



▶ Introduction

To make it easier for our busy readers to scroll directly to the items they are interested in without having to read through all the material, we list the issues covered in this module:

- **Basic profile of a typical successful trader on the stock markets**
- **The difference between “Average” and “Smart” investors**
- **The five biggest mistakes made by investors on the stock market**
- **Five other pitfalls to also avoid when investing in equities**
- **The time dilemma with doing enough “homework” to select good stocks**
- **How one can effectively avoid most of the pitfalls**

If you are interested in accumulating useful information about stock market investments you may want to copy this module and add it to the others published, in order to build your own manual of useful tips to assist you with successful investments in the equity markets.

The statistics and historic performance used in the examples are based on historic averages and we attempted to be as accurate and fair as possible in each scenario or illustration.

■ Profile of the successful trader

Considerable research were done by the Valana team to see if there were common profile characteristics amongst the top market wizards and whilst we obviously did not consider all the top traders in the markets, there certainly seemed to be some correlations.

★ *The following characteristics were found to be common amongst successful traders:*

- ▶ They don't look at money as money; it is not that important to them.
- ▶ They have a passion for the markets; they never stop thinking about stocks.
- ▶ They look at trading as a skilful game; where the primary objective is to win.
- ▶ They know it is fine to sometimes lose; it is all part of the game.
- ▶ They use a model or defined strategy in their trading; and seldom deviate from it.
- ▶ They never panic; they rely on their strategy and value to pull them through.
- ▶ They have won the game before they started; they have confidence in their strategy.

■ Difference between “Average” and “Smart” Investors

* Average Investors

- They do what most others seem to do, they display "herd behaviour".
- They rely on "red hot" tips, hope and wishful thinking.
- They believe almost everything the so-called “experts” say in the media.
- They have no fixed strategy or valid method to enhance their trading results.
- They confuse good companies with good stocks.
- They often tend to gather much more information than they actually need.
- They often buy into falling stocks in order to obtain a better price average.
- They fear losing much more than they enjoy winning.
- They buy very average stocks at premium prices.
- They almost always re-enter the markets too late after a crash.
- They are overly concerned with safety, diversity, hedging and the like.

* Smart Investors

- They do what others fail to do or they do it before the others can.
- They rely on verified information from credible tested sources.
- They know that the “experts” are probably more wrong than they are right.
- They have a clear, well validated trading strategy that works for them.
- They know good companies will almost always lead to good stocks.
- They attempt to only concern themselves with the most relevant information.
- They never add to falling stocks, but may add to rising stocks already held.
- They enjoy winning much more than they fear losing.
- They buy quality stocks at discount prices.
- They take pro-active action to overcome the re-entry dilemma.
- They focus on value, term and return on investment.

■ The five biggest mistakes made by investors in the stock markets

(1) *Selling good stocks too soon*

Concepts like “target pricing” often lead to investors selling good quality stocks too soon.

The application of stop loss strategies may also often result in good quality stocks with considerable more upside after a temporary dip being sold too soon.

Whilst there is some merit in the loss containment element of stop loss strategies, one should maybe only apply **trade stop losses** to speculative stocks and **trailing stop losses** to stocks held for more than three years. (*Stop losses covered in previous module*).

(2) Listening and responding to market noise and other media hype

It is said that the greatest attribute of really successful investors is the ability to totally ignore market noise and other unverified trading hype in the media.

Whilst one may sometimes buy a stock on market noise, one should **never** sell a stock on such hype or rumour, only sell on fact.

Investors with a sound investment strategy find it much easier to cope with this destructive *market noise element* than those who simply tend to respond to what they hear in the media.

A very good example of how misleading market noise could be is the issue with platinum during 2009.

