What to Look for in a Stock

This article was written some years ago, but is very relevant to today. The charts used to illustrate the text are now somewhat dated, but still relevant for the present purpose of teaching a technique.

The history of stock markets is littered with what psychologists call manias. These episodes are generally wild booms in which some idea catches public imagination. Fortunes are made almost instantly, but most are lost just as quickly.

People are drawn into these manias because they always manifest themselves as something new and therefore without precedent. There is also no shortage of “experts” who reinforce this idea. Once this is accepted, then the stage is set to depart from reality. This reality is not checked against the past, because the initial assumption is that the new idea is different to anything that has gone before.

The latest of these manias concerns technology stocks. This is a broad term covering the Internet, information technology, telecommunications or biotechnology. This is exciting stuff too, because it is at the frontiers of science and its application. It is easy to cross the dangerous line into thinking that the past is not relevant to the new opportunities.

Most dangerous of all are the “experts” in the media, who make wild claims about the promised benefits of the new ideas and always seem to convey the idea that it is happening very quickly. We need to jump in or we will miss it.

I have only been around in the markets for just over 30 years, yet I have seen it all before. Moreover, I have read widely on the history of stock markets and about the many similar episodes in the past. You might say that I am a cynic and cannot see that it is different this time.

However, cynicism is a good characteristic to have in markets. Everything should be suspect until it is tested and proved. Every time one of these booms has happened in my lifetime and in the books I have read, there were people saying that it was different this time and that the latest idea would change the world. They were often right that it would change the world, but seldom that it was really different this time.

One of the more valuable skills we can develop in stock markets is an ability to see what is happening in general terms. Once we do this, it is obvious that there have been a series of technology booms in the last 100 years or so. Some of them were: Railways, electric light, the telephone, motor cars, motion pictures, radio, air travel, television, antibiotics, computers, electronics generally, the Internet, the mobile phone and gene-based biotechnology.

Most of these booms followed a similar pattern. They caught public imagination. Hundreds of new companies were formed and floated, raising money from the public. Higher and higher prices were paid in a frenzy to get on board the new thing. Most of the new companies rose to crazy prices and then crashed, going bust or being absorbed by a few survivors. Eventually, only a few were left. Sometimes they made superior profits, but more often the new products became like commodities and the survivors competed furiously at low profit margins. For example, there were once about 300 automobile companies in the US market. You can count what is left on the figures of one hand.

These situations present us with a choice, whether we know that we are making the choice or not. Most people will, in ignorance or greed, try to speculate on the wildest of the bunch of new stocks. Most of them will even manage to make initial paper profits that act to drag them in further. However, unless they are very lucky, it will end in tears. They will not know when to get out. They will be fearful of taking small paper losses only to see them turn into large paper losses or even total loss. If you ask them at the time, they may even recognise the risk at some level, but believe that they will be smarter or luckier than everyone else. This is exactly what every player at the casino believes.

Those who are seasoned in markets will largely stay out of the boom. They might make a few strategic investments, but the key will be that they use strict risk control and money management so that they protect their investments from catastrophic loss. The greatest investor of the last 50 years, Warren Buffett, said he did not understand the tech and Internet boom, so he stayed out of it. That is why he is still one of the richest men in the world. What he did not understand was how he could make money investing in a company that had no product or service, made no profits and for which he had to pay an absolutely ridiculously high price.

So, how do we profit from technology stocks? The first thing is to realise that there are no geese out there laying golden eggs. Business is tough and every successful business soon attracts competition. Only the best-run companies succeed. The essential values are universal: Conservative financial structure, high profit margins and return on equity, consistent growth in sales and profits, concern for shareholder returns rather than enrichment of the management.

However, there is more to it than this. To succeed, it is necessary also to pay the right price. The market gets carried away from time to time over the success of every company and prices go far too high. Many professional investors are no better than the public in this area. It is never enough just to find a great company; it is necessary to find it at a reasonable price. This requires great patience at times. Lack of patience loses more money in the markets than almost anything else. People buy because they desperately want to get into the game now, even though it may be the wrong time.

Fundamental analysis will be the essential tool to tell whether any company is reasonably priced. However, it is often not a good tool for timing. Prices may yet go lower. The market may not agree with you. Even if you are right and the market wrong, there is an opportunity cost to having funds tied up waiting. And of course, the market is frequently right and we are wrong.

The great reality check is the price chart. What we want to do is to try to find the technology stocks that are going to survive and to buy them at a reasonable price. This means waiting what sometimes seems forever for the boom to be played out and prices to fall very significantly. Then we want to see prices level out and form some kind of platform. It might take a year to several years for this platform to develop. Then, we buy the ones that start to rise off the platform. Of course, we do all our fundamental research into the company while the platform is developing, so we know whether the stock fits our investment plan and does have a superior business. We also never put all our money into one stock, but spread the risk over a number of stocks. We also ruthlessly prune from the portfolio any that falter significantly. Also, if they again rise to “silly” prices again, they will sell out.

Two charts will illustrate this very simple, yet powerful idea. First, DVT Holdings (DVT), which changed its name, probably because of the notoriety of its old name, Davnet.

The few smart speculators bought it in late 1999 at under $1, when it started rising. They got out within a dollar or so at the top around $6.

The simple trend line shown on the chart was all that was needed, so long as they had not lost connection with reality. Most people bought DVT in the red box on the chart and gave back most of their profits, took horrendous losses, or still hold near-worthless stock.

The other example is Institute of Drug Technology (IDT). Notice how it ran from low prices in 1991/2 to silly prices in 1993/94. Then the big fall. It then formed the platform from 1995. In 1999 it started upward. Smart investors bought in 1999 in the 20c to 40c range and maybe still hold it at between $3 and $4, if they were not shaken out sometime on the way up.