle and mark time. This use of the *maximum allowable* amount of margin leverage also means that if the position moves against you, you are likely to lose a huge amount of your account equity, in other words the part of the account you actually own. In fact, with margin you can actually end up losing more than all of your money, under the most extreme conditions.

As we said before, current regulations allow us to buy twice as much stock as we have cash. That is the *most* risk we are allowed to take, but we are not going to take anywhere near that level of risk with our hard-earned money. So, our rule for use of margin will be:

To control our use of leverage, We will choose our initial position size in a stock so that we will always have *enough cash on hand to make our initial purchase and half of our second purchase*, without borrowing anything.

In the chart below, I've taken our previous chart for illustrating the Reverse Scale Strategy and added two columns, "Percent financed," and "Cumulative Cash Deposited." Since each successive purchase is always $1,000 in value in this example, we deposit $1,000 to make the first purchase and $500 to make the second purchase in accordance with our rule for margin trading. Our total cash deposited for this trade is therefore $1,500.

Reverse Scale Strategy, 50% Price Increments.

Decision Point Price Level	Amount Invested this Purchase *	Shares Bought this Purchase	Cumulative $ Invested	Cumulative Shares Owned	Current Value of Shares	Total $ Profit/(Loss)	Total $ Borrowed	Percent of Position Financed	Cumulative Cash Deposited
20	$1,000	50	$1,000	50	$1,000	$0	$0	**0.0%**	**$1,000**
30	$990	33	$1,990	83	$2,490	$500	$490	**19.7%**	**$1,500**
45	$990	22	$2,980	105	$4,725	$1,745	$1,480	**31.3%**	**$1,500**
67 4/8	$1,013	15	$3,993	120	$8,100	$4,108	$2,493	**30.8%**	**$1,500**
101 2/8	$1,013	10	$5,005	130	$13,163	$8,158	$3,505	**26.6%**	**$1,500**
151 7/8	$1,063	7	$6,068	137	$20,807	$14,739	$4,568	**22.0%**	**$1,500**
227 7/8	$911	4	$6,979	141	$32,122	$25,142	$5,479	**17.1%**	**$1,500**

* Since shares can only be bought in increments of one, this number does not always equal $1,000 for each purchase, but the cost of the closest increment of one share that can be purchased with $1,000.

The Cumulative Cash Deposited column shows the total amount of our own dollars we would have deposited, which in this example is never more than $1,500. This column added to the Cumulative Dollars Invested column and the Total Profit/(loss) column equals the Current Value of Shares column, because the current value of the stock we've invested in is composed of three elements: 1)The cash we've deposited (think of it as our down payment, 2) The amount we've

borrowed from the broker (think of this as our mortgage on the stock), and 3) The accumulated profit we carry in the position. You see, the broker's regulation requires us to only put up 50% of the value of the stock, and we can use any unrealized gain as part of the 50% downpayment we are required to make. This means that once we get to the third purchase and beyond, neither the broker's regulations nor our trading rule requires us to add any more of our *own* money to the trade, no matter how many more purchases our strategy requires us to make.

The Percent Financed column shows how much of the current value of stock we own is financed with borrowings from our broker. As you can see, at no time do we even get close to the 50% threshold, since the maximum borrowing we do tops out at 31.3% of security value as we add our third position. From then on, our profits snowball to such an extent that we are **not required to add another dime of our own money** to the trade for each purchase after the second one, no matter how many purchases we eventually end up making. Yet, our percent financed declines for each position added after the third one. The beauty of this approach is that when we lock onto a real winner, can really pile onto the position without putting up much of our own money. From the chart, you can see that should we execute our strategy on a stock which runs from $20/share to $227 7/8, we will have an open profit of $25,142, less the minimal amount of interest paid on the borrowed portion and commissions. Our total investment of our own cash was only $1,500 on the trade. You may not find a stock like this every year, but they are inevitable if you stick with the Reverse Scale Strategy and the stock picking criteria from Chapter 4. If you look at the Total Profit column, you will see that you do not need anything even close to a tenfold move to make a large profit relative to the $1,500 of your own money invested.