In January 2009 almost every analyst, fund manager, broker, etc interviewed or involved in a discussion group in the media strongly advised against holding on to platinum stocks as they generally were of the opinion that there were too many factors making it a bad choice for investment in the current environment, and let us face it, the reasoning and arguments they provided actually made a lot of sense at the time, such as:

- Considerable drop in the price of platinum
- Over supply and stock piling of platinum globally
- The strong local currency being bad for exporters
- Serious downturn in auto industry (need for catalytic converters)
- Low demand from Jewelers and affiliated industries
- Great uncertainty about global economic recovery

Logic and reasoning on items related to the stock market is never as simple as it should be or as one would like it to be.

Table 1 below should give one some idea as to how much attention one should give to “market noise” even where experts make the noise and even if the *logic* used by them (as listed above) seem to make absolute sense at the time.

Table 1	Jan 2009	Dec 2009	Move %
<i>Angloplat</i>	42005c	79500c	89.2%
<i>Anooraq</i>	350c	685c	95.7%
<i>Aquarius</i>	2522c	4895c	94.1%
<i>Eastplats</i>	295c	695c	135.6%
<i>Implats</i>	11970c	20695c	72.8%
<i>Jubilee</i>	120c	358c	198.3%
<i>Lonmin</i>	11700c	22975c	96.4%
<i>Northam</i>	1850c	4800c	159.4%
<i>Wesizwe</i>	119c	215c	80.6%

Average move during 12 months ► **113.6%**

If one listened to the market noise in January 2009 and believe it, many did, you could have missed out on a magnificent 114% yield with these stocks over the next 12-month period.

Those of you who regularly watch the DSTv Summit and CNBC equity market channels will still recall how during December 2008 most commentators and “experts” were cautiously optimistic about the performance of banks during the next year or so. However, almost without exception they recommended you stick to the big three, namely **ABSA**, **Firststrand** and **Stanbank**.

We cannot recall anyone who recommended a specialist niche bank such as **Capitec** which was priced at 2950c at the time. The logic for not recommending it probably was because it did not fall much since 2006 and already came from a low of under 500c in 2004.

However, if you were a Valana subscriber, you probably would have bought this stock as the company attained a good value rating when assessed at the time.

If you followed the advice of the “expert commentators” you would have achieved a 20.2% average yield during 2009 on the “**big three**”, but if you bought **Capitec** instead you would have achieved a massive yield of 158% during the same period.

Another good market noise example is **Sappi**. During the first quarter of 2009 most financial commentators seemed to predict hard times for this company, again based on seemingly good logic:

- With the immense development of Internet news and communication facilities the use and physical need for paper may drastically reduce in future.
- Sappi is expecting to suffer a probable loss for the period ending September 2009 due to negative trading conditions, locally and abroad.
- The extreme potential increase in electricity charges by Eskom should have a considerable negative impact on future earnings.
- During the ongoing downturn in global economies and contracting marketing budgets of big business consumers the need for Sappi’s products will drop even more in future, especially in respect of high-end products such as glossy paper, etc.

These negative assessments were made mostly during March 2009 when the price of Sappi was 1936c and many novice investors probably dumped the stock due to such market noise.

How surprised they must have been only 8 months later to see a price gain of 125% in the stock of this company doomed by most of the market noise less than a year before.

(3) Acting on "red hot" tips especially from uninformed or unqualified sources

This is a bit like listening to market noise and what is amazing is the fact that the less a person knows of the companies listed on the markets, the more they think they know and the more they have to say about that company's stock as an investment.

The irony and danger is that many of these “backyard stock pickers” don’t even know that they don’t know.

If you are going to seek advice as to which stocks should be considered for possible investment make sure that the source or facility who supplies that information is credible and knowledgeable. Be satisfied that they do their "homework" well and that they have a track record to back them up.

It is also wise to remain wary of some of those other "experts" who says it is all related to simple economics and/or future earnings or any other single factor. It is not that simple.

(4) Underestimating the negative impact of intermediation fees on your returns

Almost any strategy is better than paying high intermediation charges when trading on the markets.

Research seemed to indicate that the advice and extra service you get for the intermediation fees charged, is seldom worth the limited benefit obtained, especially if one considers the compound cost thereof over the long-term.

