The difference between stock market investment and speculation

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The issue of successful stock market investment affects us all. Even if we are not directly engaged in the industry, all of us will need some form of pension to fund our retirement. Whether we like it or not most of our retirement funds will find their way into the financial markets. For this very reason, the issue of pensions has moved politically centre stage, in particular the investment strategies used to direct pension funds. Due to mismanagement over the last seven years, many retirement portfolios have become under-funded at best, or, at worst, totally bust. This situation is a direct result of the managed funds having been speculated rather than invested. Many cynics will say that the whole investment environment today has more of the characteristics of a casino than of a professional market of equities and, therefore, they doubt that one can ever achieve a faithful and fair return on capital. However, this view is erroneous as there is a distinct difference between speculation and investment. This essay sets out to explain some simple rules for successful long-term investment.

Benjamin Graham, the father of security analysis, and mentor of Warren Buffett, long believed in the stock market as a means to achieve financial freedom. The wealth he accumulated and the school of successful investment gurus he educated are testament to his insight and genius. The key to his formula has always been one simple concept: VALUE. His central message never changed and in a financial community which bores easily, his conservative investment style became "classical" and then "old fashioned". Graham ultimately derided the fads and trends that engulfed Wall Street and he eventually gave up trading and managing funds. However, his "baton" of value was spectacularly taken up by his acolyte, Warren Buffett, who went on to become the most successful investor of all time.

Buffett, like Graham, believes the policy of investing does not require high qualities of insight or forethought, as long as some simple rules are applied. In essence these simple rules are:

1. **Safety of Capital**

2. **Adequacy of Return**

An operation that does not seek both of the above is not an investment but a speculation.

Now in today's complex, volatile, media-driven and fast-moving market environment how does one actually apply these simple rules? The essential thing to realise is that when you buy an equity, you are purchasing part of a business. Investment is most intelligent when it is most business like. For my part, the best way to achieve this business-like goal is to focus on price, and through systematic analysis of this factor, the grail of value will be discovered.

At Wealthbuilder, for pension purposes, we educate clients in how to review up to three thousand stocks every quarter. Using a number of filters, equity prospects are identified and compiled into watch lists. Then, through the use of basic technical analysis, appropriate buy-in and sell-out points are pinpointed. The main criteria that are used to filter these stocks are:

1. **Dividend Yield**
2. **Financial Strength**
3. **Price/Earnings Ratio**
4. **Dividend Growth**
5. **Sales/Earnings Growth**
6. **Return On Capital**
7. **Business Model Strength & Sustainability**

Of these seven elements, dividend yield and dividend growth are the most important. Let me explain.

The big driver of investment returns over time is not figuring out which sector is going to do best, or which country will surpass the rest, or what investment style will be in vogue, or which consumer group will prevail. No, the biggest driver is: INVESTMENT INCOME RECEIVED AND RE-INVESTED. The facts are that with dividend yielding stocks, over a rolling five-year period, 40% of your return will be based on income. Over a twenty-five year period (the time frame of most pension portfolios) 60% of total return will be attributable to income and its re-investment. The reason being, that income buys more shares, and the additional shares buy you more income and so on, increasing your overall return through the power of compound mathematics.

If distributable income received is our key driver, then the objective of successful investment analysis is to find those higher yielding stocks. Higher yield comes from high dividends and high dividends are funded from earnings. We must seek out those superior, earnings-driven companies. However, this alone is not sufficient. Since we are dealing with pension funds that have correspondingly long time-frames, those earnings must also be sustainable and growing. The profile of such profit generating institutions can only come from companies in large markets with proven solid products, such as: financial services, consumer staples, healthcare, energy and insurance.

With regard to the power of sustainable growth over investment portfolios, some statistics may be helpful in understanding the essence of our focus and our strategy. Earnings growth in the 5-10% per annum range is ideal. If you increase your earnings and dividends at 5% a year, in 12-14 years you will have doubled the yield on your entire original investment. Moreover if your increase is 10% per annum, in just 7 years you will have doubled your return on the original capital. Studies have shown that the companies with the most consistently rising dividends, and the most quickly rising dividends outperform the market by far. In summary, the investment formula is as follows:

> **Financially Strong Businesses + Large Growing Sustainable Markets + Growing Earnings + High Dividend Yield + High Dividend Growth = Superior Value**

In terms of value one cannot really compare a company that fits into our high dividend yield model with a company that offers no return, other than potential capital gain. Unfortunately, the majority of equities traded on the financial markets fit into this latter category. These stocks, in the main, benefit only stock exchanges and brokers who obtain commissions and fees through trading activity. This is why we classify such stocks as "speculations" and not "investments".

Despite appearing to be a complex matter, the path to investment success is quite simple, as pointed out by Graham all those years ago. The financial achievements of his students: Warren Buffett, Charkie Munger, Ed Anderson, Bill Ryane, Rick Guerin and Stan Perlmeter, are testament to the enduring power of his investment philosophy. By applying this philosophy the average investor, using discipline and patience, has within his or her grasp the power to earn superior returns in the stock markets and thereby win for themselves and their families financial freedom and independence.