The decision to use margin or not is yours alone. You can still use the Reverse Scale Strategy without borrowing, by simply ceasing to buy additional positions when you run out of cash. The decision points in the chart are still useful in such a case for deciding when to sell out your position. Obviously, the use of margin makes a big difference in your return only when the stock makes a big move. Here is how the profit picture would look if you simply took a $1,000 position and didn't add to it at all:

Reverse Scale Strategy, no margin leverage:

Decision Point Price Level	Amount Invested this Purchase	*Shares Bought this Purchase	Cumulative $ Invested	Cumulative Shares Owned	Current Value of Shares	Total $ Profit/(Loss)	Total $ Borrowed	Percent of Position Financed	Cumulative Cash Deposited
20	$1,000	50	$1,000	50	$1,000	$0	$0	0.0%	$1,000
30	$0	0	$1,000	50	$1,500	$500	$0	0.0%	$1,000
45	$0	0	$1,000	50	$2,250	$1,250	$0	0.0%	$1,000
67 4/8	$0	0	$1,000	50	$3,375	$2,375	$0	0.0%	$1,000
101 2/8	$0	0	$1,000	50	$5,063	$4,063	$0	0.0%	$1,000
151 7/8	$0	0	$1,000	50	$7,594	$6,594	$0	0.0%	$1,000
227 7/8	$0	0	$1,000	50	$11,391	$10,391	$0	0.0%	$1,000

Using both Chart #1 and Chart #2,

we can construct the following comparison of the profit results of the same trade both with and without using margin leverage:

Profit Comparison of Margin versus Cash-only Basis:

Price Level	**Profit Using Margin**	**Profit Without Margin**	**Additional Profit from Margin**
20	$0	$0	$0
30	$500	$500	$0
45	$1,745	$1,250	$495
67 4/8	$4,108	$2,375	$1,733
101 2/8	$8,158	$4,063	$4,095
151 7/8	$14,739	$6,594	$8,145
227 7/8	$25,142	$10,391	$14,751

So, if the stock moves from $20 to $227 7/8, the difference in profit is nearly $15,000, whereas the difference in our *own* dollars invested is only $500 (the $1,500 deposit in the margin example versus the $1,000 cash deposit in the non-margined example). For stock trends of smaller proportions, the differences are less huge, but still substantial.

The use of margin is always more risky than not using it. This is simply because whatever you do to try to control the risk, you still own more shares than you would if you were trading without the use of borrowed money. However, I feel anyone who is comfortable taking a little more risk for a lot more potential reward should use margin, and I will assume throughout this book that the reader intends to use margin in building stock positions using the Reverse Scale Strategy.

Precautionary Guidelines

Some important principles to remember when using the Reverse Scale Strategy:

- Never buy a larger dollar position in your subsequent positions than you took in the initial entry into the trade. In our example where we bought $1,000 of stock at 20, for instance, **never** buy more than $1,000 of that stock in any single subsequent purchase. If you break this rule you will increase your average cost per share significantly enough that you will practically guarantee yourself a loss at some point.
- Only buy at the decision points. Don't try to make "extra" buys between decision points. This is just another way of breaking the first rule and leaves you exposed.
- Never set your decision points closer than 50% in price above the previous one. If you do, you can get whipsawed by normal market fluctuations, resulting in less profit and exiting trends prematurely. You will kick yourself as you watch your stock recover and start making new highs once again - without you.
- Do not depart from these guidelines!

Applying the Reverse Scale Strategy to Portfolios of Stocks

Up until now we have concentrated on how you would go about making buy and sell decisions for just one stock at a time, because it's much easier to explain the concepts this way. It's easy to adapt the Reverse Scale Strategy to a portfolio environment because all we have to do is construct a separate decision chart for each of the five, ten, or however many stocks are in our portfolio, and **begin with an equal dollar amount in each stock**. In the next chapter we will review in a step-by-step manner how to use our strategy to accumulate and manage a portfolio of stocks.

When using the Reverse Scale Strategy to manage a portfolio of stocks, always begin with an equal dollar amount invested in each stock. Do not try to guess which stocks will perform best.

Diversification

For the sake of being clearly understood, let me state this in no uncertain terms: You should **never** invest a major amount of money in just one stock. For one thing, it is risky because all of your eggs are in one basket. Furthermore, it is **unnecessarily** risky. If you have a number of stocks in your portfolio and use the Reverse Scale Strategy, those few that perform exceptionally well will be added to as they progress upward in price. This will guarantee that in the final analysis your best-performing stocks will make up a larger percentage of your portfolio than your poorer-performing ones. So you don't need to try to second-guess which stock will perform best beforehand.

If you are disciplined and follow the strategy, you will have the benefit of starting with a shotgun approach at the outset and progressing to more of a rifle-shot as the winners begin to emerge. So don't try to hit a home run by investing all your money in one stock. Chances are, you'll simply strike out.

Ignoring principles of diversification and investing your money in only one stock is a risky and foolhardy thing to do - don't do it.

In my opinion, you should never invest in less than five stocks to begin with, and that's the bare minimum number assuming you just don't have enough money to invest in more. As a rule of thumb, aim to have about **ten** stocks in a Reverse Scale Strategy portfolio. There is nothing magical about the number ten, but I feel this number represents a good balance between diversification and the time required for tracking the stocks.

