Investing Strategy Report

A free report By Susan Hayes, The Positive Economist

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Investing strategy report - exclusively for newsletter subscribers!

In July I published the article "Why making more money is the worst investment strategy you can have". It was part of the bond series on my blog, so it concentrated on bonds. You can read it here.

The truth is, I could write volumes about investment strategy – and I have decided to go into more detail, but only for my newsletter subscribers.

The following article will not be published on the blog and is only for you, as a way of saying thank you for reading my newsletter. Enjoy!

So, how long was this piece of string already?

In the original blog post, I talked about a question I get asked all the time: "What is a good stock to buy at the moment? Any tips?" As I said, this is akin to asking "How long is a piece of string?" It only shows that the person asking the question knows nothing about investing, and certainly very little about the stock market.

When somebody asks that question, it means they have no idea that, before investing in a stock (or a bond, or anything!), they should have clear guidelines and clear objectives. And when I hear that question, I simply shake my head and sigh, because this person is a sitting duck for the first stock market or day trading scam that comes their way.

Something that I see very often is people putting their money in stocks and then giving out because the stocks are not performing the way they would like them to – even though they themselve are not quite sure what they want! When you probe them a bit deeper, you find out they just bought stocks that sounded good, or on recommendation – and you also find out they would be happy to make 5% per year.

My reaction is – why not invest in bonds?! It's relatively easy to find a bond that pays a 5% yield, and if you buy an investment grade bond, you're fairly certain of getting your money back at maturity. But they didn't think of bonds because they were focused on stocks, and they were focused on stocks because they didn't really think their strategy through.

What's a good stock to buy – for you and your investment objectives?

The only way you can ask this question is "Considering who I am, what my risk profile is, how much money I have available for investment purposes, my personality traits and what objectives I have; considering my expectations, how they will play out, and the current state of affairs with the company in question – what is a good stock to buy?"

Only in this context does this question make any sense.

Unless you have an understanding of each of the above, it's a very dangerous question to ask, and most of all to answer!

Indeed, what is the point in me telling you what stock to buy, when it's not when buying a stock that you make your profit, but when selling it!

For example I have bought UK stocks in the past because I felt that the sterling would appreciate. Rather than simply holding the currency itself, I invested in high yielding UK stocks offering good value, to generate some income and capital gain also. My plan was that, at the end of the exercise, on repatriating the money back from sterling, I would make a return.

Now I got it wrong, because the sterling didn't appreciate – it was the euro that fell. So in fact I got it right! Whether the sterling appreciates or the euro depreciates, the end result is the same: the euro is weaker than the pound. So I got it right, but completely inadvertently. The main thing here is that I had a strategy (and a back-up strategy). As a result my objective was very clear – and I would also know equally clearly if that objective was not met.

In addition, I had made sure to invest in high dividend yields, in case I was wrong and the sterling didn't appreciate. In the intervening period, one of those stocks produced a capital loss and the others produced a gain, so I broke even. However, I had the income from the dividends and the depreciation of the euro, so I did produce the return I had been planning for.

Moral of the story: some of my expectations and predictions were borne out, but not at all in the way that I had imagined. To get there, they took a different route altogether!

But what would have been the point in me giving you such a "tip"? As you can see, I bought those UK stocks for very precise reasons, that had nothing to do with the amount of profit I wanted to make, and more to do with the prospects on offer.

And then, considering how the scenario unfolded, and the elements contributing to the return, how would somebody have used that "tip"? They may have only looked at capital gain, and in that case breaking even wouldn't have been enough for them: that "tip" would have been no good to them. However, unless they understood the entire picture (which consisted of three strategic decisions), they wouldn't have understood the context of the "tip"… That's why I neither give nor take those tips.

You sell when the reason you bought is no longer there

What you need is a reason to buy. This reason to buy gives you a reason to sell: when the reason you bought is not there anymore, then it is time to sell. Then you have something to work from.

