

# The KISS of Death

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The KISS principle in engineering seems to have originated around the time of the Apollo project in the 1960s. The idea of **Keep It Simple, Stupid** has spread widely through many disciplines, including trading and investing.

The basic idea, which is to eschew unnecessary complexity is a sound one for engineering and largely ignored by developers of mobile phones and software, which become more complex every day while the user is demanding simplicity.

I often hear investors refer to the KISS principle and it worries me a lot. I think there is a strong case for using only easily understood ideas in analysis and avoiding complexity that renders the analysis almost unintelligible. It is, after all the basic ideas that account for most of the return we try to achieve and those ideas are not difficult to get our mind around. Basic ideas like diversification and financial risk management are the cornerstones of a robust investment plan.

What worries me is when I hear the KISS principle used as an excuse to simplify things so much that it is an excuse for proper analysis and risk management. The users often disclose an appalling lack of knowledge and thought, excusing it as KISS.

The extreme examples of the KISS principle in action are the traders and investors who openly admit that they have no idea what company they are investing in. All they know is its code and the price. At this stage in a bull market, it is difficult to warn them that they are accidents waiting to happen, but they may learn the hard way when the music stops.

The sad thing is that they would be better traders and investors if they learned some of the important things about the companies they are investing in that may save them from being bitten badly down the track. The basic ideas in analysis that give you a reading on the risks you are taking are not difficult to implement. The minimum things I believe that a trader or investor should find out and assess before placing their buy order are set out below.

## **What phase is the market in?**

Dow theory sets out the six phases of bull and bear markets. Different strategies are appropriate for each phase. I teach this from time to time and after explaining the phases, most of my audience identify where they are in the phases within one phase of the consensus view.

## **Is your stock in an uptrend?**

I am amazed at how many traders and investors buy into stocks that are in downtrends. You should know how to analyse a chart for trend without any indicators. If you are going to buy it then you should see an uptrend or at least an upward breakout from a broad accumulation or consolidation pattern that promises to turn into an uptrend.

## **Is the trend too extended?**

While buying any uptrend is better than buying into a downtrend, you should know when your trend is in “greater fool” territory. This is when the only way you can profit is by selling it at an even higher price to an even greater fool than you are. Your purchase should be situated in a trend that is not accelerating steeply upward.

## **What does the company do?**

Unless you know what sort of business the company is in, how can you have any idea of the level of risk you are taking on and whether you should treat it as a speculation or an investment? Even if you are looking to be a speculator, you need to pick the right sort of company and structure. This information is readily available on the internet.

## **What are the dynamics of the industry?**

Ideally you need to be buying companies in industries that are in growth phases or in upward swings in their cycle. If not, you need to find a very special company that can make progress against the tide. To recognise those special cases, you need to understand what drives profit in the industry and ensure that your company offers something special in that respect. In an ideal case you will be an insider in such an industry. If you aren't, then you need to read widely about it and/or consult people who understand that industry.

## **Who is running the company?**

In the past I have knowingly speculated (never invested) in companies run by crooks. If you are going to speculate, you must have your eyes open. If you are playing a game against crooks, and you don't know it, you are likely to become a victim. You can find the CV for directors and chief executives in annual reports. Then ask around about them if you do not know their track record from your study of the markets.

## **Does the company make a profit?**

You can see up to a ten year profit record of any company that has been listed that long on the Aspect Huntley website, carried free on many internet broking sites. If the company has never made a profit, you need to know a lot more about it and its industry dynamics, or you are speculating. Likewise if was profitable and has recently fallen into losses.

## **Things to watch for**

Favour companies whose net profit is growing faster than its sales. This means its margins are increasing. Be wary of any company whose receipts from customers on the cash flow statement are significantly less than the sales figure on the statement of financial performance. This may indicate some creative accounting is being practiced.

## Does the company pay a dividend?

If the company has never paid a dividend you are relying totally on capital gain unless you have inside knowledge that suggests the situation will change. Likewise, be wary of any company that has passed recent dividends and is not making good profits. Be very wary of a company whose dividend per share is greater than its earnings per share. Ideally the dividend yield should be greater than the average yield for the market.

## How much are you paying?

The much maligned price earnings (PE) ratio is the most readily available information. While you can adjust the calculation to the rate of inflation as I show in my book, the quick-and-dirty rule of thumb is that over 20 times earnings, you need a very strong reason to be buying. The higher the PE ratio over 20 times, the further you may be into greater fool country. Look for strongly growing companies with PE ratios less than 15 times and recovery situations below 10 times earnings.

## Why are you buying?

You should be able to write down why you are buying the stock, listing the internal or industry dynamics that are going to produce the result you are looking for. Then the important bit – write down why someone would be prepared to sell the stock to you at the current price. This will record the risks that you need to monitor going forward. If you cannot write down why someone would sell to you, then you may be well into greater fool altitudes.

## To read more of my work

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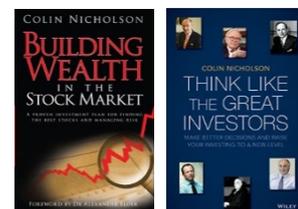
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