Do not churn your account!

Once you have chosen the stocks you will trade, do not change stocks (selling one, buying another) unless it meets the predetermined exit plan. That is, do not sell a stock unless it hits one decision point below the previously achieved decision point. Ever. If you do depart from this system you will no doubt end up making emotional decisions, and they will most likely be poor ones. Plus, you will lose peace of mind because **you will no longer have a plan** that you are resolved to stick with no matter what. In short, you'll be right back where you were before you read this book.

There have been a number of studies over the years showing that excessive trading tends to reduce investment results. The other name for excessive trading is **churning**. Whatever you call it, it is a waste of time and generally is a tip-off that the investor doing this is confused about their strategy or is investing for excitement rather than profits.

If you resolve to use the Reverse Scale Strategy, stick with it consistently. In the long run it will be the best policy.

Guidelines for placing orders

Market orders versus Limit Orders

When you place an order with your broker, they will ask you if you want to execute your trade as a *market order* or as a *limit order*. **You should *always* use market orders when buying or selling stocks.** A market order specifies a willingness to buy at the current market price, whatever it may be. A limit order instructs the broker to buy at a specified price. A market order ensures that you will have your order filled, but the exact price is not guaranteed. A limit order guarantees that you will not pay a higher price than you specified, but does not guarantee that your order will be filled.

So why not use limit orders? Because if you do, you will find that what would have been your most profitable orders are seldom filled, as the market moves away from your specified price. On the other hand, the orders that are filled on a limit order will most likely turn out to not be your best potential trades. The reason for this is that stocks of companies where something really good is happening will move steadily upward at times, without pausing to backtrack and fill the orders of those who have decided to use limit orders. The use of limit orders generally means that a person is being greedy, hoping to cut his purchase price by a small amount. But, instead, the hapless limit order is constantly left behind by the really good stocks, and wonders why his biggest fish got away.

Bottom line, in real life with the Reverse Scale Strategy it is not critical that you get filled at exactly the prices listed in the decision chart. We are going after the big gains and a quarter or half -point variation won't matter much in the long run. It is important to *always* use market orders as opposed to limit orders.

It is much more important to get your order executed than it is to get a specific price.

Stop-loss orders

There is another type of order you should know about, called a stop - loss order. They are commonly referred to as simply 'stop orders.' This order is placed below the market price if it is a sell stop order, or above the market if it is a buy stop. If the stock's market price reaches the price specified in the stop order, then the stop order becomes a market order to buy or sell. As an example, let's say we bought shares of ABC Co. at $20. They then rise to reach the first decision point price of $30/share, signaling that our sell signal will be reached if and when the price of the stock goes to $20. We could place a sell stop order for our shares at $20, which would instruct the broker to enter a market order to sell our shares **if and only if** the market price of ABC Co. again returns to $20 or below. If we enter it on a *good till canceled basis,* (GTC), the order will stand until it is either triggered by the stock's price reaching $20, or until we cancel the order. If you do not specify GTC status for this or any other type of order, your order will be classified as a day order, meaning it will expire at the end of the day it is entered. So be careful to specify GTC on stop orders if you want them to last more than a day. Otherwise you may have a false sense of security that your order is still entered when it really is not.

Currently, stop orders are only available on listed (New York Stock Exchange and American Stock Exchange) stocks, and not on Nasdaq (Over-the Counter) stocks. However, some brokers are starting to offer stop orders on Nasdaq stocks. So, perhaps soon these orders may be available for all stocks in your portfolio. I certainly hope so, because stop orders are a very useful thing for the average investor who cannot be watching the market constantly. They in essence watch it for you.

If you cannot watch the market during the day (and who can?), I encourage the use of stop orders once you have accumulated a large position in a company's stock. The decision point parameters are set far enough apart with the Reverse Scale Strategy that using intraday prices (which is what stop orders are triggered by) or closing prices will not likely change your performance very much and may give you greater peace of mind.

Chapter 9: Implementing the Reverse Scale Strategy: A Step-by-step Approach

Now that you have a good grounding in the Reverse Scale Strategy, we are ready to review the steps needed for you to implement it. Obviously, going through these steps the first time will take more than five minutes, but after you are set up it should only take five minutes a day to maintain and execute the strategy.

Step 1: Determine how much you can afford to commit to this strategy.

