Beating the Street Study Guide

Beating the Street by Peter Lynch (director)

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Plot Summary

Peter Lynch, manager of Fidelity Investment's incredibly successful Magellan Fund from 1977 to 1990, writes this book to provide investors with insight into his investment methodologies and tactics. He begins with a tale about a group of 7th graders who make mock investments as part of their class. The children are instructed to invest in companies they own and to research their choices to explain to their classmates why they made them. The 7th graders do extremely well, beating the S & P 500 index significantly. Their story demonstrates that even a child can invest successfully if they choose companies they are familiar with and do their research. Knowing one's investments is the main theme of the book.

Next, for those who might be timid about investing in stocks, Lynch explains why stocks are a better investment than bonds or certificates of deposit. While a conservative investor may prefer a bond that provides a guaranteed return on investment, at the conclusion of the bond period, the investor is returned the exact amount initially deposited. When inflation is accounted for, the investor has less money than when he started. On the other hand, a stock with a dividend will pay a return while it is owned, and will almost certainly increase substantially in value over a lengthy period, like ten years.

The next few chapters chronicle Lynch's years managing Magellan. He explains why he chose certain stocks and how they performed. When he begins, Magellan is a small, closed fund of about $100 million that is not doing particularly well. Through investments during the early 80s in companies like Chrysler, Ford, GM, Philip Morris, Volvo, General Electric and Fannie Mae, Magellan grows into a huge fund. By 1987, Magellan is up to $10 billion.

The second half of the book details how Lynch researched and chose the 21 stocks he recommended for the 1992 *Barron's Magazine* Roundtable stock guide. The first and most natural place, to look for stocks is the retail sector. The average person likely eats out often and shops regularly. These mundane activities can actually lead to good stock picks if the shopper pays attention to new and potentially successful stores and chains. If the investor can get in on a business as it is in its prime growth phase, which ordinarily lasts several years, the retailer can be very profitable.

Next, Lynch demonstrates that investing in depressed industries or situations can be very profitable. An area where other investors are scared away because of gloomy news is often the best place to find undervalued stocks. The depressed real estate market of the early 1990s was a perfect example. By digging deeper into the seeming problem, he found that there was no problem at all. There are always some good companies to be found in lousy markets. Lynch advises looking for thrifty, no-frills companies that pay close attention to the bottom line and that treat their employees well. A well run company in a lousy industry may have the added advantage of being able to buy up some of its failing competitors. Savings & Loans had a terrible reputation in the late 1980s and early 1990s. There were, however, some good S & Ls to be found amongst the industry's devastation.

Cyclical stocks are another favorite of Lynch. Cyclicals are industries with a somewhat predictable pattern of boom to recession and then back again. Lynch analyzes how to watch and track a cyclical and what sort of research will result in successful cyclical investment.

Lynch analyzes his history with Fannie Mae, his number one stock over his tenure at Magellan. Fannie Mae started as an unnoticed stock selling for almost nothing. Lynch watched them grow and mature into a giant. They perfected the "mortgaged-backed securities" market and became extremely profitable buying and repackaging mortgages.

Lynch concludes the book by re-examining the performance of his recommendations at the six month mark. Always re-evaluating investments is necessary to successful investment. By researching a company's future prospects and plans, one can make an informed decision on whether to maintain the investment, invest more, or sell. Oftentimes, additional research into one's investments can produce new companies in which to invest.

Chapter 1

Chapter 1 Summary and Analysis

Peter Lynch, manager of Fidelity Investment's incredibly successful Magellan Fund from 1977 to 1990, writes this book to provide investors with insight into his investment strategies. Lynch believes amateur stock pickers can outperform mutual funds.

He begins with a tale about a group of 7th graders who make mock investments as part of their class. The children are instructed to invest in companies they own and to research their choices to explain to their classmates why they made them. The 7th graders do extremely well, beating the S & P 500 index significantly. Their story demonstrates that even a child can invest successfully if they choose companies they are familiar with and do their research. The kids compiled a list of potential stocks, and then researched each one thoroughly, checking earnings and relative strength. Before any kid could put a stock in their portfolio, they had to understand the company's business. Thorough knowledge of your investment is a central theme of the project. The kids bought stock in such companies as Wal-Mart, Pepsi, Disney, Kellogg, Jiffy Lube, IBM and a few toy stores and manufacturers.

The kids produced a 70 percent gain over a two year period. They outperformed the S & P and outperformed 99 percent of all mutual funds. Lynch suggests this basic axiom: "never invest in any idea you can't illustrate with a crayon." The point being that investors should have an understanding of what they are investing in.

Through their stock market exercise, the kids learned several valuable lessons. For example: the stock market fluctuates regularly, so an investor has to be willing to be in the market for the long term. Investors should seek companies with room to grow. Try to make investments in industries you know something about. Pay attention to consumer trends. Good companies increase their dividends every year. Losing money in the market can be done quite quickly, but making money requires patience. The stock market isn't really a gamble if one picks good companies for investment. Always research a company before making an investment. Always be sure to diversify. Out of every five stocks you buy, one will do better than expected, one will do worse than expected and three will perform okay. Always have an open mind about your stocks—never fall in love with a stock. Just because a stock goes down does not mean it cannot go lower. As long term investments, small companies are better than large companies.

