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Stock Strategist: Stock Investing's 12 Deadly Sins
by Pat Dorsey   |   1/6/2003 06:00AM

Resolve to avoid these pitfalls in the new year.

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With the new year in full swing, I thought I'd review our list of a dozen sins that should be avoided by anyone investing in stocks. Think of these as resolutions—tips for kicking the bad investing habits of years past. Although some of these may sound pretty basic, avoiding mistakes is half the battle when it comes to successful stock investing. You'll be amazed at how much your investment performance will improve if you follow the financial version of the Hippocratic oath: "First, do no harm."

1. Don't short stocks. Yes, some professional investors make money doing this for a living. But that's precisely the point—they do it for a living, and they have the capital to back up the inevitable margin call if they make their bearish bet too soon. Remember, when you short a stock, you're borrowing the shares, which means that you're liable for unlimited losses if the shares keep skyrocketing. Folks who shorted Yahoo YHOO at $50 in 1998 are happy now, but they had to ante up some serious money in 1999 as the shares rose to four times that level. Who needs ulcers like that?

2. Don't buy concept stocks. As much as we'd all like to think that the road to riches is as simple as buying the next Microsoft MSFT, the harsh reality is that most speculative companies wind up failing miserably. (Trivia stat: Over time, emerging-growth stocks have had the lowest return of just about any investment class.) Buying a small firm with a revolutionary idea or product is like buying a lottery ticket: Fun and exciting, but not a great way to pay for your kids' college tuition.

3. Don't trade too much. One of the keys to successful investing is treating your stock as pieces of a business, rather than "little wiggly things with charts attached to them," as Warren Buffett would say. If you trade a lot, you're focusing on what doesn't matter (how much GizmoTron shares are moving from day to day) rather than on what really does matter (whether GizmoTron is going to be successful in launching Gizmo 2.0). Moreover, frequent trading drives up your portfolio's overall transaction costs, which is a sure route to poor performance. And if you don't believe me, check out the research of Professor Terrance Odean at U.C. Berkeley. He studied thousands of individual-investor brokerage accounts and found that the rapid traders seriously underperformed their slowpoke brethren. We've also done studies on the thousands of mutual funds that we track showing
pretty much the same thing—higher turnover generally leads to lower returns.

4. Don't try to make a quick buck. No one—not chartists, not Warren Buffett, not even those investment newsletters that keep spamming you—knows what stock prices will do in the short run. Therefore, never buy companies because you're expecting "positive news flow" or some short-term development that will pump up the stock price. If you can't imagine what the company will look like in three to five years, and you don't intend on holding it that long, don't buy it in the first place. In the long run, share prices track business value, but in the short run... well, you might as well consult an astrologer.

5. Don't bet big on a single stock or industry. The world has this nasty habit of changing without notice, and what looks like a slam-dunk no-brainer today could be headlining the scandal sheets tomorrow. No matter how much research you do, the unforeseen is always out there. So control your risk by not putting too large a portion of your assets in any single place. (This goes double for those of you with nothing but company stock in your 401(k) plans. Diversify, diversify, diversify.)

6. Don't fall in love. It doesn't matter how large your gain or loss, how charming the CEO, or how many rationalizations you can come up with for hanging on—if a company's financial performance is deteriorating in a big way, you need to think about selling the stock. The day you buy a stock, write down the reason you bought it. When things start looking ugly, pull out your reason, and if the original investment thesis doesn't hold, it may be time to end the relationship. Ideally, all of our investment relationships would last for decades, but companies change and investors make mistakes, so sometimes you have to move on.

7. Don't ignore valuation. At the wrong price, even the greatest company is a poor investment. You could have bought steady-Eddy Coca-Cola KO a few years ago and still be underwater, after all. The key thing is to remember that successful stock-picking has two parts: Find a great company and pay a reasonable price. You've got to pay attention to both.

8. Don't buy just because the price went down. Cheap stocks can always get cheaper, and yes, stocks really can go to zero. I've heard a lot of coffee-shop conversation along the lines of "Well, the stock's at $2, how can it go any lower?" Just remember that a $2 stock that drops to $1.50 has just eaten 25% of your investment.

9. Don't buy IPOs. The vast majority of initial public offerings are overpriced. After all, why would a company go public unless it thought it was getting a high price? Over the long haul, IPOs have significantly underperformed similar stocks, and there's just no reason to pay any attention to them—until they've been on the market for a little while and dropped about 50%, of course. Then, you can often find some good bargains. (Exceptions to the "no-IPO" rule are spin-offs, which are often underpriced—look at Zimmer Holdings ZMH or Coach COH for good recent examples—and forced sales, such as CIT Group CIT, which are sold cheap because the parent has to raise capital and can't wait.)

10. Don't be impulsive. No matter how great a bargain something may appear, don't buy without doing your homework first. At an absolute minimum, this means reading the last year's 10-K filing. Think about it this way: If you make a rash decision and buy a bad stock, you'll lose money. But if you merely fail to pull the trigger on a poorly researched stock, the worst that can happen is that you might not make some money. Real costs hurt more than opportunity costs.

11. Don't listen to stock tips. Any stock you read about in a magazine, hear about in the newspaper, or read about in this column deserves further investigation before committing your own money. Why? First of all, it's your money, and second, how are you going to know when to sell? You certainly can't rely on that smart pundit to reappear in your favorite financial magazine and tell you it's time to get out. You have to know the company well enough to make that decision for yourself.
12. Don't ignore your stocks. Buy and hold doesn't mean buy and forget. Keep up on your stocks by checking the news once in a while, and always read the annual report (the 10-Q reports, too, if you have the time). If you do this, you should be able to see big problems before they become terminal problems.

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