A MATTER OF OPINION

Qualitative criteria offer higher return possibilities than quantitative criteria, but are riskier and harder to apply. However both can help individuals outperform the market.

The Advantages of the Do-It-Yourself Approach to Investing in Stocks

By James B. Cloonan

Over the past months I have been making a case for managing your own stock portfolio, as opposed to using mutual funds.

Certainly not everyone should be selecting their own stocks. Those with no time cannot, but it really doesn't take a lot more time to select stocks than it does to choose mutual funds. The major reason not to do-it-yourself is if you cannot maintain a strict discipline. There are many approaches to investing in the stock market that can be successful, but failure to identify an approach and follow it religiously will lead to disaster.

The Case for Do-It-Yourself

If you have the discipline, however, I truly believe you can outperform most mutual funds as well as the market average. Individuals have a tremendous advantage over institutions. No only will they have lower transaction costs because they don't have large enough trades to affect the bid-asked spread, but they can select from a universe of over 6,000 stocks, while most institutions are limited to the largest 1,000 to 1,500 issues.

In addition, you can adjust your aggressiveness to your investment horizon. For assets that you won't need for 20 years, you can accept more volatility in exchange for higher returns. Fund managers must be short-term oriented because they are evaluated quarterly and annually. With poor short-term performance, they won't be around to see the long run.

Often when I mention that the majority of mutual funds don't beat the averages, I get the response that some of them do and that if one can select the "right" funds they can outperform the market easily. This is true—if you select the best six funds in any year, you will likely average a return considerably higher than the market. But if you select the best six stocks in any year, you will likely average 10 times more than the return on the best six mutual funds. And there are as many mutual funds as listed stocks.

Of course, no one is likely to select the best-performing mutual funds or stocks each year. But I feel that interested and disciplined individual investors can do better selecting stocks than selecting mutual funds. I make an exception for foreign stocks, where access to information is limited, and to the extent individuals want to diversify internationally they should use mutual funds.

If in doubt, why not try an experiment? Continue to use mutual funds, but invest a part of your equity assets yourself, and compare the results. However, keep in mind that to do the comparison properly, you must manage a diversified portfolio with a disciplined strategy, not just occasionally pick a stock willy-nilly.

The Approaches: A Summary

In this series, I have also discussed how to go about accomplishing the do-it-yourself approach, including the various strategic approaches to portfolio management. These have ranged from very basic quantitative approaches, such as the Beginner's Portfolio, to the difficult-to-define approaches that are qualitative in nature.

A quantitative approach is one based on the numerical data available about a company and its stock. It has specific rules for using the data to make decisions. The strategy should be spelled out in such detail that you could give the rules to high school students and they could implement the portfolio management.

There are many quantitative decision rules that can be used. Some of the ones I have discussed include rules concerning: the size of the firm (market capitalization), earnings per share and growth in earnings per share, share price changes, book value, cash flow, sales revenue and sales growth, profit margin, return on equity, dividends and dividend growth, and assets relative to liabilities.

While many of these factors are important in understanding the prospects of an individual company, only a few have been proven to lead to above-market rates of return when used as a stock selection tool on their own. These include:

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- Company size (market capitalization, or number of shares outstanding times the share price)—the smaller, the better.
- Price-to-sales ratio (share price divided by sales per share)—the lower, the better.
- Price-to book value ratio (share price divided by book value per share)—the lower, the better.
- Relative strength (percentage increase in price over one year relative to percentage increase in price for other stocks over the same time period)—the higher, the better.

These criteria have generally been applied to the market as a whole. They could probably be applied industry by industry to ensure diversification, but I know of no research that has done this. (An interesting book that evaluates quantitative criteria historically is "What Works on Wall Street" by James O'Shaughnessy; published by McGraw-Hill.)

While quantitative selection criteria have outperformed the market, they cannot be expected to outperform it dramatically. This is because there are many exceptions to the application of these general rules, so that many stocks with great potential get eliminated and many dogs are included when they are used. Nonetheless, an approach as simple as the Beginner's Portfolio has beaten the S&P 500 over the four years of its existence by 1½% a year on an absolute basis and by over 5% a year on a risk-adjusted basis.

Qualitative approaches offer the possibility of higher returns, but can be risky. Qualitative analysis can begin with further evaluation of the quantitative figures discussed previously. Is the book value equal to the market value or is it significantly understated or overstated? Is the relative strength high because of a one-time phenomenon that is now over?

But qualitative analysis gives in to an almost endless number of criteria that are pure judgment calls: value of patents and research, quality of management, market overreaction to news, new products in development, etc. Qualitative factors can also relate to exogenous factors such as the industry, the economy, legislative changes, etc.

The market will reward the investor who discovers something significant early, but finding new information or seeing a different interpretation of existing information is time-consuming and requires skill. It is unlikely that an individual investor will succeed in this area in large-cap stocks where hundreds of analysts spend their full time. Smaller-capitalization stocks provide more of an opportunity for individual investors to mine relatively unexplored ground.

I suggest that if individuals want to select stocks on a qualitative basis, that they diversify and either use this technique for only a portion of their portfolio or use it on stocks that have already passed quantitative screens.

Portfolio Suggestions

In terms of portfolio management, no matter how stocks are selected, I strongly suggest that the individual keep written records indicating why each stock was bought and under what circumstances it should be sold.

In addition, I have found it useful to maintain a dummy portfolio of stocks that I have sold, using my sales figure for the purchase price. This is not designed as an exercise in self-flagellation, but rather it lets you know if you are selling stocks too soon. If the dummy portfolio is doing as well as your active portfolio, you might do better holding onto your stocks longer. Keep track of capital gains dates and review the portfolio at the end of the year for possibly realizing losses. One important advantage of managing your own portfolio, if it is taxable, is the ability to time executions to provide tax benefits. In contrast, most mutual funds are focused on pretax returns.

If you are a "fundaholic," you should at least give some thought to managing all or a part of your portfolio yourself. If you can maintain discipline, I truly believe you can outperform the vast majority of mutual funds and the market averages.