Lynch makes more basic recommendations for amateur stock pickers that he attributes to the National Association of Investors Corporation: a portfolio should contain at least five stocks; an investor should never hold more stocks than they have time to adequately follow; always make regular investments; be sure sales and earnings advance at a rate that makes purchasing the stock a good value; consider the company's financial strength to evaluate whether a few bad years would prevent long term growth; understand the reasons for past sales growth to determine the chances of future growth.

Chapter 2

Chapter 2 Summary and Analysis

The successful investor cannot be afraid of the minor fluctuations and corrections of the stock market. Investors must resist the natural human urge to cut and run at the first sign of trouble.

The Barron's Roundtable, an annual meeting of the best and brightest investors, is used to demonstrate that even the experts get too caught up in letting the news of the day influence their stock purchasing and selling thoughts. Each year, during the late 1980s, after the crash of 1987, the group found pessimistic news to dissuade them from buying stocks. 1990 and 1991 were predicted to be especially gloomy years. In fact, the doom and gloom and slightly depressed market created a perfect opportunity to buy.

The best way to avoid being scared out of stocks is to buy them on a regular basis, month in and month out. Looking to the "Even Bigger Picture" as opposed to the "Big Picture" helps the investor through tough times. Take solace in the fact that over the last 70 years, stocks have gained an average of 11% per year. Treasury bills, bonds, and CDs have returned less than half that amount.

Despite all of the bad news during the past century, stocks continue to do well. In the past 70 years, there have been 40 declines of 10% or more. Thirteen of them were for more than 33%. Fear of the Big Crash, the crash of 1929, has kept many people from investing in the stock market—even 70 years later. In all but one of the 40 significant declines in stock market history, the market rebounded. Declines in stocks are recurring and inevitable. With patience, one can see them through.

Chapter 3

Chapter 3 Summary and Analysis

Mutual funds are intended to take the confusion out of investing. You invest your money in the fund and do not have to worry about picking stocks or following the market. Mutual funds are so popular today that there are more mutual funds available than there are stocks on the New York and American stock exchanges combined.

Many investors make their investment decisions based on the amount of income a given type of investment will generate. They ignore growth potential. They often invest in bond or money market mutual funds because of the steady interest income they provide. Investors often ignore the income potential of stock dividends and the investment growth factor stocks provide. In other words, if you buy a bond, you will receive steady interest over the term of the investment, but, in the end, you receive your original investment back. This amount, when reduced by inflation, has declined in value. Stocks, on the other hand, produce dividend income and generally increase in value over a long period of time. Stocks' value will likely increase at the end of a term of investment.

Fear of a huge loss in the market keeps many people from investing in stocks. Even if an investor lost 25% of his investment to a market correction the day after a stock was purchased, 20 years later, that investment would be worth double the same amount invested in a bond.

Lynch recommends investing in stock funds. Stock funds take much of the guesswork out of investing in the stock market, while providing the same benefits and returns. There are many different types of stock funds available. Stock funds will invest in certain industries or companies depending on their type. Lynch explains each different type of stock fund in detail.

Chapter 4

Chapter 4 Summary and Analysis

Lynch took over Magellan in 1977. His first year was spent selling his predecessor's favorites and buying his own. These included Congoleum, Transamerica, Union Oil, Aetna Life and Casualty, Hanes, and Taco Bell. The variety of different companies reflects that Lynch did not have an overall strategy to investing. He was always looking for undervalued companies, no matter the industry. Lynch liked growing fast food chains because if they could be successful in one region, they would be successful nationwide.

Lynch made a point of getting to know every industry he could. One of the most valuable lessons he learned was the importance of doing his own research. Lynch made it a habit to meet with at least one industry representative from every sector once a month for a general update. This provided an opportunity to spot potential trouble early. Another trick he learned was to end every conversation by asking a company representative which of his competitors he admired most. This often led him to buy stock in the competitor's company.

Lynch's favorite stocks in the early years were the "secondary" stocks-small or mid-sized companies including retailers and banks. Regional banks were often undervalued, but earning consistently. At the end of the 1970s, fund managers and other experts advised that secondary stocks had run their course. They advised investing in the blue chips. Lynch is glad he did not take their advice. During his first three years as fund manager, Lynch consistently beat the S & P average.

Chapter 5

Chapter 5 Summary and Analysis

Lynch believes that focusing on the companies is more important than focusing on the stocks. Lynch used the methods of an investigative reporter: reading public documents for clues, talking with analysts and investor relations people for more clues, and then going to the companies themselves. After each contact, he would make a note in a loose-leaf binder with the name of the company, the current stock price, and a one or two line summary of the story he had just heard.

As Magellan grew, Lynch used assistants to call companies and analysts to keep up on developments. Lynch found that when people are given more responsibility, they usually live up to it. This was a revolutionary concept in the industry. Traditionally, fund managers choose stocks based on their analysts' research. Unfortunately, this allows managers to blame the analyst for a poor performing stock. If an analyst knows his or her job may be on the line if they give bad advice, they will no longer stick their neck out. Instead of making an imaginative recommendation, they will tout acceptable companies like IBM. Fund managers at Fidelity did independent research and were held accountable for the results. Analysts did parallel research and passed it along to the fund managers who could take it or leave it.

