

ALSO BY PETER LYNCH

*Learn to Earn*

*One Up on Wall Street*

(with John Rothchild)

# BEATING THE STREET

The Best-selling Author of *One Up on Wall Street*  
Shows You How to Pick Winning Stocks and  
Develop a Strategy for Mutual Funds

**PETER LYNCH**

*with John Rothchild*

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## INTRODUCTION

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### *Escape from Bondage*

A retired fund manager is qualified to give only investment advice, not spiritual advice, but what inspires me to retake the pulpit is that a majority in the congregation continue to favor bonds. Obviously, they must have slept through the last sermon, *One Up on Wall Street*, in which I tried to prove once and for all that putting money into stocks is far more profitable than putting it into bonds, certificates of deposit, or money-market accounts. Otherwise, why are 90 percent of the nation's investment dollars still parked in these inferior spots?

Throughout the 1980s, which was the second-best decade for stocks in modern history (only the 1950s were slightly more bountiful), the percentage of household assets invested in stocks declined! This percentage, in fact, has been declining steadily—from nearly 40 percent in the 1960s to 25 percent in 1980 to 17 percent in 1990. As the Dow Jones average and the other stock indexes quadrupled in value, a mass of investors was switching out of stocks. Even assets invested in equity mutual funds shrunk from around 70 percent in 1980 to 43 percent in 1990.

This calamity for the future of individual and national wealth cannot go unchallenged. Let me begin, then, where I left off the last time: if you hope to have more money tomorrow than you have today, you've got to put a chunk of your assets into stocks. Maybe we're going into a bear market and for the next two years or three years or even five years you'll wish you'd never heard of stocks. But the 20th century has been full of bear markets, not to mention recessions, and in spite of that the results are indisputable: sooner

or later, a portfolio of stocks or stock mutual funds will turn out to be a lot more valuable than a portfolio of bonds or CDs or money-market funds. There, I've said it again.

The most persuasive bit of proof I've discovered since I argued this point before can be found in the *Ibbotson S&P Yearbook, 1993*, chapter 1, page 17, under the heading "Average Annual Return for the Decades 1926-1989." This is a summary of the profits you would have made, per year, by investing your money in the S&P 500 stocks, small-company stocks, long-term government bonds, long-term corporate bonds, and short-term Treasury bills. The results are shown in Table I-1.

The investment geniuses among us could have put all their money into the S&P 500 stocks in the 1920s, switched in 1929 to long-term corporate bonds and held these throughout the 1930s, moved into small-company stocks in the 1940s, back into the S&P 500 in the 1950s, back to small companies in the 1960s and the 1970s, and returned to the S&P 500 in the 1980s. The people who followed that inspired strategy are now all billionaires and living on the coast of France. I would have recommended it myself, had I been clever enough to know beforehand what was going to happen. In hindsight, it's quite obvious.

Since I've never met a single billionaire who made his or her fortune exactly in this fashion, I must assume that they are in short supply relative to the rest of us who exhibit normal intelligence. The rest of us have no way of predicting the next rare period in which bonds will outperform stocks. But the fact that it's only happened in one decade out of seven, the 1930s (the 1970s was a standoff), gives the dedicated stockpicker an advantage. By sticking with stocks all the time, the odds are six to one in our favor that we'll do better than the people who stick with bonds.

Moreover, the gains enjoyed by the bondholders in the rare decade when bonds beat stocks cannot possibly hope to make up for the huge advances made by stocks in periods such as the 1940s and the 1960s. Over the entire 64 years covered in the table, a \$100,000 investment in long-term government bonds would now be worth \$1.6 million, whereas the same amount invested in the S&P 500 would be worth \$25.5 million. This leads me to Peter's Principle #2:

➤ **Gentlemen who prefer bonds don't know what they're missing.**

Table I-1. AVERAGE ANNUAL RETURN

	1920s*	1930s	1940s	1950s	1960s	1970s	1980s
S&P 500	19.2%	0.0%	9.2%	19.4%	7.8%	5.9%	17.5%
Small-Company Stocks	- 4.5%	1.4%	20.7%	16.9%	15.5%	11.5%	15.8%
Long-Term Government Bonds	5.0%	4.9%	3.2%	- 0.1%	1.4%	5.5%	12.6%
Long-Term Corporate Bonds	5.2%	6.9%	2.7%	1.0%	1.7%	6.2%	13.0%
Treasury Bills	3.7%	0.6%	0.4%	1.9%	3.9%	6.3%	8.9%
Inflation	- 1.1%	-2.0%	5.4%	2.2%	2.5%	7.4%	5.1%

\*Based on the period 1926-29.

SOURCE: *Ibbotson S&P Yearbook, 1993*



FIGURE I-1

Yet we continue to be a nation of bondholders. Millions of people are devoted to collecting interest, which may or may not keep them slightly ahead of inflation, when they could be enjoying a 5–6 percent boost in their real net worth, above and beyond inflation, for years to come. Buy stocks! If this is the only lesson you learn from this book, then writing it will have been worth the trouble.

The debate over whether to invest in small stocks or big stocks, or how to choose the best stock mutual fund (all subjects of later chapters), is subordinate to the main point—whichever way you do it, big stocks, small stocks, or medium-sized stocks, buy stocks! I'm assuming, of course, that you go about your stockpicking or fund-picking in an intelligent manner, and that you don't get scared out of your stocks during corrections.

A second reason I've taken on this project is to further encourage the amateur investor not to give up on the rewarding pastime of

stockpicking. I've said before that an amateur who devotes a small amount of study to companies in an industry he or she knows something about can outperform 95 percent of the paid experts who manage the mutual funds, plus have fun in doing it.

A sizable crowd of mutual fund managers dismisses this notion as hooey, and some have called it "Lynch's ten-bagger of wind." Nevertheless, my 2½ years away from Magellan have only strengthened my conviction that the amateur has the advantage. For non-believers on this point, I've stumbled onto some additional proof.

This can be found in Chapter 1, "The Miracle of St. Agnes," which describes how a bunch of seventh graders at a Boston area parochial school have produced a two-year investment record that Wall Street professionals can only envy.

Meanwhile, a larger bunch of adult amateur investors claims to have bested their professional counterparts for many years in a row. These successful stockpickers belong to the hundreds of investment clubs sponsored by the National Association of Investors, and their annual rates of return have been just as enviable as those turned in by the students at St. Agnes.

Both bunches of amateurs have this in common: their stockpicking methods are much simpler and generally more rewarding than many of the more baroque techniques used by highly paid fund managers.

Whatever method you use to pick stocks or stock mutual funds, your ultimate success or failure will depend on your ability to ignore the worries of the world long enough to allow your investments to succeed. It isn't the head but the stomach that determines the fate of the stockpicker. The skittish investor, no matter how intelligent, is always susceptible to getting flushed out of the market by the brush beaters of doom.

A group of us investment seers meets every January to participate in a panel discussion sponsored by *Barron's* magazine, which later publishes the transcript. If you had bought many of the stocks that we recommended, you would have made money, but if you paid attention to our expert opinions on the direction of the market and the economy you would have been too scared to own stocks for the last seven years. Chapter 2 deals with the pitfalls of this "weekend worrying" and how to ignore it.

Chapter 3, "A Tour of the Fund House," is my attempt to devise a strategy for mutual fund investing. Although I remain a stockpicker at heart, my retirement gives me the opportunity to discuss a subject

I was reluctant to tackle as a fund manager. When you're still in the business, almost anything you say about it could be construed as either self-serving or a sneaky way to attract new customers—charges that I trust will not be leveled against me now.

Recently, I helped a not-for-profit organization in New England devise a new portfolio strategy. (This organization shall remain nameless because its identity isn't relevant to the exercise.) We first had to decide how much of the money to put into stocks and how much into bonds, and then how to invest each portion. These are the same decisions that every household CEO must make, which is why I've provided a detailed description of how we approached the problem.