All stock market investments involve some degree of risk, no matter what your approach to the market. Bear markets, national emergencies, and other factors are unpredictable and cause most stocks to decline temporarily when they do occur. Because of this unpredictability of short-term stock market performance, you should only invest capital which you will not need for at least *five years*. Therefore, it's necessary to establish exactly how much you can afford to commit to a longer term strategy such as the one we've just developed - your pool of "risk capital." The term "risk capital" means different things depending on the psyche and risk tolerance of the individual involved, and determining that number for you personally is outside the scope of this book. You alone must determine how much you can commit, but the following are some things to consider when making that decision:

1) *Investment experience*.

If you have never before traded stocks, start small in using the Reverse Scale Strategy until you are very comfortable w ith the Strategy and with your understanding of the mechanics and practices of stock trading. If you lack confidence, there is no use compounding your discomfort by adding the stress of trading with the lion's share of your money. You will learn things as you trade that will give you confidence in handling larger amounts. Be patient and give yourself time to learn before committing big money.

2) *Establish an emergency fund*.

By definition, if you are not going to commit funds which you will need in the next five years, then you must establish an emergency fund. No one, no matter what position they are in, can rule out the

possibility of a personal emergency over the next five years. Most financial experts recommend six months' living expenses, and I would consider that the minimum amount necessary.

3) *Age*.

The older you are, the less years you have to recover from reverses in the stock market. If you are only five or ten years away from retirement, it goes without saying that you may want to be a little more conservative in the amount of capital you devote to an actively managed stock portfolio. More predictable investments such as bonds, CD's, convertible securities and such may need to compose the majority of your holdings.

Using these factors, you need to take an honest look at your situation and assess just how much you want to commit to a relatively risky, longer-term investment program.

I do not recommend that you trade on margin with the majority of your money!

Do not speculate in stocks with money that you will need to consume within the next five years.

Step 2: Choose an Appropriate Brokerage Firm

As I see it, there are several criteria to use in choosing a brokerage firm to handle your account: 1) Commission structure, 2) Insurance, and 3) Attitude.

***1) Commissions*.**

With this method (or any other, for that matter), it is vital that you cut your commissions to the bone in order to maximize net returns. In most instances, this will mean using a discount broker instead of a full-service broker. To enhance net returns, commissions should total no more than 1% to 2% per trade, or else you are paying too much. The techniques in this book work with accounts of any size above $5,000. But the smaller your account size, the harder it becomes to maintain reasonable diversification without incurring large commissions as a percentage of your account value. So if you have a relatively small account and are buying stocks in $2,000 increments, choose a broker which will handle your trades for less than $40. You should have no trouble finding a discount broker that will handle your trades for less than that amount actually, and I recommend you do so. My broker charges $25/trade and I get a level of service that has always been more than adequate. The

smaller your account size, the more closely you'll have to pay attention to finding a broker who can keep your commissions down to 1% to 2% of the principal amount per trade.

***2) Insurance*.**
Make sure your brokerage account is insured in case they should go bankrupt. Before you open an account, ask to see (in writing) what would happen in the case of the brokerage firm's bankruptcy. The vast, vast majority of firms these days have adequate insurance in case of failure through the Securities Investors Protection Corporation (SIPC), but the possibility that a firm wouldn't have insurance exists and it's good to inquire about such things before committing your funds.

***3) Attitude*.**
Discount brokers are essentially order-takers who offer no advice, which is precisely what we want and need. Even so, before you open an account it is good to call the firm's customer service department and ask a few questions, even if you have to make some up. I believe that you can learn a lot about the attitude of the brokerage firm and its employees by speaking with them personally. This provides a good reality check on whether you will be able to do business with them or if there will be a clash between their culture and your personality.

Step 3: Determine how many stocks you will invest in.

It's best to pursue the Reverse Scale Strategy with ten stocks or more if you can, with five stocks being the absolute minimum number to achieve adequate diversification. Because of the practical constraint of trying to minimize commissions as a percent of the value of your portfolio, the goal of owning ten or more stocks is probably only realistic with accounts of $20,000 or more. If your account is small (between $5,000 and $20,000) you may have to settle for five to nine issues and get a very inexpensive discount broker in order to keep commission expenses manageable.

Amount of Capital Available	Recommended Number of Stocks
$5,000-$10,000	Five
$10,000-$15,000	Six or Seven
$15,000-$20,000	Seven to Nine
$20,000 & Up.	Ten or More

If you are adequately capitalized, though, ten issues represents an acceptable level of diversification and is a manageable number of issues to track daily. This number is not critical, though. If you feel you have time, and a fairly large amount of risk capital (say, more than $100,000) you can have fifteen or twenty stocks in your portfolio.

I would not try this method with less than five issues, because the volatility in your account will likely be emotionally taxing. One thing to keep in mind is that the more stocks you have, the better your chances of finding an exceptionally good-performing stock.

