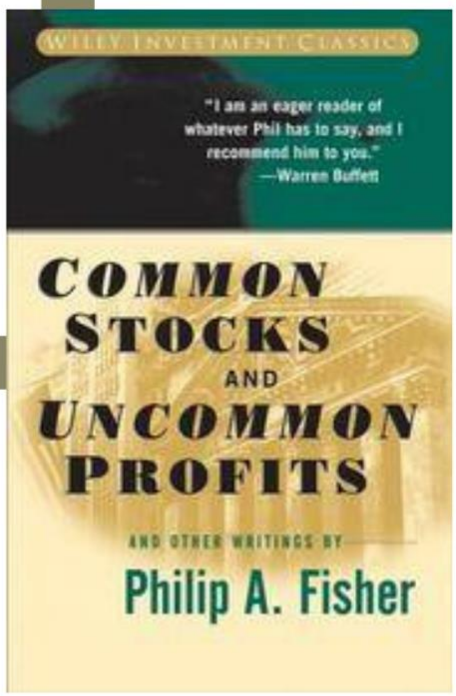

CLIFFS NOTES

COMMON STOCKS AND UNCOMMON PROFITS

THE FifthPerson

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COMMON STOCKS AND UNCOMMON PROFITS – CLIFFS NOTES

Life gets busy and, sometimes, we just don't have time to go through an entire book. These Cliffs Notes are here to help pick up key ideas from the book.

Then again, we're scratching the surface here. If you don't already have the book, you can order it from your nearest bookstore.

Smart Investing

Smart investing requires planning and is often **focused on the long term**.

Smart investors don't seek to make quick profits but, rather, look for companies that have the potential to multiply an initial investment.

While it may not be easy to always spot such companies, there are some common characteristics that we can look at to improve our odds.

These companies usually have **a product or service that can sustain high sales volumes for years**. They also actively invest in research and development to continue growing, to prepare for a day that the current product line no longer offers opportunities for growth.

For example, in the 1950s, everyone wanted a TV. And by the middle of the decade, everyone who wanted a black and white TV already had one. So until color TVs came along, TV manufacturers faced stagnant growth.

Motorola (also a TV manufacturer back then), however, ventured into two-way communications business (phones) and continued to grow their sales while other TV manufacturers waited for the color TV to be invented.

Scuttle Butting

When considering a company's potential, you'll want to **collect information from every possible angle**.

You can do so by deploying the 'scuttlebutt' method – digging information from every possible source.

These can be from vendors, customers, former employees, or executives in a similar trade.

In fact, you may even want to **consider contacting competitors of the company you are interested in**. You might be surprised to find several pieces of hidden information not shared to the public.

Once you have the required information, you can then contact the company's investor relations to ask detailed, more informed questions.

Because scuttle butting takes a lot of time, make sure to choose your companies very selectively.

Stock Prices And The Market

Stock prices mirror the market's perception of a stock's value at the current moment. If the market values a stock upward, people rush in to buy, raising the price some more and, thus, creating a bubble.

Many people don't buy or sell a stock with the future in mind.

For example, a stock may be downgraded if its profit comes down – which could be due to a *temporary* issue that would be resolved down the road. Understanding this irrationality can help you make money.

Companies with potential to grow are often innovators and they'll constantly run into bumps. When that happens, the market will often downgrade these companies. These are usually the best times for you to buy into the stock.

If you missed an opportunity, it's ok. You can always get in during the next dip.

Author's Note (Personal Experience)

At the beginning of 2018, Facebook was embroiled in the Cambridge Analytica scandal where it was accused of data misuse. Its share price went from $190 to $158 (an opportunity for entry) within a month.

Facebook's share price briefly recovered to $210. But the company then announced a couple of bad quarters where it missed its earnings targets. This was mainly due to higher expenses as Facebook was spending to improve its data privacy and security in the wake of the scandal. And it didn't help that the WhatsApp and Instagram founders resigned from Facebook during this period.

Facebook saw its share price tumble down to $124 (yet another opportunity). By end-2019, when the dust settled, Facebook had recovered to $220.

And then in 2020, COVID-19 happened, sending Facebook's share price back down to $140.

Today, Facebook is trading at $360 at this point of writing.

You get the point.

Investor Psychology

A successful investor has no room for doubt. Most often, **doubt is created by noise in the market. Do not follow the herd mentality**.

The news and media can make it sound like it's the 'end of the world' making it to buy when everyone is selling. Case in point: the outbreak of the COVID-19 pandemic. **Yet if you truly believe in a company's quality, then it is a good time to scoop up some stock at bargain prices.**

Hesitation may result in missing a good opportunity. In fact, it is important to resist the temptation of letting the stock price fall further (when it's already cheap) to try to get the best deal. **Time in the market is better than timing the bottom**.

Once you buy a great company, hold onto it for the long term.

There are only three reasons to sell a stock:

1) Misjudged the company's growth potential
2) Change in fundamentals
3) You find a better company and decide to switch

A company with strong growth prospects won't look overvalued when you view its potential over the long term.

If you are risk averse, avoid unprofitable start-ups no matter how promising they appear. Instead, look for large, fundamentally strong companies with a proven track record that still have room for growth. These are the type of stocks you want to have in your portfolio.

Selection Criteria

There are four characteristics of great companies:

1) It can continue to earn profits even during price increases (e.g., raw materials), market crashes, or high inflationary periods
2) The company is well managed, and delivers great products and services that competitors find hard to compete with
3) The company has a long runway for growth and has a large addressable market
4) The company is a good capital allocator and is able to efficiently direct its resources to generate more profit

It is also important to look at the people behind the company. A company's success is usually based on its management and employees. In fact, you can say that a company's performance is the direct result of the work of its management and employees.

Another point to look at is how the company handles promotions. Do they promote from within or do prefer to hire from outside the company? This may be a clue about the effort a company puts into grooming and growing the potential of its employees.

The management is another important role when it comes to running a company. Is the management a one-man show, or does the CEO have an effective team where they can delegate their tasks effectively.

When evaluating a company, **it is important to make sure that the company is not only profitable today, but also in the future**.

Profit is important because for a company to grow, it needs cash, be it for R&D, marketing, or buying more inventory. With more profit, it gives the company a buffer to invest for future growth and to stay resilient during tough times.

To command huge long-term profit, a company must always be a step ahead of its competitors, doing things that the competitors are unable to do. One such example is scale. **If a company has scale, it is able to produce more (thus sell more) at a lower cost (higher margin).**

Another way is patents or copyright. Does the company have patents that protect its intellectual property from competitors?

Valuation

Valuation is always subjective and changes from investor to investor.

A risky investor might value a stock higher because they value a stock based on expectations.

The value derived from a riskier investor may not work for a conservative investor, who prefers to value a stock based on its 'intrinsic' value. If you are a conservative investor, invest in quality stocks that are currently undervalued or priced near their current value.

Once way to evaluate this is by using the price-earnings ratio (P/E).

The P/E ratio is simply taking the company's stock price divided by the company's earnings per share (EPS).

For example, if a company's share price $10 and its EPS is $1, then its P/E is 10 ÷ 1 = 10.

It means that as an investor, you are paying 10 times earnings for the company. Should the company remain stagnant without growth, it will technically take you 10 years to break even on your investment.

But if next year, the company earns $2 per share and its share price is still at $10, the P/E is now 5, which is 'cheaper' than the first example.

As a conservative investor, you must decide if the price you are paying for a stock justifies the potential growth of the company.

So how do you make this decision? This will bring us back to all the points that we've covered in the beginning. All the scuttle butting and fact gathering will give you a clearer picture whether the company is worth the investment.