Chapters 4, 5, and 6 are a three-part retrospective: how I managed Magellan during 13 years and 9 major corrections. This exercise gave me an excuse to go back and figure out exactly what factors contributed to whatever successes I had. Some of the conclusions have surprised even me, and I was there.

In this part of the book I've tried to concentrate on methodology and to downplay the idle reminiscence. Perhaps there's something to be learned from my occasional triumphs and my numerous mistakes.

In Chapters 7 through 20, which account for more than half of these pages, I describe how I went about picking the 21 stocks I recommended to the readers of *Barron's* magazine in January 1992. I've talked before about theories of investing, but in making these selections I took notes as I went along. With these notes in hand, I've tried to analyze my stockpicking habits in as much detail as possible. This includes both how to identify promising situations and how to go about researching them.

The 21 stocks that I've used to illustrate this Lynch Method cover many of the important categories and industry groups (banks and S&Ls, cyclicals, retailers, utilities) in which people routinely invest. I've arranged the chapters so that each one deals with a specific kind of company. Chapter 21, "The Six-Month Checkup," describes the regular process of reviewing the story of each company in a portfolio.

I have no pat formulas to offer. There are no bells that ring when you've bought the right stock, and no matter how much you know about a company you can never be certain that it will reward you for investing in it. But if you know the factors that make a retailer

or a bank or an automaker profitable or unprofitable, you can improve your odds. Many of these factors are laid out here.

The text is fortified with liberal doses of Peter's Principles, such as the two you've already had to tolerate. Many of these lessons I've learned from experience, which is always an expensive teacher, so you're getting them here at a discount.

(The stock prices of the 21 companies that I describe in the second half of this book were constantly changing in the course of my research. For example, Pier 1 was selling for \$7.50 when I began looking into it and \$8 when I finally recommended it in *Barron's*. On one page, I may refer to Pier 1 as a \$7.50 stock, and on another as an \$8 stock. Several such anomalies may appear in the text.)

ONE

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## THE MIRACLE OF ST. AGNES

Amateur stockpicking is a dying art, like pie-baking, which is losing out to the packaged goods. A vast army of mutual-fund managers is paid handsomely to do for portfolios what Sara Lee did for cakes. I'm sorry this is happening. It bothered me when I was a fund manager, and it bothers me even more now that I have joined the ranks of the nonprofessionals, investing in my spare time.

This decline of the amateur accelerated during the great bull market of the 1980s, after which fewer individuals owned stocks than at the beginning. I have tried to determine why this happened. One reason is that the financial press made us Wall Street types into celebrities, a notoriety that was largely undeserved. Stock stars were treated like rock stars, giving the amateur investor the false impression that he or she couldn't possibly hope to compete against so many geniuses with M.B.A. degrees, all wearing Burberry raincoats and armed with Quotrons.

Rather than fight these Burberried geniuses, large numbers of average investors decided to join them by putting their serious money into mutual funds. The fact that up to 75 percent of these mutual funds failed to perform even as well as the stock market averages proves that genius isn't foolproof.

But the main reason for the decline of the amateur stockpicker has to be losses. It's human nature to keep doing something as long as it's pleasurable and you can succeed at it, which is why the world

population continues to increase at a rapid rate. Likewise, people continue to collect baseball cards, antique furniture, old fishing lures, coins, and stamps, and they haven't stopped fixing up houses and reselling them, because all these activities can be profitable as well as enjoyable. So if they've gotten out of stocks, it's because they're tired of losing money.

It's usually the wealthier and more successful members of society who have money to put into stocks in the first place, and this group is used to getting A's in school and pats on the back at work. The stock market is the one place where the high achiever is routinely shown up. It's easy to get an F here. If you buy futures and options and attempt to time the market, it's easy to get all F's, which must be what's happened to a lot of people who have fled to the mutual funds.

This doesn't mean they stop buying stocks altogether. Somewhere down the road they get a tip from Uncle Harry, or they overhear a conversation on a bus, or they read something in a magazine and decide to take a flier on a dubious prospect, with their "play" money. This split between serious money invested in the funds and play money for individual stocks is a recent phenomenon, which encourages the stockpicker's caprice. He or she can make these frivolous side bets in a separate account with a discount broker, which the spouse doesn't have to know about.