To determine the dollar amount you will invest in each position, take the number of dollars in your trading account and multiply by 65%. Then, take this results and divide by the number of issues you will be trading in your account. This will yield the dollar amount you will initially invest in each issue.

As an example, let's say you have $15,000 in your trading account. Multiplying $15,000 by 65% yields $9,750. $9,750 represents the *total amount that you will invest to begin with*. Now, if we tried to split $9,750 up into ten stocks, we would only be investing $975 per stock. Since we would have a hard time keeping our commissions down to the 1% to 2% of principal level on a $975 trade (for instance, if our commission was $25 per trade we'd be spending $25/$975 or nearly 2 1/2%), we opt to trade six issues instead of ten, after referring to the chart above. $9,750 divided by 6 yields about $1,625 per stock. This amount, $1,625, is the amount we will invest in *each* of our six issues.

The reason we are using only 65% of our capital at first is that we want to abide by the margin trading rule we developed in Chapter 8:

To control our use of leverage, We will choose our initial position size in a stock so that we will always have enough cash on hand to make our initial purchase and half of our second purchase without borrowing anything.

Using no more than 65% of our capital for our initial positions in our six stocks ensures that we are in compliance with this part of our trading strategy.

Step 4: Determine which issues you will invest in

Keep it simple. Use the criteria for stock-picking presented in Chapter 4, which is essentially:

- Restrict your stock picking to the 52-week highs list (better yet, use stocks making new all-time highs in price).
- Weed out defensive issues such as precious metals, oils, utility companies, closed-end mutual funds and food/grocery issues.
- Weed out stocks selling for less than $15/share.
- Lean toward the smaller-capitalization stocks remaining on your list that meet criteria 1 through 3 above.
- To maintain adequate diversification, select stocks from several different industries.

Check out the chart of the stock for clues on goodness of trend, volatility, and whether or not a buyout situation is responsible for its being on the 52-week highs list.

You can be assured that these stocks are high-potential and they will have a excellent chance of leading the market in a bullish environment. If we use this criteria to choose the six stocks we will buy and follow in our example, our chances of having some really big winners will be increased dramatically over just about any other method. Why? Because we are getting our recommendations directly from the market, where investors are voting with their dollars. Not from a broker who may not even have his own money invested in the stock he's selling to you. Remember, stock brokers are successful because they know how to get people to buy stocks, not necessarily because they know how to make money.

To continue our example, after applying the criteria above, let's say we end up choosing the following six stocks (these are hypothetical examples only):

StockPurchase Price Zeneca $56 3/4 Hummingbird $50 3/4 CUC International $31 1/8 Tiffany $46 3/4 First Data $69 1/2 Imperial Bcp $24 As we determined earlier, we will purchase $1,625 worth of each stock.

Step 5: Buy your initial positions in each stock

Now that you have chosen which stocks to build positions in, calculate based on the most recent closing price of each stock how many shares you will initially buy in each issue. Don't worry that they are not in even 100-lot quantities, which they almost certainly will not be. Instead concentrate on buying an equal dollar amount in each issue purchased. For example, we previously calculated an initial position of $1,625 for each of our six issues. Therefore, if one of the stocks on our buy list is Zeneca and it is selling for $56 3/4, we would place an order to buy 29 shares ($1,625 divided by 56 3/4, rounded up to the next even-number share quantity) at the market price. This calculation would be repeated for each of the other five stocks you are buying using their specific closing prices from the previous day.

Here's a helpful hint: Try to place the orders well before the 9:30 AM market opening so that you will receive the day's opening price. Odd lot trades (less than 100 shares) are usually upcharged some amount for a handling charge, but this is often waived if the order is entered before the market opens. Also, you'll be more likely to get a price closer to the previous day's close by getting in when the market first opens. As always, use market orders and not limit orders.

Once your orders are filled, be sure to make a note of the price per share you actually paid for each position.

Step 6: Construct your predetermined entry and exit plan matrix.

Now that we have taken our initial positions, all that is necessary is to finish filling out the Reverse Scale Str ategy Decision Chart, as shown in the example below. In this chart, we define the first few Decision Points (more can be added later, for those stocks which make hefty advances) for each stock based on your initial entry point into that stock. The number of shares we acquire at each decision point can be penciled in as these acquisitions occur, as well as the total number of shares owned. For each stock individually, the sell point is always one level (33%) below its highest Decision Point reached, as cover ed in Chapter 7. Once we have constructed this worksheet we can carry it with us and pencil in acquisitions as our decision points are reached. Then we will know which Decision Points have been reached, and hence we will also know just by looking at the ch art what our current sell point is for each stock, as well as the next buy point. In keeping with our example, here is how the chart would be filled out for the six stocks we picked out for our example portfolio, once we've taken our initial positions:

