



Buying Stocks For The Long Run

Let's start today off with a little pop quiz. What if you were presented with two stocks: Company A which will likely grow earnings at 10% annually, and Company B which will grow at 3% annually – which would you choose?

Most investors might likely prefer A, the high growth company, over B, the low growth company. But here's the catch... a stock often trades at a value that has less to do with its fundamentals and more to do with investor expectations.

Where Company A might be well positioned to grow, investors may feel way more bullish about Company A's prospects that Company A might be able to deliver on. And that can cause more harm than good. So while Company A superbly executes and consistently delivers 10% growth, investors may have expected say 15% growth – and will punish Company A's shares when results show a "mere" 10% increase.

On the other hand, investor expectations for Company B may be at 1% annual growth and its stock could well get a boost when it delivers 3% growth.

Crazy... but such expectations-based stock performance is rather common in the stock market. In fact, I remember my early days following stocks and being surprised when great stocks would get hammered even when they delivered fundamentally sound results... I'd be genuinely confounded but I soon caught on... and it's this learning that I want to share with you... that it's not enough to know how much a Company expects to grow its earnings, it's equally important to also know what investor *expectations* are for that company.

And this knowledge, my friends, also creates buying and selling opportunities. So if your fundamental analysis shows a certain stock value based on say 10% growth for Company A – you'd know when to sell if the stock rises above its fundamentals based on over-optimistic expectations, and when to buy when a solid performer gets unfairly beaten down.

So, in a nutshell, and to quote Jeremy Siegel – a respected economist, "the long-term return on a stock depends not on the actual growth of its earnings, but on the difference between its actual earnings growth and the growth that investors expected." So much for efficient market theories that say a stock price is based on its fundamentals!

In fact, in his recent book – The Future For Investors – Siegel shares his research which shows that the top-performing firms in the S&P500 Index... grew earnings at a greater pace than expected... and that virtually all of these star performers paid out consistent and rising dividends which underscored their sound financials in investors' minds.

Siegel tells us that the top S&P500 performer was cigarette-maker Philip Morris, which delivered an average annual stock return of 19.5% since 1957 – incredible! – and paid out an average 4% dividend. Siegel attributes Philip Morris's performance to low investor *expectations* because of ongoing investor lawsuits and smoking bans – and these low expectations provided the perfect environment for outperformance.

So, as you go looking for stock superstars for your portfolio, I'd advise you to look for companies with the following characteristics:

- has a consistent history of beating Earnings Per Share estimates (most analysts put out EPS estimates ahead of earnings calls so it's easy to see if a company beats estimates or not)
- grows earnings at least 5% annually, so it's at least ahead of inflation
- pays dividends consistently and increases this payout at some rate consistent with its earnings growth
- has low debt so it does not run the risk of cutting dividends to service debt, or the risk of bankruptcy in an extreme case
- and choose a company that has built a moat around itself. This means make sure it is difficult for other companies to get into the business. You want a company that can fight off the competition and keeps its financial structure intact.

So the next time you're screening for shares to buy for the long run, weigh investor expectations into your analysis... and if you need a refresher, you can always find this commentary on my blog or in the archives at www.onthemoneyradio.org

Good luck!