As stockpicking disappears as a serious hobby, the techniques of how to evaluate a company, the earnings, the growth rate, etc., are being forgotten right along with the old family recipes. With fewer retail clients interested in such information, brokerage houses are less inclined to volunteer it. Analysts are too busy talking to the institutions to worry about educating the masses.

Meanwhile, the brokerage-house computers are busily collecting a wealth of useful information about companies that can be regurgitated in almost any form for any customer who asks. A year or so ago, Fidelity's director of research, Rick Spillane, interviewed several top-producing brokers about the data bases and so-called screens that are now available. A screen is a computer-generated list of companies that share basic characteristics—for example, those that have raised dividends for 20 years in a row. This is very useful to investors who want to specialize in that kind of company.

At Smith Barney, Albert Bernazati notes that his firm can pro-

vide 8–10 pages of financial information on most of the 2,800 companies in the Smith Barney universe. Merrill Lynch can do screens on ten different variables, the *Value Line Investment Survey* has a "value screen," and Charles Schwab has an impressive data service called "the Equalizer." Yet none of these services is in great demand. Tom Reilly at Merrill Lynch reports that less than 5 percent of his customers take advantage of the stock screens. Jonathan Smith at Lehman Brothers says that the average retail investor does not take advantage of 90 percent of what Lehman can offer.

In prior decades, when more people bought their own stocks, the stockbroker per se was a useful data base. Many old-fashioned brokers were students of a particular industry, or a particular handful of companies, and could help teach clients the ins and outs. Of course, one can go overboard in glorifying the old-fashioned broker as the Wall Street equivalent of the doctor who made house calls. This happy notion is contradicted by public opinion surveys that usually ranked the stockbroker slightly below the politician and the used-car salesman on the scale of popularity. Still, the bygone broker did more independent research than today's version, who is more likely to rely on information generated in house by his or her own firm.

Newfangled brokers have many things besides stocks to sell, including annuities, limited partnerships, tax shelters, insurance policies, CDs, bond funds, and stock funds. They must understand all of these "products" at least well enough to make the pitch. They have neither the time nor the inclination to track the utilities or the retailers or the auto sector, and since few clients are invested in individual stocks, there's little demand for their stockpicking advice. Anyway, the broker's biggest commissions are made elsewhere, on mutual funds, underwritings, and in the options game.

With fewer brokers offering personal guidance to fewer stockpickers, and with a climate that encourages capricious speculation with "fun" money and an exaggerated reverence for professional skills, it's no wonder that so many people conclude that picking their own stocks is hopeless. But don't tell that to the students at St. Agnes.

## THE ST. AGNES PORTFOLIO

The fourteen stocks shown in Table 1-1 were the top picks of an energetic band of seventh-grade portfolio managers who attended the St. Agnes School in Arlington, Massachusetts, a suburb of Boston, in 1990. Their teacher and CEO, Joan Morrissey, was inspired to test the theory that you don't need a Quotron or a Wharton M.B.A., or for that matter even a driver's license, to excel in equities.

You won't find these results listed in a Lipper report or in *Forbes*, but an investment in the model St. Agnes portfolio produced a 70 percent gain over a two-year period, outperforming the S&P 500 composite, which gained 26 percent in the same time frame, by a whopping margin. In the process, St. Agnes also outperformed 99 percent of all equity mutual funds, whose managers are paid considerable sums for their expert selections, whereas the youngsters are happy to settle for a free breakfast with the teacher and a movie.