During the early 1980s, Lynch became more impressed with the long-range potential of restaurant chains and retailers. As they expanded across the country, they could grow at a rate of 20% for 10 to 15 years. He believed that restaurants and retailers could greatly outperform cyclicals and undervalued stocks. He preferred them to high tech companies for one simple reason: a tech company can lose half of its value overnight if a competitor comes out with a better product. If a burger joint's new competitor makes a better burger, it may be years before burger joint #1 sees any effect.

Lynch was not reckless in his investment in retailers and restaurants. He invested only if the company had a strong balance sheet. Other fund managers avoided these stocks because they were perceived to be too risky. Lynch was given wide latitude with Magellan. No one was looking over his shoulder and judging each pick he made. Other fund managers do not have that luxury. The end result is what matters.

During the early 1980s, the automobile industry was in shambles. Lynch thought to himself that people have to drive and they have to buy cars. He figured the auto industry would rebound. This led him to Chrysler, which most commentators believed to be on the verge of bankruptcy. Lynch saw something different. He saw a company with $1 billion in cash and an impressive new lineup of cars. By the end of that year, the Chrysler Minivan had become an incredible hit. The stock soared.

Chapter 6

Chapter 6 Summary and Analysis

The amount of time needed to research your portfolio depends on how many you own. A few hours a year must be dedicated to reading annual and quarterly reports and calling companies for periodic updates. One person with five stocks can do this as a hobby. The fund manager of a medium sized fund can do it as a 9-5 job. In a larger fund, a 60-80 hour work week is required. By mid-1983, Magellan had 450 stocks. Before the end of the year, the fund doubled to 900. Magellan was criticized for being too big-by owning that many stocks, they couldn't beat the market, they were the market.

When Magellan had 900 stocks, 700 of them accounted for less than 10% of the fund's total assets. The smaller stocks accounted for a tiny portion of the fund for two reasons: 1) the companies were small, so even if Magellan owned the maximum allowable, it wouldn't amount to much; 2) Lynch was not convinced they deserved substantial commitment. Sometimes Magellan owned small stocks just to keep better watch on them for future purchases.

Occasionally, a very small holding could lead to a big opportunity. Lynch cites the example of a small jewelry supplier. He attended a company presentation and learned that they were doing well because discount clubs like Costco were making large orders. This information convinced Lynch to research the discount clubs, because if they were selling jewelry that fast, their overall sales must be booming. He discovered that business was booming. Earnings were on the upswing, but stock prices were still on the downswing. It was a perfect opportunity to buy. Employees and shoppers of these stores would have been the first to notice the increase in sales. Lynch suggests that an alert shopper can easily spot a booming business before Wall Street.

Many fund managers get themselves in trouble by avoiding stocks they perceive as thinly traded and lacking in liquidity. This shuts them out of most of the market. Lynch sees opportunity in thinly traded stocks. He doesn't necessarily want to be able to get out quickly. He prefers to pick wisely and hold onto stocks for awhile.

Lynch was among the very first large fund managers to invest heavily in foreign stocks. Europe actually has a higher percentage of large companies than the U.S. The drawback was that European companies were not held to the same stringent SEC reporting standards as U.S. companies and could be mysterious and harder to analyze. He researched European companies the same way he researched American companies-by paying them a personal visit.

An investor should always re-examine stocks already held: "The best stock to buy may be the one you already own." Fannie Mae was an excellent example. During the first half of 1985, Fannie Mae was a minor Magellan holding. After some re-checking the numbers and finding they had dramatically improved, Fannie Mae was elevated to 2.1% of the fund.

By 1987, Lynch decided it was time to make a major tactical shift. It would be his first in five years. Since the economy had largely recovered, he decided that most of the people who would buy new cars had already done so. He also noted that the analysts who follow the auto industry were making earnings projections that he did not feel were possible. He decided to reduce his automobile holdings and increase S & L holdings, especially Fannie Mae.

Lynch was tiring of the enormous amount of work necessary to maintain the fund. He considered quitting, but then came the Great Correction. He feels he should have seen it coming: the market was wildly overvalued and primed for a 1000 point decline. Magellan went from being up 39% for the year prior to the Great Correction to being down 11% for the year in December. He tried to prepare the Magellan shareholders for what was about to come after the Correction. By the end of the year, Magellan had gained 1% for 1987 and the rebound had beaten the market. Unfortunately, there was enough selling that he had to liquidate a portion of the fund. He would have much rather been a buyer than a seller immediately after the Correction.

Some of his best performers in the immediate rebound were the autos. Chrysler and Ford rebounded very well on the short term, but very poorly in the long term. By 1990, Chrysler was selling for $10 and Ford for $20. During this slide, Lynch noticed that many analysts were touting Chrysler. His best yearly earnings estimates tended to be about half of what the analysts predicted. This was not a good sign. Chrysler holdings were sold.