As intermediation charges apply to each transaction made, frequent trading can have a devastating effect on your eventual profits (*Tyranny of Costs*).

Your ultimate objective must be to align other valid information sources and facilities that are less expensive and that will make it possible to avoid the compound effect of intermediation charges to be paid per trading transaction.

(5) Having no investment strategy and panicking when things turn sour

It is almost impossible to make sound investments on the stock markets if you have no strategy or validated model or method to manage the holdings in your portfolio.

These investors often end up being driven mostly by fear and greed and they almost always exit and enter the markets at the wrong time.

These investors also display strong "herd behaviour" where they run for the exits if they perceive others doing so.

The dilemma, however, is that one gets fearful very quickly, but it takes a long time to gain enough confidence again. Therefore, they tend to sell "low" and then again buy "high".

Because of their lack of strategy and discipline they not only incur unnecessary costs, but also seldom operate in a tax-efficient manner.

These investors also tend to become greedy and sometimes get involved with highly geared derivative products and option instruments such as warrants and leveraged futures in order to make a big profit quickly.

Getting involved with these derivatives can be very risky, especially to the novice and the ill-informed market player, even the so-called "experts" often get it wrong.

The worst part of this strategy, of course, is the fact that these investors seldom enjoy the trading activities in their portfolios, *because they spend most of their time worrying about it.*

■ Five other pitfalls to avoid in the stock markets

■ *Buying more shares in a losing stock*

One of the worst things one can do is to try and obtain a better price average by buying more (adding to) shares in a stock where the price is in a downward spiral.

Doing that seldom works and it usually simply boils down to throwing good money after bad.

The only way that price averaging may be effective is where one invests the amount in instalments, such as on a monthly basis. In this way you may end up with more stock for the amount invested over the term than you would if you bought all the stock at a single price at

the beginning of the period. If the price is lower during the term than when you started, you will get pro-rata more shares for the instalment made at the time.

The same does not apply to a stock rising in price, in fact it may even be a good option to buy into (add to) such a stock when in an upward spiral or where more value becomes evident.

▪ ***Trading out of winners into stocks doing less well***

A mistake many investors make is to sell the stocks where good profits can be taken and then to invest those proceeds in the stock of companies not doing well at the time.

Not only may this approach lead to considerable tax liabilities, especially if held for less than three years it may also sideline you in respect of future gains from these stocks.

Good performing stocks are usually sold because of the belief investors have in the concept of *mean reversion*, which states that over time stocks that go down will bounce back up and those that went up will come back down.

Considerable research done, however, shows that the mean reversion is to a large extent a fallacy and probably should not be relied upon.

In 1998 Terrance Odean found that if investors rather sold their losers and kept their winners, they would have done considerably better. His studies indicated that stocks that have gone up will likely go up even more and those that went down will probably go down even more.

Research did by Valana during the period 2006 to 2009 strongly support Odean's findings.

▪ ***Holding on to a stock because of sentiment or emotional attachment to it***

Never hold on to a losing stock simply because you have a "good feeling" or emotional tie to it or the company.

There is no room for emotion in any investment strategy and it should be totally avoided in any decision-making process, because it almost always lead to undesired outcomes.

If the stock triggers a stop loss or its PE ratio becomes too high or the latest Valana rating drop more than 33%, sell it and then just forget about it.

▪ ***Investing in stocks without any knowledge of the business they are in***

One should always without fail look at buying a stock exactly as you will look at a company you may consider or wish to buy.

The principles and disciplines involved are exactly the same. Only the amounts, procedures and the paperwork involved may differ.

It goes without saying that nobody of a sound mind will even think of buying a company if they did not know anything at all about such a company or the business it is involved in.

If you don't know what business the company is in and something goes wrong in the industry, you will probably not be able to link the happening to the stock you hold and you probably will never know what really went wrong.

Example:

If, in early 1900, you held stock in a company that builds ox-wagons but did not know that is what they do, you would have been in serious trouble when the automobile was introduced.