When I buy a stock, I know what the reasons are. My reasons for buying I could list in five bullet points – easily. As a result I know exactly what time I want to sell the stock: when those reasons are no longer there.

The best reason to buy, and the best reason to sell, is a totally unemotional one. If you don't know *exactly* what achieving your objective looks like, and most importantly, what *not* achieving your objective looks like, you will not be able to make decisions. Taking the decision to buy or to sell a stock shouldn't have you chewing your fingernails, because ideally it should be clear cut.

A clear example of a bad way to take a stock market decision would be "Perhaps I should sell. This stock has been falling for a whole week now. But what if it rises again? Perhaps if I wait a little longer I will recoup my losses? Perhaps if it reaches xxx price I can sell it at a profit? Perhaps I should wait a bit before I sell?"

It's impossible to take a decision in this situation. There are only wrong answers to the questions above, because the questions themselves are the wrong questions to ask.

But how can you possibly look at a stock you own take a nosedive and not be worried? How can you possibly take any decision in the stock market? For most people, taking a decision to buy or sell is akin to a roll of the dice. But this is no way to invest in the stock market – you'd be losing your sleep!

It has to be a clear yes or a clear no

Let's take another example. I save my money in a deposit account and generate around 3% per year, risk-free. Now, I would like to invest in something which gives me at least an extra 2% in income per annum, since if I buy a stock, I am risking the capital value of my holding: the rationale here is that I am looking for an investment that offers a better return than a savings account, and I also have to compound the risk of this investment.

If I can find a stock that is offering me a dividend yield of 5% or over (provided the dividend was safe too), I am achieving my objective. Notice how the reason to buy is crystal clear: there are only two possible answers to "Does this stock offer a dividend yield above 5%?"

If the answer is no, I don't buy, if the answer is yes, I buy. End of story. No emotions involved. And if it turns out that I get it wrong and this was not a good stock to buy after all, I still have a 5% cushion to offset my losses. This is a simple valuation technique, and valuation techniques can be learned.*

And this reason to buy gives me a very good reason to sell. For example the dividend might be reduced or even cut. Or the price of the stock might rise, without the dividend rising as much – then the stock would be fairly valued.

Once again, in each case, the question "Does this stock offer a dividend yield above 5%?" only has one answer: yes or no. If the answer is yes, the reason I bought is still there: I keep the stock in my portfolio. If the answer is no, the reason I bought is no longer there: it's time to sell.

If the reason you bought is no longer there, you have to sell

Now a reason to sell might be a "good" one or a "bad" one: a good, felicitous reason would be when the stock you bought has reached the objective you had for it. It served its use. A bad, not so felicitous reason would be that the good point you bought the stock for is gone.

Whether you achieve your objective or not, you have to abide by the reason you bought. In the case of the stock with the 5% dividend yield, you shouldn't second-guess yourself and decide to keep the stock if the dividend is not at or above 5% anymore.

Indeed, if you bought the stock for its 5% dividend, and the dividend is not 5% or more, the reason you bought dictates that you sell the stock. It wouldn't be a good idea to keep the stock "just because you already have it".

I see this all the time – people are uncertain, forget the guidelines they decided on, forget their strategy, and listen to their emotions instead. It might be hope (that the dividend, and particularly the price, will rise again), greed (the price of the stock rose – perhaps it will rise some more?), or fear (the price of the stock fell – I don't want to take a loss!) and, let's be honest, a bit of laziness (if I sell the stock I will need to go to the trouble of finding another one to buy... Perhaps I can't find such a good stock again).

The only reason you might want to keep this stock is because you found another non-emotional, quantifiable reason to hold on to the stock. Once again, it has to be crystal-clear, and it has to be a question whose answer is either a resounding yes or a resounding no!

* I wouldn't buy a stock for the sole reason that it offers a 5% yield, but let's keep things simple for the sake of the argument!