

JOHN SLATTER

STRAIGHT
TALK
ABOUT
STOCK
INVESTING

Straight Talk about Stock Investing

John Slatter, CFA

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Straight Talk about Stock Investing

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***To the women I love: Beverly, Carol, Sarah,
and Melanie***

Preface

Three or four years ago, I read several books on how to write a novel—none of which was able to transform me into another Dick Francis.

For some strange reason, the advice of one author lingers in my consciousness: “*Never, never, never* hold back anything from the book you’re working on, expecting to use it in a future work. The book you’re writing *now* is the one to concentrate on. Use every scrap of information, imagery, and rhetoric to make *this book* as good as you possibly can—don’t worry about the next book until you get to it.”

Rest assured, I have taken this suggestion into account in writing *Straight Talk about Stock Investing*. The ideas I have developed over the last 33 years are all packed between the covers of this book—at least the ones that were worth preserving. Nothing important has been left out. No secrets are being denied to my readers.

What’s more, my innovative methods of stock selection are entirely my own and have not been purloined from another portfolio strategist. As a consequence, this book should be worthwhile reading for veteran investors.

On the other hand, I am assuming many of my readers are new to the world of Wall Street and may not be familiar with the jargon of the investment world. To bridge this gap, I have

devoted a chapter to terms and concepts that you will need if you are to become an effective investor.

But don't stop here. Once you know the lingo, you will want to know where to find additional information such as newspapers, magazines, and advisory services.

Having written two novels, I believe that I have improved my writing skills, which should make this book easier to grasp. Three chapters, moreover, are presented in a narrative form. To do this, I have created fictional characters and put them into make-believe dramas. Those who read *Safe Investing* have told me that these animated chapters were fun to read.

Incidentally, if you have any questions as you read this book, feel free to call me at (216) 781-5600.

*John Slatter, CFA
Senior Portfolio Strategist
Hickory Investment Advisors
Cleveland, Ohio*

Acknowledgments

As most investors are aware, the investment scene is vast and complex—and getting more tangled, involved, and confusing every day. For that reason, I felt it imperative that I submit every chapter to my “board of directors.”

But before I tell you about this “brain trust,” let me pay tribute to two grand and lovely ladies who work with me at Hickory Investment Advisors. Both have been of inestimable help in figuring out the labyrinths of WordPerfect, a premier word processing system.

WordPerfect, like French, is a second language for me. When I first began to compose on a computer, I learned another system and was quite happy with it. Through no fault of my own, the rug was pulled out from under me, and I was forced at gunpoint to learn WordPerfect—I was told in no uncertain terms that WordPerfect was better and that everyone with an ounce of sense was using it. Which, of course, is entirely true. Once you know WordPerfect, it is a delight to behold.

This was some three years ago, and I am still stumbling around in the dark trying to dope out its many secrets. (The four books I purchased were all written in Greek rather than French, my second language.) Only through the patience and diligence of Susan A. Svenson and Shirley Jeung have I been able to survive this ordeal. Never at any time—when I was hopelessly

mired in confusion—have these two kindhearted damsels failed to rescue me from an agonizing demise. They are consummate masters of WordPerfect, and I thank them for their perseverance through my hours of travail.

Happily, all this computer work takes place in my elegant office in the basement of my home in Chagrin Falls. This cherry-paneled office was built by my creative and talented son, Stephen W. Slatter, who also swings a lethal tennis racket and who has no compunctions about beating his old man.

And, now, back to the “board of directors.”

Each is someone I know well and respect. More important, each (except for Dave Loyd) is a veteran stockbroker. Finally, each is a keen judge of investment products and a fount of wisdom. As a group, this editorial team has saved me from committing some egregious boners.

I pondered how to arrange their names and decided that, so as not to bruise any egos, I would name them alphabetically:

Paul R. Abbey, president of Hickory Investment Advisors, is a man of many talents. He is recognized as a superb athlete and is a leading golfer. Professionally, he has an exceptional background, having learned the rudiments of the business working for a bank trust department, followed by 12 years as a stockbroker before creating his own firm over six years ago.