With Chrysler stock sold, investments were made in growth stocks like Philip Morris, RJR Nabisco, Eastman Kodak, Merck, General Electric, and Atlantic Richfield. The two years after the Correction were very good years. Lynch outperformed the average fund for all 13 years he led Magellan.

Chapter 7

Chapter 7 Summary and Analysis

Lynch feels strongly that stock picking is part art and part science. Relying too much on either aspect, however, can be dangerous. Lynch has used the same stock picking method for 20 years. His method involves elements of both art and science with a healthy dose of legwork. He does not rely on computer programs or services. He figures that for every ten companies he researches, he will find one worth buying.

Lynch prefers a recession to an overpriced market. In an overpriced market, good value stocks are extremely hard to find. In a recession market, bargains are everywhere. He is happier to see the market lose 300 points than gain 300 points.

The investor who buys sells stocks frequently is asking for trouble. That investor would do much better to know their stocks. The investor who knows an industry and knows how a particular stock will respond to a market fluctuation has a distinct advantage. The investor, who knows how a stock will respond, may see a drop in price as a reason to buy more instead of sell.

Human nature often causes investors to never reconsider a stock they once owned. A stock they previously owned might bring back terrible memories. Lynch was forced to overcome this problem because of Magellan's size. If he didn't buy stocks that he had owned previously, there would be nothing for him to buy. Re-analyze stocks from time to time to see if the company's condition has changed.

Chapter 8

Chapter 8 Summary and Analysis

A large regional mall can be the best place to do stock research. Many of the biggest gainers of all time are retailers: Home Depot, the Limited, Gap, and Wal-Mart are just a few. When it comes to retailers, if you like the store, you will probably love the stock even more.

Lynch attributes the success of retailers to the fact that taste in both food and fashion is universal. Typically the foods that are popular in one town or region will do well in other towns or regions. Likewise, clothes and fashion that are popular in one region often become popular nationwide.

Employees at malls can recognize very quickly which stores are doing well. If you don't happen to have such an insider connection, perhaps you can get some good tips from a friend or family member who visits the mall regularly. If a teenage girl you know buys her clothes at the Gap, there's a very good chance that thousands of other teenagers are shopping at the same place.

Potential investors in retail stocks have a very large window of opportunity in which to invest. There is plenty of time to track them in their initial stages of growth and then decide whether to buy. Wal-Mart provides a nice example: in its first four years, the stock price quadrupled. During the next five years, though, the price was up 20 times the original offering. The investor who sat out the first five years of Wal-Mart still made huge profits on the stock. An investor who sat out the first ten years, and then bought the stock and held it from 1980 to 1990, would have made 30 times his investment. The key item for analysis is whether the company has saturated its market. Expansion, more than anything else, determines earnings potential and stock prices in retail companies.

Chapter 9

Chapter 9 Summary and Analysis

Investors are often rewarded by looking to industries other investors fear. In 1992, for example, there was no more feared an industry than residential real estate. Investors feared that the collapse in the commercial real estate market would spread to residential real estate.

Lynch noticed that despite analysts' concerns, the median house price steadily rose from 1989 through 1991. Since the statistic was tracked in 1968, the median home price had gone up every single year. Lynch calls this a "quiet fact." Other quiet facts for the housing market are the "affordability index" and the percentage of mortgage loans in default. Even though these facts pointed in a positive direction, companies even remotely related to the home building and home finance industries were way down.

Anticipating a boom in the housing market, Lynch looked for housing-related companies that might benefit. He thought about Pier 1, the home furnishings retailer. If people were going to buy new houses, they would have to furnish them. Pier 1 had traditionally been a solid earner, but was hit hard in the Great Correction and then again in the "Saddam Sell-off." In the fall of 1991, Pier 1 had shown a profit in a difficult year; they were expanding; they had not yet saturated the market; and the company had managed to reduce expenses. He saw Pier 1 as a fast growing company with room to grow that was improving its profit margins and had raised its dividend five years in a row.

Oftentimes researching one company leads Lynch to another. That was the case here. If Pier 1 was going to see an increase in business due to home sales, then Sunbelt Nursery, one of their subsidiaries, just might see the same increase. A home buyer would be just as likely to refurbish the grounds of the house as they would be to renovate the interior. The nursery business was one of the last mom and pop retail businesses in the country without nationwide chain competition. Perhaps Sunbelt could become a national chain. To assess the value of Sunbelt, Lynch looked to their competitor, Calloway's. He valued the companies based on income per store unit and determined Sunbelt was undervalued.

The Sunbelt Nursery and Calloway's research led Lynch to General Host. At one time, General Host was a large conglomerate that owned a variety of businesses from Hot Sam's Pretzels to Hickory Farms stores to Van De Kamp's frozen fish to American Salt and Frank's Nursery and Crafts. General Host had spun off everything but its 280 Frank's Nursery and Crafts stores. Lynch was impressed by the fact that General Host initiated a plan to buy back some of its own shares. If the owners thought enough to buy back their own shares at $10, they must be worth more than that. Lynch was impressed that General Host's shares had fallen below the $10 price that General Host had paid for them. An investor should always look closely when given the opportunity to buy shares for less than what a company paid for them. By thoroughly researching General

Host, Lynch determined that their book value exceeded the current sales price. He found that General Host had ambitious plans for the future including new computer systems and expansion. He determined General Host was seriously undervalued and a good purchase.