Table 1-1. ST. AGNES PORTFOLIO

Company	1990-91 Performance (%)
Wal-Mart	164.7
Nike	178.5
Walt Disney	3.4
Limited	68.8
L.A. Gear	- 64.3
Pentech	53.1
Gap	320.3
PepsiCo	63.8
Food Lion	146.9
Topps	55.7
Savannah Foods	- 38.5
IBM	3.6
NYNEX	- .22
Mobil	19.1
Total Return for Portfolio	69.6
S&P 500	26.08

Total return performance January 1, 1990-December 31, 1991

I was made aware of this fine performance via the large scrapbook sent to my office, in which the seventh graders not only listed their top-rated selections, but drew pictures of each one. This leads me to Peter's Principle #3:

**Never invest in any idea you can't illustrate with a crayon.**

This rule ought to be adopted by many adult money managers, amateur and professional, who have a habit of ignoring the understandably profitable enterprise in favor of the inexplicable venture that loses money. Surely it would have kept investors away from Dense-Pac Microsystems, a manufacturer of "memory modules," the stock of which, alas, has fallen from \$16 to 25 cents. Who could draw a picture of a Dense-Pac Microsystem?

In order to congratulate the entire St. Agnes fund department (which doubles as Ms. Morrissey's social studies class) and also to learn the secrets of its success, I invited the group to lunch at Fidelity's executive dining room, where, for the first time, pizza was served. There, Ms. Morrissey, who has taught at St. Agnes for 25 years, explained how her class is divided every year into teams of four students each, and how each team is funded with a theoretical \$250,000 and then competes to see who can make the most of it.

Each of the various teams, which have adopted nicknames such as Rags to Riches, the Wizards of Wall Street, Wall Street Women, The Money Machine, Stocks R Us, and even the Lynch Mob, also picks a favorite stock to be included in the scrapbook, which is how the model portfolio is created.

The students learn to read the financial newspaper *Investor's Business Daily*. They come up with a list of potentially attractive companies and then research each one, checking the earnings and the relative strength. Then they sit down and review the data and decide which stocks to choose. This is a similar procedure to the one that is followed by many Wall Street fund managers, although they aren't necessarily as adept at it as the kids.

"I try to stress the idea that a portfolio should have at least ten companies, with one or two providing a fairly good dividend," says Ms. Morrissey. "But before my students can put any stock in the portfolio, they have to explain exactly what the company does. If they can't tell the class the service it provides or the products it

makes, then they aren't allowed to buy. Buying what you know about is one of our themes." Buying what you know about is a very sophisticated strategy that many professionals have neglected to put into practice.

One of the companies the students at St. Agnes knew about was Pentech International, a maker of colored pens and markers. Their favorite Pentech product, with a marker on one end and a highlighter on the other, was introduced into the class by Ms. Morrissey. This pen was very popular, and some of the kids even used it to highlight their stock selections. It wasn't long before they were investigating Pentech itself.

The stock was selling for \$5 at the time, and the students discovered that the company had no long-term debt. They were also impressed by the fact that Pentech made a superior product, which, judging by its popularity in house, was likely to be just as popular in classrooms nationwide. Another positive, from their point of view, was that Pentech was a relatively unknown company, as compared, say, to Gillette, the maker of Paper Mate pens and the Good News razors they saw in their fathers' bathrooms.

Trying to come to the aid of a colleague, the St. Agnes fund managers sent me a Pentech pen and suggested I look into this wonderful company. This advice I wish I had taken. After I received the research tip and neglected to act on it, the stock nearly doubled, from 5½ to a high of 9½.

This same kid's-eye approach to stockpicking led the 1990 St. Agnes fund managers to the Walt Disney Company, two sneaker manufacturers (Nike and L.A. Gear), the Gap (where most of them buy their clothes), PepsiCo (which they know four different ways via Pepsi-Cola, Pizza Hut, Kentucky Fried Chicken, and Frito-Lay), and Topps (a maker of baseball cards). "We were very much into trading cards within the seventh grade," Ms. Morrissey says, "so there was no question about whether to own Topps. Again, Topps produced something the kids could actually buy. In doing so, they felt they were contributing to the revenues of one of their companies."