Of all the people I have ever worked for, Paul stands alone as a man of dedication to his trade and an exemplary human being as well. My job at Hickory is to analyze portfolios and report my findings to Paul. He handles the bond purchases but also shows penetrating insight into stocks. His contributions to this book have been invaluable.

Max Lammers, a long-time broker with Prescott, Ball & Turben (now Kemper Securities), has recently been named an executive vice president with A.T. Brod in Cleveland. Max has a keen eye for the printed word and has been one of my editors on all four of my books. From what I have heard, his clients would follow him to the end of the world never doubting his leadership. Max is also an authority on horses and can ride bareback on a steed while sitting backwards.

Steve Lazarides (pronounced *Laz ar ee deez*) is a senior financial consultant with Merrill Lynch in Canton, Ohio. I have

known Steve for many years since he started in the business when both of us were at Prescott, Ball & Turben. He is revered by his clients because of his sincerity and integrity. His charm and warmth make him the ideal luncheon companion.

Dr. David P. Loyd is a retired college professor who lives in Ashland, Ohio. After everyone else has read and commented on my chapters, the finished product was sent to Dave. That rascal found all sorts of things wrong. You can't hate a man for being thorough. I expect he will be my editor in chief when I write my next book, *The Age of Caesar and Cicero*. Dave is not only a great editor, he is a solid friend.

Denny Mardas is a senior vice president with Kemper Securities in Columbus, Ohio, and has a devout following of clients—largely because of his ability to pick stocks that are undervalued. Denny has an incisive mind and is a joy to do business with.

George G. Morris, CFA, is a senior vice president with Kemper Securities in Cleveland. George spent many years as a securities analyst before switching to the sales side. He happens to be my personal broker. Not only does George have an in-depth knowledge of the stock market, he is also eager to provide his clients with superior service. His only fault is his lack of concern and sympathy when he whips me on the tennis court.

Dick Niemiec (pronounced *Neemick*), a branch manager at Kemper Securities in Wooster, Ohio, is a graduate engineer and one of the best stock pickers I have ever known. He is also down to earth, easy to know, and a broker with impeccable credentials. Dick has a huge following of clients who have the utmost confidence in his approach to portfolio management.

My many thanks to these busy men and women for their help in perfecting this book.

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If you are looking for a book that introduces you to the world of common stocks, you will find *Straight Talk about Stock Investing* extremely helpful regardless of whether you are a novice investor or one with more experience. You will learn the language of Wall Street and the techniques of stock selection that have proven to be effective in past decades. What's more, this book will convince you that the road to financial security and wealth can be achieved by investing in common stocks. It will show you how to diversify, how to avoid the pitfalls, and why you should not be trapped into thinking mutual funds or certificates of deposit (CDs) are the best investments. Finally, you will learn how to select stocks that will enable you to build a portfolio that will perform better than the general market—and better than most professionals.

1. Setting Goals	12
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If you plan to have enough money for education or retirement, it is imperative that you save regularly and systematically. Both of these goals are important, and both are expensive. Time is on your side if you begin early—and if you invest in common stocks. Perhaps the most important goal is providing for retirement. Increasingly, however, companies are dropping their retirement plans, and some are canceling their pledges to pay for health care after retirement. In short, it is *you* and you alone who must make plans for a long and secure retirement

that could easily last 15 or 20 years—a long time to live from hand to mouth.

2. Where to Find Information 23

There is no need to grope in the dark when you are considering the purchase of a common stock. This chapter tells you about company annual reports as well as important periodicals, such as *The Wall Street Journal*, *Barron's*, *Financial World*, *Fortune*, *Business Week*, and *Forbes*. It also covers such important services as the *Standard & Poor's Stock Guide* and *Value Line Survey*, both crucial to making informed decisions.