Chapter 10

Chapter 10 Summary and Analysis

Towards the end of 1991, Lynch received a Supercuts prospectus and decided to visit a store for a haircut. He noted the prices were about the same as his regular barber, though much less than the salons his wife and daughters frequented. The company had just gone public a month or two earlier. There were 650 franchise stores established and management was embarking on an extensive expansion campaign. The theory behind the business was that the hair care industry was a $15-40 billion industry dominated by independent barbers and salons. Barbers, however, were a dying breed. This seemed a perfect opportunity for a well-managed national franchise do to very well.

Lynch liked the fact that the only expenditures for the company, besides rent, were scissors and combs. As a franchise operation, the corporation didn't have to invest its own money in expansion. The biggest plus of all, though, were the 250 million Americans who need a haircut every month, combined with the fact that there was no dominant chain store to cut that hair.

Chapter 11

Chapter 11 Summary and Analysis

Lynch is quite fond of solid companies in poor industries. It is much more difficult to find an undervalued stock in an industry that is popular and successful. In a lousy industry, weak companies fail and strong ones earn an even bigger share of the market. A growing company in a stagnant market is much better off than one that has to struggle to keep up in a fast-paced market.

Good companies in poor industries share certain characteristics. They operate at low cost. Their owners are often characterized as "cheap" or "penny-pinchers." They avoid debt. They reject the traditional corporate structure of overpaid fat-cat executives who ignore the concerns and opinions of labor. Workers are well paid and often own a piece of the business. They seek out markets that larger companies have overlooked. They tend to grow very quickly.

Sun TV, a small, discount retail television and electronics business based in Columbus, OH, is a perfect example of such a company. Sun was the only discount, high-volume electronics store in central Ohio. It was a 25-30% growing business with a P/E ratio of 15. They made money selling TVs during a recession, when no one else could.

Southwest Airlines might be the best example of a great company in a lousy industry. In the 1980s, its competitors were going bankrupt. Southwest's stock multiplied in value ten times. They were successful for filling niche market-low-cost regional flights. Their executive offices were as no-frills as their peanuts-only in-flight meals. They were the lowest-cost operator in the business. As their competitors went out of business, Southwest snapped up their routes.

Bandag, a specialist in re-treading truck and bus tires, based in Muscatine, Iowa, was another company in this category. In fifteen years, their stock jumped from $2 to $60. The CEO was extremely frugal and had managed to obtain a large percentage of the re-tread business. The key to success in this business was obtaining a very large portion of a very unique market.

Cooper Tire is similar to Bandag. In an industry where giants Goodyear, Michelin, and Bridgestone fought for the new car market, Cooper was content to sell replacement tires. Cooper's earnings rose every year from 1985 through 1991.

Green Tree Financial filled a special niche as well. They sold loans on mobile homes. From 1985 through 1990, the mobile home business steadily declined. The industry's disaster meant more and more business for Green Tree as its competitors disappeared. By 1990, they were basically the only company in the industry and began expanding into other loan markets.

Dillard department stores were noted for the frugal management of the Dillard family. They constantly combed the books for new ways to save money. They carried very little debt. By sticking to smaller towns and cities, but incorporating modern computer inventory controls, Dillard did very well.

Crown Cork & Seal was a no-frills enterprise that was the world's most successful can maker. Crown turned a great profit in a lousy industry by producing at extremely low expenses. In 1991, its stock price climbed from $54 to $92.

Nucor was a steel company. This was certainly a lousy business during the 1980s and 1990s. Nucor, however, saw its stock rise sharply from $6/share in 1981 to $75 in 1992. The CEO operated a no-frills operation. Their market was a niche market-turning scrap metal into construction-grade steel. If the economy slowed, the entire company worked a shorter week instead of instituting a layoff so the suffering would be shared by everyone.

Shaw Industries was yet another bright star in a terrible market. Their field was carpets. During the 1960s and 1970s, carpet was incredibly popular. By 1982, wood flooring regained popularity and carpet was unfashionable. Half of the top manufacturers of carpet were out of business by 1985. Shaw, however, thrived as a low-cost manufacturer during these hard times. As its competitors went out of business, Shaw picked up more and more business. Shaw did everything it could to lower costs and improve their operation. Shaw maintained a 20% annual growth rate. Its stock rose 50-fold between 1980 and 1992.

Chapter 12

Chapter 12 Summary and Analysis

In the early 1990s, Savings & Loans had a terrible reputation. After hundreds went bankrupt, the federal government was forced into a $500 billion bailout. In that environment, investors did not want to go near an S & L. Many S & Ls, however, were doing just fine and were excellent candidates for investment. Lynch provides a framework to analyze an S & L. He divides them into three categories: the "bad guys" that perpetuated fraud, the "greedy guys" that ruin a good thing, and the thrifty "Jimmy Stewart" types.