They got to the others as follows: Wal-Mart because they were shown a videotaped segment of "Lifestyles of the Rich and Famous" that featured Wal-Mart's founder, Sam Walton, talking about how investing benefits the economy; NYNEX and Mobil because of their excellent dividends; Food Lion, Inc., because it was a well-run

company with a high return on equity and also because it was featured in the same video segment that introduced them to Sam Walton. Ms. Morrissey explains:

"The focus was on eighty-eight citizens of Salisbury, North Carolina, who each bought ten shares of Food Lion stock for one hundred dollars when the company went public back in 1957. A thousand dollars invested then had become fourteen million dollars. Do you believe it? All of these eighty-eight people became millionaires. These facts impressed all the kids, to say the least. By the end of the year they had forgotten a lot of things, but not the story of Food Lion."

The only clunker in the model portfolio is IBM, which I don't have to tell you has been the favorite of professional adult money managers for 20 years (yours truly included—grown-ups keep buying it and keep wishing they hadn't). The reason for this destructive obsession is not hard to find: IBM is an approved stock that everybody knows about and a fund manager can't get into trouble for losing money on it. The St. Agnes kids can be forgiven this one foolish attempt to imitate their elders on Wall Street.

Let me anticipate some of the criticisms of the St. Agnes results that are sure to come from the professional ranks. (1) "This isn't real money." True, but so what? Anyway, the pros ought to be relieved that St. Agnes isn't working with real money—otherwise, based on St. Agnes's performance, billions of dollars might be pulled from the regular mutual funds and turned over to the kids. (2) "Anybody could have picked those stocks." If so, why didn't anybody? (3) "The kids got lucky with a bunch of their favorite picks." Perhaps, but some of the smaller portfolios chosen by the four-person teams in Ms. Morrissey's class did as well as or better than the model portfolio selected by the class at large. The winning foursome in 1990 (Andrew Castiglioni, Greg Bialach, Paul Knisell, and Matt Keating) picked the following stocks for the reasons noted:

- 100 shares of Disney ("Every kid can explain this one.")
- 100 shares of Kellogg ("They liked the product.")
- 300 shares of Topps ("Who doesn't trade baseball cards?")
- 200 shares of McDonald's ("People have to eat.")
- 100 shares of Wal-Mart ("A remarkable growth spurt.")
- 100 shares of Savannah Foods ("They got it from *Investor's Daily*.")

5,000 shares of Jiffy Lube ("Cheap at the time.")  
 600 shares of Hasbro ("It's a toy company, isn't it?")  
 1,000 shares of Tyco Toys (Ditto.)  
 100 shares of IBM ("Premature adulthood.")  
 600 shares of National Pizza ("Nobody can turn down a pizza.")  
 1,000 shares of Bank of New England ("How low could it go?")

This last stock I owned myself and lost money on, so I can appreciate the mistake. It was more than counteracted by the boys' two best picks, National Pizza and Tyco Toys. These four-baggers would have done wonders for any portfolio. Andrew Castiglioni discovered National Pizza by scanning the NASDAQ list, and then he followed up on his discovery by doing some research on the company—the crucial second step that many adult investors continue to omit.

The winning foursome in 1991 (Kevin Spinale, Brian Hough, David Cardillo, and Terence Kiernan) divided their pretend money among Philip Morris, Coca-Cola, Texaco, Raytheon, Nike, Merck, Blockbuster Entertainment, and Playboy Enterprises. Merck and Texaco got their attention because of the good dividends. Playboy got their attention for reasons that had nothing to do with the fundamentals of the company, although they did notice that the magazine had a large circulation and that Playboy owned a cable channel.

The entire class was introduced to Raytheon during the Gulf War, when Ms. Morrissey's students sent letters to the troops in Saudi Arabia. They developed a regular correspondence with Major Robert Swisher, who described how a Scud missile hit within a couple of miles of his camp. When the portfolio managers learned that Raytheon made the Patriot missile, they couldn't wait to research the stock. "It was a good feeling," Ms. Morrissey says, "knowing we had a theoretical financial interest in the weapon that was keeping Major Swisher alive."

