The Rennie Quarterly Return

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Stock Investing: if it were easy, we'd all be rich

Everyone has made oodles of money in stocks, or so it seems. Every stock purchased went up - big time. Have you ever heard about the ones that went down? Neither have we.

While stocks have produced the highest returns over the long-term, investing in them profitably requires careful research, discipline and a rare ability to evaluate both objective and subjective data correctly. The oft-heard Hill Street Blues admonition that "it's a jungle out there" applies just as well to stock investing as it does to fighting crime.

What should one know before buying a stock? Here are just a few of the fundamentals:

- price/earnings ratio
- price/sales ratio
- price/book ratio
- return on equity, assets and net margins
- market capitalization & debt
- current and projected cash-flow
- management competence
- current products and those in the pipeline
- distribution network

to name just a few.

Is it really this hard? Well if one accepts the buy low/sell high tautology, the above data must be known and evaluated skillfully to assess whether a stock is low or high. So, yes, it is this hard.

If one has neither the time, energy, nor inclination for such a pragmatic, "bottom-up" approach, several companies sell their evaluations and opinions of such data. Even so, much scrutiny is still required to use their recommendations profitably.

Rather than deal with individual stocks, one can move up one level and focus on industry sectors. The key here is to evaluate the macroeconomic environment, and then identify which sectors (energy, materials, health care, financials, utilities, etc.) will benefit from current and forecast trends - then buy stocks in the favored sectors. This approach is commonly referred to as "top-down."

Technical analysis is another approach that discounts both company and economic fundamentals in favor of the alleged predictability of stock price patterns. What is the trend of the stock price? Is it below its 30/60/90 day moving average? How does it relate to "head and shoulders" and other patterns?

Mutual Funds

For most individuals fully involved with job/family/social activities, mutual funds can provide the much-needed investment expertise. Mutual funds generally come in two varieties: passive and active. The objective of passive mutual funds is to replicate rates-of-return of some identified index, the S&P 500 Index for example. Such passive or "index" funds are usually computer driven. While essentially a no-brainer approach, they usually outperform about 70% of actively-managed funds that try to beat their index. If one simply doesn't want to go through the challenge of picking mutual funds, an index fund is a great default option.

Actively-managed mutual funds seek to produce rates-of-return higher than some passive benchmark, usually an index. Few are successful. Many charge very high fees. There are, however, a small group of low-cost funds that have produced superb, consistent returns over the long-term.

ETFs

Exchange-Traded Funds are the new kids on the block. They began as index fund surrogates, but trade on an intra-day basis (mutual funds trade only at close-of-business, 4:00 p.m. EST). Initially, ETF returns mirrored those of some sector or segment of the market. Recently, they began employing much more diversified and risk-multiplying strategies (leverage).

Our clients know that we prefer actively-managed stock mutual funds. The portfolio managers of these funds, along with formidable staffs, spend all of their time evaluating stocks, hopefully with skill, objectivity, and most importantly experience. The challenge is to identify these funds and managers; we think we have.

E. P. Rennie, CFP®, CFA®
President

Gary B. Rennie, CFP®, AWMA®
Chief Executive Officer

1608 Galaxy Drive
Newport Beach, CA 92660

Phone: (949) 650-8622
Fax: (949) 650-6683

www.rennieandassociatesfp.com

Email: ecrennie@att.net

Our Two 

"Rhetoric is an instrument of error and deceit. Or both: talking people into error."

John Locke

Quarterly Trivia:

How much is the median retirement savings balance, in dollars, of consumers over age 60?

$42,000 (Tiburon Strategic Advisors)