The "bad guys" tended to run them into the ground in the same ways. For example: several investors get together and collectively invest $1 million. This is their equity. They take in $19 million in deposits and then make $20 million in new loans. In order to raise the $19 million in deposits, they paid sky-high interest rates. Those deposits were guaranteed by the FSLIC. The $20 million in proceeds from the CDs was lent to their friends and relatives for construction projects of dubious merit. A building boom was created in many places that did not need it. The S & Ls looked healthy because of the up-front fees they skimmed from the loans. For every dollar the equity increased, they made another $20 worth of loans. As the loans and equity grew, they gave kickbacks to accountants and auditors and payments to representatives and senators.

The "greedy guys" saw their competitors, the bad guys, getting rich on fees from commercial loans. The greedy guys, who had been plodding along with residential mortgages, seek the advice of an expert on maximizing profits. The expert tells them to get into commercial lending. They take the advice and get in over their heads. An S & L that may have taken 50 years to build up could be destroyed in only five.

The "Jimmy Stewart" category of S & L is Lynch's favorite. They turned a respectable profit each year. They were no-frills, low-cost operators who were content to work locally and stick with residential housing loans. They were commonly found in small cities and towns across the country as well as urban areas neglected by commercial banks. Thrifty, well-run S & Ls operate on a very narrow spread. They can make a profit without making a loan at all by paying its depositors 4% and investing that money in Treasury bonds at 6%. On the other hand, when an S & L makes a few loans at 8-9%, it becomes a very profitable business.

Lynch offers a list of factors to consider when evaluating an S & L. He recommends comparing the current price to its initial offering price. If it is selling below its initial offering price, it may be undervalued. The Equity-to-Assets ratio measures the financial strength of an S & L—the higher the ratio the better. Dividends are an added bonus. Their book value is important. If an S & L has made high risk loans, the book value may not be accurate. The P/E ratio should be low. If high risk construction and commercial loans exceed 5-10% of the S & L's portfolio, there could be a problem. 90-day Non-performing Assets (loans that have defaulted) should be less than 2% of total assets.

There is another reason that S & Ls can make very good investments: an S & L with excess equity, excess lending capacity and a loyal depositor base is coveted by commercial banks and a prime target for a buy-out.

Chapter 13

Chapter 13 Summary and Analysis

A casual stock picker could pick five conservative S & Ls, invest an equal amount in each, and wait for the profits to roll in. One would likely do better than expected. Three of them would make an average return. One would do worse than expected. The overall result should be better than a traditional investment in Coca-Cola or Merck.

Lynch would try to improve his odds through in-depth research. He spoke with the CEO of Glacier Bancorp. It was a 12-15% earner selling at 10 times earnings. Nonperforming loans were almost non-existent. The dividend rose for the 15th straight year. It had just acquired two other S & Ls. Strong S & Ls grow quickly by acquiring troubled and defunct S & Ls. Glacier held a relatively high percentage of commercial loans, but these loans for multifamily housing, not vacant office buildings or condos.

Lynch phoned the CEO of Germantown Savings, an S & L located in suburban Philadelphia. Their stock price raised $4 the previous year. They had a P/E of less than 7 and a book value of $26. Only 1% of their loans were nonperforming and they had $1.4 billion in assets. Germantown increased its holdings in Treasury bills, bonds, stocks and cash the prior year. When an S & L worries about the economy or the credit of its borrowers, it puts its assets into investment securities instead of lending them. When the S & L feels the economy has improved, it will sell these assets and make more loans, thus making more earnings.

Sovereign Bancorp served a wealthy clientele in southeastern Pennsylvania. Their balance sheet looked very good. Sovereign had recently acquired two New Jersey S & Ls. This instantly increased their deposits and would soon increase their earnings. The CEO was determined to grow the business at least 12% per year. The only drawback was that the company had sold 2.5 million additional shares the previous year. It is normally a very good sign when a company buys back its shares. Selling more shares is not normally a good sign, because it devalues existing shares. Sovereign used the money to purchase another S & L. Sovereign also seemed attractive because they sold most of their loans to Fannie Mae or Freddie Mac instead of holding them. This allowed them to reinvest their money into new mortgages and profit from points and upfront fees. The risk of owning the mortgages was transferred to others. Sovereign was very conservative in its loan practices.

People's Savings in New Britain, CT was a solid performer in a depressed market. People's became stronger as its competitors failed. Despite strong economic indicators on their balance sheet, their stock was up less than one dollar after five years. The reason for this was the sad state of the economy in Connecticut. An S & L that does well in a depressed market is a better buy than one that has ridden the coat tails of a strong economy.

First Essex was a long shot that Lynch thought worth the risk. They had some frightening numbers on their balance sheet. They lost $11 million in 1989 and $28 million in 1990. They made some questionable condo investments. They were cash poor, but owned many properties through foreclosure. Despite these negative facts, they had a strong book value and a strong equity-to-assets ratio. If the commercial real estate market rebounds, the foreclosures would stop and the S & L would recoup its losses. The stock price could rise significantly. The problem was that it was impossible to tell when or if the commercial market would rebound.