### THE ST. AGNES CHORUS

After visiting Fidelity, eating pizza in the executive dining room, and giving me the Pentech advice I wish I had taken, the St. Agnes stock experts returned the favor by inviting me to address the school and to visit their portfolio department, a.k.a. the classroom. In

response to my visit to this 100-year-old institution, which offers classes from kindergarten through eighth grade, I received a cassette tape the students had recorded.

This remarkable tape included some of their own stockpicking ideas and stratagems, as well as a few that I'd suggested and they decided to repeat back to me, if only to make certain that I wouldn't forget them myself. Here are some of their comments:

Hi, this is Lori. One thing I remember you telling us is over the last seventy years the market has declined forty times, so an investor has to be willing to be in the market for the long term. . . . If I ever invest money in the market I will be sure to keep the money in.

Hi, this is Felicity. I remember you telling us the story about Sears and how when the first shopping malls were built, Sears was in ninety-five percent of them. . . . Now when I invest in a stock, I'll know to invest in a company that has room to grow.

Hi, this is Kim. I remember talking to you and you said that while K mart went into all the big towns, Wal-Mart was doing even better because it went into all the small towns where there was no competition, and I remember you said you were the guest speaker at Sam Walton's award ceremony, and just yesterday Wal-Mart was sixty dollars and they announced a two-for-one split.

This is Willy. I just want to say that all the kids were relieved when we had pizza for lunch.

Hi, this is Steve. I just want to tell you that I convinced my group to buy a lot of shares of Nike. We bought at fifty-six dollars a share; it is currently at seventy-six dollars a share. I own a lot of pairs of sneakers and they are comfortable shoes.

Hi, this is Kim, Maureen, and Jackie. We remember you were telling us that Coke was an OK company until five years ago when they came out with diet Coke and the adults went from drinking coffee and tea to diet Coke. Recently, Coke just split its stock at eighty-four dollars and is doing quite well.

At the end of the tape, the entire seventh-grade portfolio department repeated the following maxims in unison. This is a chorus that we should all memorize and repeat in the shower, to save ourselves from making future mistakes:

A good company usually increases its dividend every year.

You can lose money in a very short time but it takes a long time to make money.

The stock market really isn't a gamble, as long as you pick good companies that you think will do well, and not just because of the stock price.

You can make a lot of money from the stock market, but then again you can also lose money, as we proved.

You have to research the company before you put your money into it.

When you invest in the stock market you should always diversify.

You should invest in several stocks because out of every five you pick one will be very great, one will be really bad, and three will be OK.

Never fall in love with a stock; always have an open mind.

You shouldn't just pick a stock—you should do your homework.

Buying stocks in utility companies is good because it gives you a higher dividend, but you'll make money in growth stocks.

Just because a stock goes down doesn't mean it can't go lower.

Over the long term, it's better to buy stocks in small companies.

You should not buy a stock because it's cheap but because you know a lot about it.

Ms. Morrissey continues to do her best to promote amateur stock-picking, not only with students but with her fellow teachers, whom she inspired to start their own investment club, the Wall Street Wonders. There are twenty-two members, including me (honorary) and also Major Swisher.

The Wall Street Wonders have had a decent record, but not as good as the students'. "Wait until I tell the other teachers," Ms. Morrissey said after we had gone over the numbers, "that the kids' stocks have done better than ours."

### **10,000 INVESTMENT CLUBS CAN'T BE WRONG**

Evidence that adults as well as children can beat the market averages with a disciplined approach to picking stocks comes from the

National Association of Investors Corporation, based in Royal Oak, Michigan. This organization represents 10,000 stockpicking clubs, and publishes a guidebook and a monthly magazine to help them.

Over the decade of the 1980s, the majority of NAIC chapters outperformed the S&P 500 index, and three-quarters of all equity mutual funds to boot. The NAIC also reports that in 1991, 61.9 percent of its chapters did as well as or better than the S&P 500. Sixty-nine percent beat that average again in 1992. The key to the success of these investment clubs is that they invest on a regular timetable, which takes the guesswork out of whether the market is headed up or down, and does not allow for the impulse buying and impulse selling that spoil so many nest eggs. People who invest in stocks automatically, the same amount every month, through their retirement accounts or other pension plans, will profit from their self-discipline just as the clubs have.

