

Rules of Thumb and Key Phrases: Gleaning the Nuggets of Truth

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Article Highlights

- These 22 tidbits of wisdom are based on years of experience and have an element of truth in them.
- Diversification is one rule worth paying attention to, but it does not completely safeguard your portfolio.
- You cannot go wrong taking a profit, but let the fundamentals guide your sell decision.

Humorist Will Rogers was once asked for investment advice. He responded, “Buy a stock. When it goes up, sell it. If it doesn’t go up, don’t buy it.” Wall Street has many golden rules. While many of them may seem about as useful as Rogers’ advice, they all have an element of truth and carry the wisdom of years of experience.

You will notice, however, that some of these 22 tidbits of wisdom contradict one another. Furthermore, some are more useful than others, and some are of very questionable value. Our advice: Take them all with a grain of salt.

1. Diversify, diversify, diversify

They say the three most important things to know about real estate are “location, location and location.” Well, diversification is to investing in stocks and bonds as location is to investing in real estate.

This is one rule worth paying attention to. What works well on the farm also works well in the investment world: Don’t put all your eggs in one basket. Look at the portfolios of major estates, trusts and endowments and you are likely to find a large number of securities and very broad diversification. Even their real estate holdings are diversified. The collapse of the tech sector in 2000 is an excellent example of what can happen and how it can decimate a portfolio that lacks adequate diversification.



Traders, rather than investors, usually prefer to concentrate their holdings in just one or a few securities. They do not want to spread themselves too thin. That is fine as long as they understand and can tolerate the risks. Even some long-term buy-and-hold investors like Warren Buffett prefer to take a concentrated approach.

While diversification is important, keep in mind that it does not completely safeguard your portfolio. Researchers have noticed that in times of crisis, assets that were once thought to be uncorrelated with one another suddenly start behaving in a similar manner. As a result, the ability of diversification to protect you may actually end up being weakest when you need that protection the most.

2. Buy low, sell high

Duh! That’s the whole point of investing. The problem is that it is not always clear when a price is low or high. If it were clear, we would all be rich.

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3. Eternal vigilance is the price of safety

Successful market observers of years gone by were devotees of eternal vigilance. They watched the market constantly, almost religiously, and more often than not they emphasized the importance of timing.

Jay Gould, a famous 19th century speculator, said it best. "The perfect speculator must know when to come in; more important, he must know when to stay out; and most important, he must know when to get out once he's in."

However, those who favor a long-term buy-and-hold strategy would say that you should not try to time the market at all. Settle on a proper asset allocation, diversify your investments and go to the beach.

4. You won't go broke taking profits

A very successful investor was once asked how he became so wealthy. Rumor has it that he replied, "I always sold too soon." The point is that you cannot go wrong taking profits. There is no point in regretting a decision to sell, even if the price later moves higher. Paper profits can quickly turn into losses. So, even if you make only a few dollars on an investment, be happy.

5. If the way is not clear, do nothing

Daniel Drew, a colorful speculator of the 1880s, believed fervently in this principle. He used to say that unless the way looked clear, buying stocks "was like buying cows by candlelight."

6. The market will be here tomorrow

Be patient with your investments. Don't jump in just because you are afraid that you might miss the boat. Patience often pays. Bide your time until the proper moment. Wait until a cheap stock is even cheaper. Even if you miss a good opportunity today, chances are another will present itself tomorrow.

7. Cash is king

This is often the defining difference between successful and unsuccessful

traders. Bargains often find their way into the marketplace. But to capitalize on them, you must have cash available. If you are fully invested, you may miss some excellent opportunities.

Baron Rothschild, the famous 18th century British nobleman and banker, made it a habit to keep a good part of his capital free for such bargains. In this way, he was able to "buy when others were selling" so he could later "sell when others were buying."

8. Cash is trash

This is just the opposite of No. 7. It is often heard during a bull market, when you are sacrificing returns if you are holding too much cash.

9. Sell to your sleeping point

When you put your head on the pillow at night, you do not want to have to worry about your portfolio. If you are constantly worried about losing money, it is time to make some changes.