It is interesting to know that the great guru, Warren Buffet, to this very day still avoids investing in IT companies, mostly because he admits that he still really does not understand the computer business, even though his good friend Bill Gates on several occasions tried to explain to him what it is all about.

His reasoning makes a lot of sense. It is almost impossible to tell what went wrong in your stock selection if you don't understand the business you invested in.

▪ **Placing too much weight on a single performance element, such as earnings**

In-depth research done by Valana found that one cannot reliably assess the future performance of a company by just looking at any single element in isolation.

In August 2009, the latest results for Grindrod became available and according to those results the earnings dropped by almost 50%, yet within a few days the stock advanced nearly 15% on that bad earnings news.

The dilemma with an element like earnings is that it reflects what already happened whilst share prices are future focussed.

Even if you could accurately identify future earnings it will not be as helpful as so many investors and even seasoned players may think it is.

Of the companies assessed by Valana in 2008 to 2009 the 25 companies with the best earnings during that period would have given the investor a negative return on its stock of almost **-35%**.

During this same period, the stock of the top 25 Valana rated companies would have given you a positive return of **23.5%**.

Although it is true that certain elements may influence future price moves, it is not reliable enough or sufficient to assess the true value contained in a specific company by looking at anything in isolation.

For example, a company may show excellent earnings and even good potential future earnings and still have the share price dropping. This may happen if the actual earnings still did not meet the expectations of those investors who held that stock at the time, or if the earnings for the period do not relate in a positive or acceptable manner with, for example, asset accumulation, debt control, cash generation, return on capital, etc.

Certain fundamental components will have a tendency to attract investors such as a low PE (price to earnings) ratio, a good ROE % (return on equity) an attractive NAV % (net asset value) a good Roam % (return on assets) free cash flow, sound revenue and profit factors, etc.

To really identify embedded value and performance prospects one has to understand the interrelationships between different factor groups and the weightings each deserve under different market, earnings and economic scenarios. One has to understand and identify the "**Enterprise DNA**" of specific companies in order to recognise real value.

Analysing and assessing such "Enterprise DNA" is the speciality of Valana.

■ **The time dilemma with doing enough "homework"**

Most investors with enough money to benefit from the vast array of opportunities contained in the stock markets just simply do not have enough time to do all the necessary "homework" required in order to make effective investment choices.

These investors then often revert to one or more of the following options:

Option 1 ▶▶▶▶▶▶

Become a "**layman expert**" and use their own perceived knowledge of markets, economies and business environments to select stocks for investment. These investors also often tend to rely on non-verified information and pure "gut feel".

Research has clearly shown that these "layman experts" seldom, if ever, succeed in beating the All Share Index on the markets over the long term.

Option 2 ▶▶▶▶▶▶

They give their stock brokers a **full mandate** to trade on their behalf and they blindly trust the broker to select the best stocks to buy and sell on their behalf.

They do not seem to realise that there are *two big pitfalls* tied to such an option:

Firstly; stock brokers are not always good stock selectors. If they were, they probably would have been running an investment fund or traded full-time for their own script account which may be much more rewarding.

They are traders (salesmen) who earn their money on every transaction they make on your behalf; *the more transactions, the better for them*.

Secondly; with a full mandate, stock brokers will tend to do much more trading than you would do each year and with the intermediation charges involved such a high turn around in your stock holdings can erode more than half your potential profits over time.

Some past research also seem to indicate that a frequent trading strategy often lead to very mediocre performance, mainly because they sell good stocks too soon and it may also bring about unpleasant tax implications.

Terrance Odean and Brad Barber who did some trading frequency analysis came to the conclusion that those investors who traded least, earned, on average, seven percentage points a year more than those who traded more frequently.

Option 3 ▶▶▶▶▶▶

They obtain all their stock market exposure through **Equity Funds** such as Exchange Traded Funds (ETF) on the JSE or the many **Collective Funds** (Unit Trusts) available.

