

Stock Selection or Indexing?

While the frustration seems to be growing within the investment community, the stock market is doing better than the media portrays. While the major indexes are under water year to date, individual stocks are behaving much better. Close to 70% of all NYSE companies are trading above their 200 day moving averages, showing a very bullish trend. The advance decline lines are strong and the high list compared to new low list is also very constructive. So what is the problem? Clearly, too many investors have been schooled to dwell on the major market indexes. They are missing out on the opportunities presented by having a portfolio of the cream of the crop. Maybe it is time to re-explore the art of portfolio management!

Despite the positive action of the stock market below the major indexes, the public remains skeptical. The high profile corporate and accounting scandals over the last several years have sent shell-shocked investors into their bomb shelters. In addition, the lack of international stability has added to the sharp drop in investor's confidence in recent years. Now even with consumer confidence returning following the recession in the US of 2001-2, the distrust of Wall Street continues. With real estate taking center stage, people would rather put on an addition to their home than trust their money to the stock market. In light of the current backlash against the stock market, the public needs to be reminded, that over time, investing in equities has generated significantly higher returns than real estate- especially if you can identify the right companies!

One of the big problems we have these days is the continued hangover from the dot.com bust. Companies in the commodity and basic material sectors have been shunned even though that is where the profits and action have been. The large capitalization technology sector continues to receive too much attention and is producing too little returns. This only contributes to today's frustration. The reality is that a lot of companies in the technology sectors have been doing well – not just the largest and high profile ones.

The reason people often gravitate to the larger companies is not only because they are better known- but they can be “traded” easily. In the late 1990's investors were “educated” in day trading. The result was a shift from true investing into technical trading. People's expectations and time horizons became their biggest enemies. Investors need to get away from instant gratification – stock market returns come over time. That is not to say we are advocating buy and hold – we are talking about buy and monitor your portfolio.

It is critical for investors to understand that they can regain their confidence and embrace individual stocks by isolating companies they can trust and feel comfortable with- for a while. The hardest concept to understand is that even most of the best companies do not stay good investments forever. Using our proprietary quantitative Magnet Stock Selection Process we rank all companies based on several criteria. Sorting and ranking by revenue growth, profit margin growth, free cash flow, and several proprietary ratios we created

we attempt to identify the strongest companies at the moment. History, and our experience, tells us that our list of “Magnets” changes over time. When we can identify the companies that rank out on our model that have a high level of shares held by management, are still relatively under- followed by Wall Street, and are under-owned by the large mutual funds – that is when we feel most comfortable. Companies with these characteristics often attract capital and then pull in the institutional investors. Once companies get sufficiently large and have to live up to excessive expectations and valuations; that is when trouble often begins. Staying ahead of the curve can be difficult and requires a significant amount of work.

If you are willing to buy individual stocks, it is important to continue to monitor your holdings and make sure they continue to make progress from a fundamental basis. It is important not to fall in love with any holding no matter what industry they are in or how well you think you may know the company. Any company can decline significantly enough to ruin your overall investment results because no company is immune to going out of business. There are too many examples of former industry and stock market leaders that have gone belly up. It is hard to imagine, with the booming steel prices of today, that former market leader Bethlehem Steel is bankrupt. In another striking example, if you would have stuck to your guns and stayed with the former airline leader Pan Am, despite all the current air travel, you would have lost all your money.

Interestingly, the indexes continue to go higher over time precisely because they continue to change the components of the index. So while long term investing in indexes has proven profitable, investing in the components has not worked out as well. There are less than 50 companies in the S&P 500 that were in the index over 30 years ago, and only a handful of these have actually outperformed the index itself. While several of the names that have been removed from the index were part of mergers the majority of the names were removed due to underperformance. New industries continue to be born and new market leaders show up unannounced. It is for the individual investor to find his own way to identify these industries and companies. It has been shown over bull market cycles that the leaders of the prior bull market are often not the leaders of the next.

Today’s conditions are ripe for a strong bull market – everything is in place except investor confidence. Corporate profits as a percentage of the Gross National Product is the highest it has been in 38 years. The valuation of the S & P is the best it has been in several years. Corporations are buying back stock at record paces. Merger and acquisition activity has increased because corporations are flushed with cash. The largest investors are already moving money out of real estate, while the smaller investors are still more confident in the housing market than the stock market. The bond market offers very little competition to the stock market right now as rates are rising and there is very little interest income available at these still historically low rates. The last time we had this much uncertainty and negativity swirling around the stock market you were paid to wait, this time rates are too low to attract the big money. There is more money parked on the sidelines as a percentage of the total capitalization of the stock market than any time in history. This is the fuel that will propel the market higher once investor confidence is regained. Primarily, because many of the stagnant largest companies continue to hold

back the major market indexes, the media has still not picked up on all the good news- and the relative attractiveness of the equity markets.

I see so many individual companies that rank up high on our Magnet® Model, and I continue to be amazed at the overall pessimism surrounding the stock market. Despite the unsettlingly international headlines, worldwide consumers will be coming on board in dramatic numbers. Billions of people will buy their first dishwasher and pair of sneakers soon. The demographics of an aging worldwide population points to tremendous opportunities in the healthcare industry while aging healthy baby boomers and their active lifestyle demands clearly offer opportunities in the leisure and travel industries; the challenge is to identify the companies most benefiting from these demographic shifts, not necessarily the biggest companies in those industries. Stock selection is the key. Opportunities abound, do not let the media or the major market indexes hold you back.

Disclaimer

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