10. No grist can be ground with water that has run past the mill

Forget your investment mistakes and lost opportunities. They are gone forever. We all err at one time or another. Press ahead and begin planning today your investment program for the future.

11. Speculation begins where certainty ends

No investment is risk-free. There is always some element of risk involved, but the degree of risk varies from one investment to another. Make sure you take only calculated risks, but realize they are risks all the same.

12. Caution is the father of security

Be safe or be sorry. The more careful you are, the better your chances of achieving investment success. The people who lose much of the money on Wall Street tend to be careless amateurs, operating blindly and without an intelligent plan.

13. Be right more often than you are wrong

No one is right all the time. Even the

most astute traders make mistakes. But you can bet that they achieved success because they were right more often than they were wrong. Even if you are right just 51% of the time, that is enough to make money.

14. Do not sell just as a stock begins to rise

Sometimes a stock seems to just sit there and do nothing. Suddenly it begins to rise. Often, frustrated investors who had been holding the stock for a long time take this opportunity to sell and get out. This could be a big mistake. The sudden rise in price could be a harbinger of better gains to come.

15. Cut your losses; let your profits run

When you realize you have made a bad investment, do not hold on forever hoping it will someday recover. Unload it and move your funds into something more promising.

Conversely, do not be too quick to take profits. A stock that has been going up is likely to continue going up for some time.

16. Don't let success go to your head

Many novice investors get lucky: The first few stocks they pick do extremely well. Unfortunately, they start believing in themselves. They think they have a magic touch; or worse, they think they are smarter than everyone else.

This often leads to disaster as they put more money at risk only to watch it blow away.

17. Bulls win; bears win; hogs get slaughtered

Avarice has ruined even the best of traders. Trying to squeeze a few more pennies out of a trade can sometimes backfire when prices suddenly move against you. Don't be too greedy.

18. Don't stay wrong long

Once it is obvious that you have planned poorly, don't let pride or stubbornness blind you. Admit your mistakes and rectify them quickly.

Investment Insight

“Too many investors fail to follow some simple, time-tested tenets that improve the odds of achieving success and, at the same time, reduce the anxiety naturally associated with an uncertain undertaking,” says Arthur Zeikel, former president of Merrill Lynch Asset Management, in

“Managing Your Own Portfolio: One Father’s Advice.” You can read his open memo to his daughter for more down-to-earth insights and thoughts about investing for the long haul at www.cfainstitute.org/about/investor/Documents/managing_your_portfolio.pdf.

19. Make price a secondary consideration

Don’t buy a stock simply because it is cheap. Buy it because the fundamentals indicate it will go up. Likewise, don’t sell based on price alone. Let the fundamentals be your guide.

20. The market will do what it should, but not always when it should

By late 1998, it was abundantly clear to many experts that the stock market had become seriously overvalued. Based on this observation, many investors got out of the market. The more aggressive ones shorted the market. Although they were eventually proved correct, many incurred large losses as stocks continued to rally for more than a year.

Stock prices and investors behave rationally over the long term, but they may behave very irrationally in the short

term. You can lose a lot of money if you are on the wrong side of a trade. See No. 22.

21. Be bullish in a bull market; be bearish in a bear market

Investors must be flexible. Never be permanently bullish or bearish. You need to adjust your strategies to the times.

Recognize that there is a bias toward the bullish camp on Wall Street. Investment professionals do not like being labeled bearish on America. However, you should know when it is time to change your views. There are times when even the strongest bull must jump out of the way or risk getting trampled.

22. The market can stay irrational longer than you can stay solvent

This is a quote from John Maynard Keynes, the famous mid-20th century economist who was also a successful

investor.

Like many economists, he fully acknowledged that the market can be irrational. This is the basis of behavioral finance. However, profiting from irrationality is harder than recognizing it.

Final Comments

The world of investing is a wonderful place, and the stock market is the most fascinating part of the investment world. The stock market is where capital is raised to fund entrepreneurs, where investors and speculators match wits and where fortunes are made and lost.

The stock market does not care who you are or where you come from. It is where those with just a high school education and a good dose of common sense can compete against the best and smartest professionals Wall Street has to offer—and often beat them. ▲

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