The following calculations, made at my request by Fidelity's technical department, have strengthened the argument for investing on a schedule. If you had put \$1,000 in the S&P 500 index on January 31, 1940, and left it there for 52 years, you'd now have \$333,793.30 in your account. This is only a theoretical exercise, since there were no index funds in 1940, but it gives you an idea of the value of sticking with a broad range of stocks.

If you'd added \$1,000 to your initial outlay every January 31 throughout those same 52 years, your \$52,000 investment would now be worth \$3,554,227. Finally, if you had the courage to add another \$1,000 every time the market dropped 10 percent or more (this has happened 31 times in 52 years), your \$83,000 investment would now be worth \$6,295,000. Thus, there are substantial rewards for adopting a regular routine of investing and following it no matter what, and additional rewards for buying more shares when most investors are scared into selling.

All 10,000 clubs in the NAIC held to their timetables during and after the Great Correction of October 1987, when the end of the world and the end of the banking system were widely predicted. They ignored the scary rhetoric and kept on buying stocks.

An individual might be scared out of stocks and later regret it, but in the clubs nothing can be accomplished without a majority vote. Rule by committee is not always a good thing, but in this case it helps ensure that no foolish proposal to sell everything will be

carried out by the group. Collective decision making is one of the principal reasons that club members tend to do better with the money they invest with the group than with the money they invest in their private accounts on the side.

The clubs meet once a month, either in members' houses or in rented conference rooms at local hotels, where they trade ideas and decide what to buy next. Each person is responsible for researching one or two companies and keeping tabs on the latest developments. This takes the whimsy out of stockpicking. Nobody is going to get up and announce: "We've got to buy Home Shopping Network. I overheard a taxicab driver say it's a sure thing." When you know your recommendations will affect the pocketbooks of your friends, you tend to do your homework.

For the most part, the NAIC groups buy stocks in well-managed growth companies with a history of prosperity, and in which earnings are on the rise. This is the land of the many-bagger, where it's not unusual to make 10, 20, or even 30 times your original investment in a decade.

In 40 years of experience, the NAIC has learned many of the same lessons I learned at Magellan, beginning with the fact that if you pick stocks in five different growth companies, you'll find that three will perform as expected, one will run into unforeseen trouble and will disappoint you, and the fifth will do better than you could have imagined and will surprise you with a phenomenal return. Since it's impossible to predict which companies will do better than expected and which will do worse, the organization advises that your portfolio should include no fewer than five stocks. The NAIC calls this the Rule of Five.

The NAIC Investors Manual, which the directors kindly sent to my office, contains several important maxims that can be added to the repertoire of the St. Agnes chorus. These can be chanted as you mow the lawn, or, better yet, recited just before you pick up the phone to call the stockbroker:

Hold no more stocks than you can remain informed on.

Invest regularly.

You want to see, first, that sales and earnings per share are moving forward at an acceptable rate and, second, that you can buy the stock at a reasonable price.

It is well to consider the financial strength and debt structure to see if a few bad years would hinder the company's long-term progress.

Buy or do not buy the stock on the basis of whether or not the growth meets your objectives and whether the price is reasonable.

Understanding the reasons for past sales growth will help you form a good judgment as to the likelihood of past growth rates continuing.

To assist investors in delving more deeply into these matters, the NAIC offers its investors manual and a home study course that teach how to calculate earnings growth and sales growth; how to determine, on the basis of earnings, if a stock is cheap, expensive, or fairly priced; and how to read a balance sheet to tell whether or not a company has the wherewithal to survive hard times. For people who enjoy working with numbers and who want to do more sophisticated investment homework than they've done up to now, this is a good place to start.

The NAIC also publishes a monthly magazine, *Better Investing*, which recommends stocks in promising growth companies and provides regular updates on their status. For further information, write to the organization at P.O. Box 220, Royal Oak, MI 48068, or call (313) 543-0612. This completes my unpaid and unsolicited advertisement.