Apart from the problem of switching regularly as market scenarios change, mainly because they just do not have the time to attend to such issues, they will find that the performance of many of these funds are often rather disappointing over the long-term.

This lesser performance is not because fund managers are incompetent or bad stock pickers, but rather as a result of the nature of collective funds and how it works.

(Collective funds will be dealt with in Module 8)

Option 4 ▶▶▶▶▶▶

They use credible **stock selection facilities** such as Penny Hot Shares, The South African Investor, Prestige Bulletin or Valana Stock Market Investment Sense and many others that may be available to them.

There seems little doubt that these facilities, as a rule, perform better than most other options and, of course, the time and costs it saves an investor cannot be ignored.

The reason why these facilities do so well is probably because they have to earn and retain their credibility and, therefore, they will tend to do their homework very well if they want to stay in business.

Also, unlike collective funds, they do not have to buy large volumes of the stock at rising share prices in order to attain a desired weighting with such a stock in a portfolio.

Most stock selection facilities, other than Valana, have some major short comings:

- (1) They don't tell you how good or bad the potential for a specific stock is, they just give you a choice of three options: *Buy it, Hold it or Sell it*. This makes it difficult to decide whether you should replace it with something better or judge the parameters of how much funds should be allocated to it.
- (2) They provide you with lengthy newsletters and long discussions often loaded with trivia based mostly on personal opinion and vague anticipations. We at Valana found that few busy people ever take the time to read any of it.
- (3) They often tend to place too much emphasis on future earnings potential and/or other economic or industry developments anticipated.
- (4) They over estimate by far the reliability of logic in stock selection. If logic could identify the winners on the stock markets, most people with more than three brain cells would have been a billionaire.

■ The most effective way to avoid these many pitfalls

The most effective way to avoid falling into all the pitfalls and traps explained above will be to select a reliable source to guide you as to which companies one should consider for investment without the need for you to study lengthy reports and sift through a mass of debatable reasons, logic or motivation for selecting such a stock.

A facility such as Valana.co.za provides you with a simple to understand "bottom line" rating of what the probable odds are for future performance and this enables you to devise a very effective investment and trading strategy that not only suits your specific risk profile, but also considerably reduces your trading costs, which greatly enhances your investment return.

Valana does not tell you to buy or sell a stock, it only provides you with an "odds for winning" rating in respect of listed companies. This will indicate how good or bad the odds are for the big players to soon buy or sell the stock of such a company, which in turn obviously will move the share price.

It is a fair assumption that those investors who influence the markets (big players) will almost always seek out the companies with great odds for winning to invest their funds in.

With the Valana facility you also have the choice as to how good the rating should be before you invest in that specific company, the actual score (value criteria) you choose is up to you.

Ratings above 100 indicate favourable odds and below 100 will indicate unfavourable odds.

This unique approach, of course, also now makes it possible to select stocks you wish to go "short" on (those with low Valana ratings) or where you may want to invest in put warrants, so to benefit from falling share prices.

With such a facility all one now needs to do is to draw up a simple set of rules and trading disciplines to abide by and then you are on your way to become a successful investor in the most rewarding asset class available for investment.

The rules and disciplines should relate to issues, such as:

- Quality parameters of the stocks to consider (Valana value ratings)
- Evidence criteria for when to sell the stock
- Value identification for when to add to the stock
- Selected stop loss applications to apply to certain stocks
- Levels of diversity to be maintained in the portfolio
- Defensive stock spread required in your holdings
- Define conditions for “safe haven” instruments to be acquired

(These tutorial modules cover all the above issues to make it possible for you to do so).

The greatest benefit of having a good source based strategy is that one may now be able to buy what the big players are ***still going to buy; before they do;*** a real winning recipe.

General Comments

In sport it is said, *the more you practise the luckier you get*, but in investments one could say:

The more you adhere to the rules and the desired disciplines, the luckier you get.

In the following module we will deal with the merits of making investments in the property asset class instruments and we will see if those investments are really as good as many claim it to be.