Lawrence Savings was similar to First Essex. It suffered from the depressed economy of its location in rural New England. Despite losing money to bad commercial loans, Lawrence had a strong equity-to-assets ratio. Lawrence was riskier than First Essex. Lawrence had a higher percentage of commercial real estate loans while maintaining less equity than First Essex. Since Lawrence was only selling for $1, Lynch thought it was a good play.

Lynch advises opening an account at a privately held S & L. S & Ls are owned by their depositors. The net worth belongs to everyone who has a savings or checking account. Until the S & L goes public, this means absolutely nothing. When the S & L goes public, depositors and directors are given the opportunity to buy at the IPO. In 1991, of 16 S & Ls that went public, the worst performer increased 40% in value. The best quadrupled.

Chapter 14

Chapter 14 Summary and Analysis

Another class of company ignored by Wall Street was the master limited partnership or "MLP." The term limited partnership, in 1991, brought back memories of terrible tax-shelter partnerships that went bust. Another reason they were ignored was that an MLP forced the shareholder to do extra tax paperwork. The biggest difference between an MLP and a normal corporation is that the MLP distributes all of its earnings to the shareholders in the form of a very high dividend. A substantial drawback was that most all MLPs were forced to close out in 1997-1998 because of tax laws.

EQK Green Acres owned a shopping mall on Long Island. Lynch recommended this company in 1991. Management owned many shares and the dividend rose every quarter since it went public. Future earnings would be good as well, because rent would increase substantially a year down the road. He was worried about heavy borrowing, a high P/E ratio and the vulnerability of a mall to recession. The return on the stock for 1991 was 20%. That the company would not raise its dividend in the impending quarter was cause for concern. Another concern was that the company announced ongoing negotiations with two new major tenants rather than announcing signed contracts. He decided to wait until the contracts were signed to recommend Green Acres.

Cedar Fair was another MLP that Lynch recommended the prior year. Its price climbed significantly. It owned and operated two amusement parks in the Midwest. Lynch believed that an amusement park might actually do better during a recession. During a recession, more people might want to stay close to home and visit a nearby amusement park than fly around the world. Lynch asked himself whether 1992 would be a better year than 1991. He recommends that investors ask themselves this question with every stock. If the stock does not have a good outlook, the next question needs to be "why do I own it?" In 1991, Cedar Fair had a new roller coaster that attracted business. There was nothing new for 1992. He passed on Cedar Fair.

Sun Distributors sold auto glass and other parts to auto repair shops. Wall Street paid no attention to Sun. The price of Sun's Class B shares had fallen from $4 to $2 during 1991. Lynch asked himself whether Sun deserved the price drop or whether it was an annual tax-loss sale. Sun still had earnings. It made money every year, in spite of the fact that the glass and automotive electrical parts business was terrible at the time. Sun seemed to be a low cost operator. Sun's business required little capital spending. More important than earnings and cash flow was the fact that Sun had acquired 36 related businesses in the previous 5 years. Sun would do just fine, even in a bad economy.

Tenera Limited Partners was involved in software and consulting. They were in serious trouble financially because of a dispute with the feds, their major contractor. The feds had cancelled some contracts. The company cut its work force drastically. In June 1991, the dividend was cancelled. Despite all of this bad news, Lynch liked Tenera because it had no debt and no large expenses to pay. Its well-regarded nuclear services division could always be sold at a profit in case of liquidation. If the company solved some of its problems, it might make a huge rebound, otherwise, it would almost certainly make a small rebound. He recommended Tenera when he learned that a new exec had been brought in to oversee the recovery and that the insiders were holding onto their stock.

Chapter 15

Chapter 15 Summary and Analysis

In a poor economy, fund managers often turn to cyclicals. Cyclicals are companies which typically follow a pattern of boom to recession and then back again. Common cyclical industries are: aluminum, steel, paper, automobiles, chemicals and airlines. Wall Street seemed to be anticipating the return of cyclicals earlier and earlier, making it that much more difficult to successfully invest in them. While a low P/E ratio is regarded as good with most stocks, such is not the case with cyclicals. When they are very low, a cyclical is usually at the end of a favorable period. Inexperienced investors will stick with the company because business is good and earnings are high. This, however, will soon change. Smart investors will sell. The price of the stock falls quickly once the selling begins. Never buy a cyclical after several years of record earnings and when the P/E ratio is at a low point. High P/E ratios, normally bad for a stock, are good for a cyclical. A high P/E ratio indicates that a company has likely passed through the worst. Business should improve and the price of the stock should go up.

Investing in cyclicals is difficult because of the anticipation required. The investor should have knowledge about the particular cyclical industry chosen. For example: a plumber who knows something about the price of copper likely has more insight than an analyst with an M.B.A. buys because it "looks cheap."

In January of 1992, Lynch was too late to capitalize on the home builder's stocks but had another idea about a related market: copper. The analysts had not yet anticipated the rebound in the copper market. Lynch's plumber confirmed that the price of copper was going up. Lynch recommended Phelps Dodge 1991 but it did nothing. Sometimes the best thing to do with a stock that does nothing is to buy more. Environmental regulations had forced the closing of many smelters. Phelps Dodge had plenty of smelters and fewer competitors. Lynch theorized that the new Soviet republics would have a great need for copper wire for telephone lines. Phelps Dodge had a strong balance sheet. Its subsidiaries were performing very well. Even a relatively small increase in the price of copper would translate into a huge increase in the value of the stock.