3. Why Common Stocks Are Your Best Investment 40

I am constantly amazed at the number of successful people who are blithely ignorant of common stocks. Even though they can easily afford to invest, they mistakenly think that stocks are beyond the realm of understanding—and so speculative that only a reckless plunger would dare indulge. Nonsense. Not only are common stocks the real road to wealth, they are not that hard to understand. There are methods of stock selection, moreover, that will enable you to build a portfolio virtually blindfolded.

4. The Glossary 47

Nearly every glossary you have ever seen is stuck at the back of the book—where you won't notice it or use it. By placing the glossary up front, I give you a bird's-eye view of the terminology and philosophy of investing. This glossary alone is worth the price of the book. If you read it first, you will have less trouble understanding the chapters that follow.

5. Diversification and Asset Allocation 64

If you invest long enough, you will occasionally lose money. But you will also *make* money if you spread the risk of investing through diversification. This means buying 10, 15, or 20 different stocks, being careful not to concentrate your assets in any two or three industries. What's more, diversification can also mean investing in foreign stocks because these offshore markets march to a different drummer than domestic stocks. Asset allocation involves balancing your investments among common stocks, money-market funds, and bonds. If done properly—and this book shows you how—you have nothing to fear but your own timidity.

6. A Simple Way to Play the Stock Market 82

Investors often want capital gains as well as liberal dividend yields. This chapter shows you how these seemingly contradictory goals can be reached with relative ease. The 30 stocks that make up the Dow

Jones Industrial Average are all you need—plus a good calculator. This chapter also instructs you on how to calculate the standard deviation, a valuable statistical tool.

7. Some Thoughts on Analyzing Stocks 99

One of the best tools for analyzing stocks is *Value Line Survey*. Each issue contains reports on half a dozen different industries. An industry may be made up of a dozen or more companies. Unless you know what to look for, this mass of figures and tables will be meaningless. This chapter shows you how to evaluate growth, financial strength, and value, the three key ingredients in analysis.

8. The Logic of Foreign Investing 112

In years past, most Americans focused exclusively on domestic stocks, often those listed on a major exchange. Today, our horizon is much broader, largely because of advances in communications. Prudent investors now include three or four foreign stocks in their portfolios. Such stocks as Royal Dutch Petroleum; Unilever, N.V.; Schlumberger; and Reuters no longer sound so odd. This chapter offers some thoughts on how to spice up your portfolio with stocks from abroad.

9. A Detective Story 124

In this chapter, I resort to a story to explain an interesting way of constructing a portfolio. I have invented a detective on the Cleveland police force. Dan Pomodoro tells me something about police work, and I indoctrinate him in the ways of Wall Street. Don't worry about being shot. Dan keeps his six-shooter firmly in the holster till the very end.

10. How to Build a Portfolio for Growth and Income 136

Throughout this book, I harp on a few simple truths. One is that you can easily combine growth and income in one portfolio. In this chapter, I demonstrate a simple way to select stocks, using just two factors: the dividend yield and the number of institutional owners. Institutions (such as banks, mutual funds, and pension plans)—as I will repeat time and time again—are often wrong when they invest heavily in such stocks as IBM, Merck, and Philip Morris.

11. How to Reduce Risk 146

If you invest in common stocks, you must be prepared to accept a certain amount of risk. It goes with the territory. Most stocks fluctuate every day, sometimes a point or more. Every once in a while, a stock will rise or fall four or five points. In order to mitigate this risk, there are a dozen or more strategies that you should know about. They're all in Chapter 11.

12. An Interview with a Middle-Aged Couple 157

On a recent trip to London, I met Mr. and Mrs. Bryce Wicker, a farmer and his wife, who were staying at our hotel in Hampstead. While the ladies rested up before dinner, "Wick" and I hashed over an idea on how to pick stocks. I was determined to explain it fully, but he kept insisting it was time to "put on the feed bag." It took a little doing, but I finally finished my presentation—just as he collapsed on the floor from lack of food. A pity.

13. How to Combine Quality, Income, and Growth in One Portfolio 172

Here is still another method of building a portfolio. It combines two disparate elements: a group of high-quality stocks coupled with a group of high-yield stocks. In any given year, one group will do well; the other may not. By combining the two groups you will have consistently good results every year—or nearly every year.