Reverse Scale Strategy Decision Chart

CompanyZenecaCompanyHummingbirdSymbolZENSymbolHUMCFTarget Price/shareShares PurchasedTotal Shares OwnedTarget Price/shareShares PurchasedTotal Shares OwnedInitial sell point37 7/8(n/a)(n/a)Initial sell point33 7/8(n/a)(n/a)Inital entry point56 3/42929Inital entry point50 3/43232Decision point 185 1/8Decision point 176 1/8Decision point 2127 3/4Decision point 2114 1/4Decision point 3191 1/2Decision point 3171 1/4**CompanyCUC Int'lCompanyTiffany**SymbolCUSymbolTIFTarget Price/shareShares PurchasedTotal Shares OwnedTarget Price/shareShares PurchasedTotal Shares OwnedInitial sell point24 3/4(n/a)(n/a)Initial sell point31 1/8(n/a)(n/a)Inital entry point37 1/84444Inital entry point46 3/43535Decision point 155 3/4Decision point 170 1/8Decision point 283 1/2Decision point 2105 1/4Decision point 3125 1/4Decision point 3157 3/4**CompanyFirst DataCompanyImperial Bankcorp**SymbolFDCSymbolIBANTarget Price/shareShares PurchasedTotal Shares OwnedTarget Price/shareShares PurchasedTotal Shares OwnedInitial sell point46 3/8(n/a)(n/a)Initial sell point16 (n/a)(n/a)Initial entry point69 1/22323Initial entry point246868Decision point 1104 1/4Decision point 136 Decision point 2156 3/8Decision point 254 Decision point 3234 5/8Decision point 381

Step 7: Monitor your positions

After we have taken our positions, it's pretty much a game of waiting to see what happens next. We must check performance of all the issues in our portfolio after the close of *every* trading day in order to see if you need to add to any of your positions or sell any of them. If you can, check twice a day, but this is not a requirement for success. Even though our decision points are placed far apart, under certain market conditions large moves can happen in a single day, so it's critical to keep on top of developments - and so the necessity of checking in every day. The way to accomplish this is by using a

discount broker that offers a touch-tone quoting and order entry service, which should bring the time necessary to check up on things down to about about two or three minutes a day. Who knows, we may become a "Less Than Five Minute" Investor! If your discount broker does not offer this service, find one who does and save yourself a lot of time. These services allow you to set up a list of stocks whose closing prices will be automatically reported to you at the end of the day when you call. With this type of service, monitoring your stocks can easily be accomplished by even the busiest persons. I like the touch-tone quote retrieval services because even if I am on a business trip, I can check my investments at 10PM in my hotel room, and I don't need a computer to do it. If a buy or sell point has been reached, I can enter the necessary orders right there on the telephone, without talking to anyone or having to wait until the broker gets in in the morning.

I strongly recommend that when you have built a fairly large size position in a successful stock, use good-til-cancelled stop-loss orders, which were described in Chapter 8. I use these whenever I have made two or more purchases in a stock, because at that point I have enough invested in the stock to warrant protecting myself with such a mechanism. However, there is no reason you can't choose to use a stop-loss order on every position in your account. This helps to avoid the situation where you call in at the end of the day only to find that your stock has fallen to substantially below your Decision Point for selling. Stop orders give you peace of mind for keeping your mind on your job during the work day, without the distraction of needing to watch your investments. One necessary discipline for the use of good-till-cancelled orders of any kind is that you must keep meticulous records of your orders, so that you know exactly which orders you have entered and which ones you have canceled. Otherwise, you may end up executing orders which you did not intend to execute.

Step 8: Know and Apply the Trading Rules

As you monitor the stocks in your portfolio, eventually one or more of the stocks will reach the next decision point above where you got in, or will decline below the decision point previously reached. In either case, action on your part is required. Thus it is good to review and know the trading rules well so that you can apply them decisively.

Trading rule #1: Whenever a stock *advances* so that it touches a Decision Point not previously achieved, add a dollar amount to your position in that stock approximately equal to the dollar amount originally bought.

In our example, we bought $1,625 worth of Zeneca at $56 3/4, so if Zeneca rises to touch $85 1/8, we will call the broker and add 19 shares ($1,625 divided by $85 1/8) to our position. We would update the Zeneca portion of our decision chart as follows in the highlighted area:

CompanyZenecaSymbolZENTarget Price/shareShares PurchasedTotal Shares OwnedInitial sell point37 7/8(n/a)(n/a)Initial entry point56 3/42929Decision point 185 1/8**1948**Decision point 2127 3/4Decision point 3191 1/2No other stocks' decision charts are affected by t his change. We are making decisions for each stock separately, based on the performance of *that stock alone*. Now that the chart has been updated, we can see all the information we need to know: We can see that the Decision Point of $85 1/8 has been reached, that we now own 48 shares, and that in order for us to sell our entire position Zeneca would have to decline to $56 3/4 or lower. This scenario is covered in the next trading rule.