14. An Interview with a Widow from Vermont 189

Here is yet another drama in real life. I met Olivia Terpsichorean, a retired widow from Vermont. She and I were both visiting Natchez, Mississippi, on a hot day in August. Her husband, a physician, had left her a portfolio with too many pharmaceutical stocks, most of which had seen better days. Here I show her how to achieve better diversification using the 30 stocks in the Dow Jones Industrial Average.

15. How to Achieve Income and Growth in One Portfolio 202

You may get the idea that some of my chapters have similar titles. To be sure, there is some repetition. But that's not all bad. Because these ideas are new to you, it often pays to explain them more than once. In this instance, however, I add a new wrinkle to the equation. I show you how to combine the dividend payout ratio with the yield to construct a balanced portfolio.

16. When to Sell 213

Investors tend to be worriers. The day after they buy a stock, they sit back and begin to stew about the best time to sell. If the stock goes up five points, they are sure it is only temporary. Better call a broker and see whether it's time to bail out. After all, you can't lose money by making a profit. That happens to be one of the biggest lies you'll ever hear. Long-term investing is the way to riches. Still, there are times when you should consider selling. It's all here in Chapter 16.

17. The Ultimate Road to Wealth 220

This is the chapter you've been waiting for. The method for selecting stocks is a bit more complicated—that's why I have saved it for now. If you have gotten this far in the book, you have proved your mettle. You are made of sterner stuff. This method of stock selection uses four factors: the price/earnings (P/E) ratio, the normalized P/E ratio, the payout ratio, and the normalized payout ratio. This may all sound like Greek, but it is really quite simple, once you read this chapter. One word of warning. This is a growth-stock formula, so don't expect fat dividends.

18. How to Restructure a Growth Portfolio 237

Now that you know the basics, you are ready for the heavy stuff. If you have been investing for several years, your portfolio is probably in dire need of some restructuring. Assuming you are a growth investor, this chapter explains how to put your house in order.

19. How to Restructure an Income Portfolio 246

If you are more interested in income, as most investors are, then this chapter will help you patch up your portfolio. But first you must read Chapter 18 because it gives you the feel of the restructuring process. Then, return to this chapter and dive right in.

20. Some Maxims on How to Keep on the Straight and Narrow 252

As a grand summary to my book, I give you a wealth of pithy maxims—mostly dos and don'ts. It's a chapter you may want to read once a month until you get these ideas emblazoned into your consciousness. You may come to believe that this chapter has more good horse sense than the rest of the book put together.

Introduction

Although *Straight Talk about Stock Investing* gives you all the basics you'll ever need, it jumps headlong into the real meat—my simple yet effective methods for picking stocks and building a portfolio. It is here that I think you'll find this book a unique and valuable tool.

To be sure, money can be made in stocks even if you pick them blindfolded—or by throwing darts. But if you use my simple strategies, your results should be distinctly better than random selection.

In fact, each idea presented has been back-tested (verified) for its validity in past markets. Admittedly, this does not guarantee that it will work equally well year in and year out. However, bear in mind that I have made money for my clients—and for myself—for more than three decades.

If you are just getting acquainted with the world of investing, *Straight Talk about Stock Investing* explains:

- How to read and understand *The Wall Street Journal*
- What to look for when you read an annual report
- How to fathom the handy monthly reference manual, the *Standard & Poor's Stock Guide*
- How to use *Value Line Survey* for fun and profit.

In fact, I have devoted a whole chapter to explaining the secrets of reading and understanding these informative, important, and interesting publications: what to concentrate on; what to ignore.

Most important, you will find *Straight Talk about Stock Investing* easy to read, without the jargon that many professionals spew forth. If I use a term that I think may not be familiar, I will explain it. In addition, I have included a helpful glossary at the beginning—rather than at the end—of the book (see Chapter 4).

What about Mutual Funds?

Straight Talk about Stock Investing also tells you how mutual funds work and outlines their advantages and disadvantages. Unfortunately,