Had Zeneca risen to $191 1/2 or higher over the next several months or years, we would have added positions at $127 3/4 and at $191 1/2, for a total position of about 68 shares. At that point, the new sell stop for all 68 shares would be at $127 3/4.

Trading rule #2: Whenever a stock declines to touch the previous Decision Point, sell the entire position.

If, instead of advancing, Zeneca had declined instead of advancing and had dropped as low as $37 7/8 after we took our initial position, we would have to sell out the initial position (29 shares) for a loss. Obviously, we never got the signal to add to the position because we are assuming here that it reached $37 7/8 before it got the opportunity to hit $85 1/8.

Once one of the sell points is reached, do not hesitate. Sell. Likewise, do not hesitate to buy whenever a new decision point is reached during an uptrend. Sometimes the best stocks rise very quickly, so to act decisively is all-important whether buying or selling. He who hesitates is lost. If you believe in your plan, there is no reason to be hesitant.

Trading Rule #3: Once you have sold a stock, recommit the proceeds of that sale to a different stock (or stocks) than the one you've just sold. To pick this new issue, use the same criteria used in choosing your original list of stocks.

As we've reviewed, some people, once they've taken a loss on a stock, take it personally and they keep trying to "get even" with the stock by looking for an opportunity to buy it again. Don't fall into this trap, because if you do you are acting like the Ego-Driven Investor described earlier in the book. Forget the loss and the stock. If a stock has fallen far enough from its highs that it's now down at least 33%

from the peak (the percentage difference between every Decision Point and its next lower Decision Point), then it may be entering a downtrend, and you don't want it. Take what's left and buy a different stock, one now making new highs. Your money will be better employed and your account won't end up looking like the dog pound.

A Trading Rule for Bear Market Insurance

In any trading system, the *most* important thing is to preserve your capital. Capital preservation is all-important because if you seriously deplete your trading capital, it becomes very difficult to get back even to where you started out, much less make a profit since you are then working with a smaller amount of capital.

The two main sources of capital depletion are from *whipsaw losses* (rapid-fire in and out trading, which almost always results in lots of small losses and large commission expenses) and from failing to cut losses on poor investments. The Reverse Scale Strategy already has many capital-preserving mechanisms built into it. Among these are diversification among many securities, our loss-cutting decision rules, and the fact that we do not add to positions until they are showing us a good profit. Also, our decision points are set far enough apart (50%) so that whipsaw losses are extremely unlikely, especially when applied to stocks selling for more than $15 per share.

However, for good measure we need to address the worst-case scenario in order to short-circuit the prospect of several losses coming in quick succession. These types of events tend to occur during bear markets. Since bear markets are a reality and are unpredictable, we need to add the following trading rule to ensure that we can survive those inevitable times when the market goes down for an extended period, pulling almost all stocks down with it:

Trading Rule #4: When you've been forced out of a stock position (by applying trading Rule #2), do not reinvest the proceeds of that sale into another stock until the Standard and Poor's 500 stock index (commonly referred to as the S&P 500) makes a new 52-week high.

The purpose of this trading rule is to force us to wait until the market as a whole is showing signs of positive momentum before recommitting funds. In other words, we do not want to get into a situation where we are buying a new stock, selling it for a loss, using the proceeds to buy another new stock and then being forced to sell it for a loss, and so on in quick succession. This can happen during very severe market downturns. That's why we want to wait until the market has shown some strength before recommitting funds to a new position. Your win to loss ratio will be much better if you observe this rule.

Since the market (as measured by the S&P 500 index) is commonly making 52-week highs, most of the time you will not have to wait too terribly long to reinvest proceeds of a sale. If Trading Rule #4 does prevent you from reinvesting for a long period of time, there is a very good reason for it, and you will no doubt be glad that you were patient in waiting for a new 52-week high for the S&P 500 before recommitting funds.
Of course, it goes without saying that any stock you would pick for reinvestment needs to be chosen using the criteria from Chapter 4.

Step 9:Periodic Adjustments

As your account value grows, you will have to periodically adjust the size of the initial positions you are taking in a stock. For instance, if our $15,000 account equity grew to $25,000 and we sold one or two stocks, we probably wouldn't want to take new initial positions to replace them that were as small as we originally took. Instead of taking $1,625 initial positions, we might decide to take position s that were proportionally in line with our new account equity balance, say $2,700 in this case. With any successful investment plan, these types of adjustments need to be made as the amount of money you have to invest grows.
The other thing you could do in such a case is to stick with the $1,625 initial position size and simply work with a larger number of stocks. For diversification purposes, this is the preferred route to take, at least until you reach the goal of having ten stocks.
The main thing to beware of is that you **don't over-commit yourself**. When you sell a stock, **don't invest more in new stocks than you received in proceeds from the one you've sold**. If you adhere to this rule, you will never overcommit yourself.

Chapter 10: Getting Started

If you are a beginner in the world of investing, it is natural to be a bit apprehensive about getting started investing in stocks. Even though you now have a good strategy, you may want to see this strategy work before committing a major amount of funds to it. After all, bear markets are an unpredictable reality and it could so happen that you will begin trading at just the wrong time. For those who are fearful of this and may wish to begin by taking a very conservative stance in the market, it is a fine thing to do especially if you have limited experience in investing. **You can never err by giving yourself time to learn something before plunging headlong into it**. It's a fairly safe bet that if you don't feel like you know what you are doing, then you are probably right and would be well advised to start on the conservative end of the scale.

Once you are comfortable with these concepts and your ability, you can start getting more aggressive. Until then, the following chapter addresses some ideas for adjusting our system in order to accomplish a more careful approach when you are just starting out.

Start Small

One of the simplest ways to reduce your risk as a beginner is to implement the Reverse Scale Strategy with just 50% of your capital. So if you have $20,000 available for stock investing, you may want to just pretend you have $10,000, pick five stocks using the procedure in the text, then invest just $1,500 in each one of them. This will leave you with $12,500 in cash to begin with which will earn interest for you as you are learning. Should you have the misfortune of entering the market as a bear market is beginning, your interest earnings will help to offset any temporary losses or worries. From this cash-rich position, you can learn while remaining comfortable that you won't lose your entire stake.

Time-based Diversification

Another way of reducing risk is by gradually implementing the Reverse Scale Strategy one stock at a time. Suppose you have $20,000 in your account and your long-term goal is to have your money spread out over seven stocks. So, in this case you employ the formula from the last chapter and multiply your $20,000 times 65% and then divide

that number by seven. This means that your initial position in each of the seven stocks would be about $1,885. There is no reason you have to rush out and buy all seven stocks at the same time. Instead if you are a little nervous, add one position each month. This will mitigate the possibility of starting your investment program at the beginning of a bear market and make it unlikely that you will have a bad experience right out of the gate. So, the first month of your program you would only have one stock, with $1,885 total invested and $18,115 in cash. The next month, you would at that time choose another stock that is making new highs in price and meets our other criteria, leaving you with $3,770 invested in two stocks, and approximately $16,230 in cash, and so on until you have your seven stocks. Since we manage each stock separately in this Strategy, if your first stock does well and hits its next Decision Point before month two, you may actually end up having $3,770 invested in the first stock *before* having purchased the second issue. This will be relatively rare, but if it happens it is cause for celebration, not panic, and you should implement your strategy just as you would if you were starting with all seven issues right off the bat. That is, do not let the success of the first purchase hinder you from adding your second issue in month two, even though you may already have $3,770 invested in the first one. In either case, you will have your seven positions in hand when month seven finally arrives. Needless to say, if you want to be very careful, you could add one position every two or three months, instead of one every month. It all depends on what makes you feel most comfortable given your own personal level of risk tolerance.

Market Momentum

An additional line of defense is to wait until the broader market is showing signs of strength before beginning. Bull markets usually do not end overnight, so if you wait until the S&P 500 makes a new 52-week high before you select and purchase your stocks for the first time, you will have a good chance of success as you start. In the last Chapter, Trading Rule #4 was added to keep us from recommitting funds from a sale until the S&P 500 makes a new 52-week high. There is no reason that you can't apply the same principle in order to determine a reasonable time in which to *start* your investment program. In fact, I think that this is a very good idea.

Remember the Basics

As you enter the world of stock investing using the Reverse Scale Strategy, I wish you the best of results. I could wish you luck, but luck

has nothing to do with investing. Once you start applying the principles in this book, you will find that your luck will improve greatly.

If you are ever confused about what to do, reread the sections on Stock Market Myths (Chapter 1) and Investor Mistakes (Chapter 2). Avoid the mistakes and the myths and you will find that you can figure out on your own what to do. The best policy is to understand the principles and trading rules of the Reverse Scale Strategy, not to memorize them. If you let this be your guide, your results will be much better than they would be otherwise.