Automobile manufacturers are a classic example of a cyclical. By 1991, auto stocks were down 50% from their recent highs. Sooner or later, Lynch thought, cars would need replacing. One interesting and useful indicator of when to buy auto stocks is the price of used cars. If used car prices are low, car dealers are having trouble selling them and the new car dealers are having even more trouble. When used car prices rise, new car sales should rise soon, too.

An even better indicator of the new car market is called "units of pent-up demand." This statistic estimates how many cars and trucks should have been sold based upon demographics, sales in previous years, ages of cars on the road and other consideration. The difference between the number of cars actually sold and the estimate of how many should have been sold is "units of pent-up demand." Between 1980 and 1983, 7 million people who should have purchased new cars did not. A boom in sales was forthcoming. Once four or five years go under the trend, it is time to expect an upsurge. Four or five years of brisk sales will pass before things even out. By 1990, a modest amount of pent-up demand had built up. By the end of 1993, Lynch foresaw a pent up demand of 5.6 million. This would produce a boom in car sales from 1994-1996.

Timing, though, was only one consideration in picking an auto stock. The other consideration was picking the right company. While GM had doubled during the 80s, Chrysler increased in value 50 times between 1982 and 1987. Ford increased in value 17 times. Lynch attributes GM's poor performance in the 1980s to company arrogance. In 1991, GM was regarded as a weak company with a terrible outlook for the future. Lynch saw GM as the new Chrysler. The difference was that GM had a better balance sheet in 1992 than Chrysler had in 1982.

Lynch discovered that GM could succeed without selling any more cars in the U.S. GM's most profitable businesses were its European operations, its financing business, Hughes Aircraft, Delco and Electronic Data Systems. If the company could only break even on its U.S. auto sales, it could increase substantially in value. GM was a good bet.

Chapter 16

Chapter 16 Summary and Analysis

Utility stocks have traditionally been consistent earners. They are often better than a CD because they pay a nice dividend and normally appreciate in value over the course of several years. Troubled utilities can be excellent investments. A troubled utility almost has to fix itself because they are regulated by the government and the population has to have electricity. A utility may declare bankruptcy or eliminate its dividend, but it is going to have to stay in operation.

With several distressed utilities to choose from at the end of 1991, Lynch looked to CMS Energy, the utility company of Michigan. The company had done very well until it built a nuclear plant that regulators would not allow them to operate. Its stock fell from $20 to $4.50 in 1984. The company was forced to take a $4 billion write off-the cost of building the plant. Despite the huge hit, CMS did not go bankrupt during the 1980s. By the end of the 80s, it had converted the nuclear plant to run on natural gas. The stock recovered all the way back to $36/share. Things looked good until regulators refused a rate increase and the stock plummeted to $17/share.

CMS' problems did not warrant a 50% drop in the stock price. Demand for electricity in Michigan had risen every year for 12 years in a row. Also favorable was the fact that CMS sold $1 billion worth of bonds to finance the plant conversion. Bondholders had faith in the company. Most of CMS' equipment was new and would not need much in repairs. A new regulator was predicted to act more favorably towards a rate increase. Lynch saw much potential in CMS at $18.50/share.

Chapter 17

Chapter 17 Summary and Analysis

Privatization of government-run business can be very profitable, no matter which country is selling. Privatization takes something that is owned by the public, sells it to the public, and then it is private. In America and Britain, privatization is almost always a no-lose situation. Elected officials do not want to upset the voting public by losing their money in a privatization deal that goes wrong. Privatizations almost always favor the investor with very low prices.

Telephone companies around the world have privatized and done extremely well. Privatization of telephone companies in Mexico, Spain, and the Philippines all resulted in investors making a once-in-a-lifetime killing. The Mexican phone company, for example, went up almost 800% in only two years.

Privatization in the United States is somewhat rare since the types of companies that might be privatized in other countries likely started out private in the U.S.

Chapter 18

Chapter 18 Summary and Analysis

During Lynch's last three years at Magellan, Fannie Mae was its biggest position in the fund. Fidelity's clients made over $1 billion in profits from Fannie Mae during the 1980s. Looking back, Lynch thinks Fannie Mae was a rather obvious pick. He realizes, however, that no one can make that much on a stock unless the stock is grossly underestimated by the market.

Fannie Mae created the concept of the "mortgage-backed security." They bought mortgages, bundled them together, and then sold the bundle to anyone, including the banks that originated the mortgages. Fannie Mae earned a fee for this package and passed the interest rate risk on to new buyers. This service became very popular among the banks. Before it was invented, banks and S & Ls were stuck administering thousands of little mortgages. They were hard to keep track of and hard to sell. Now the bank could sell the mortgages to Fannie Mae and use the money from the proceeds to buy new mortgages or to even buy back some mortgage-backed securities from Fannie Mae.

By 1983, Fannie Mae was doing $1 billion a month in new mortgage-backed securities. Lynch figured that Fannie Mae was now like a bank, but whereas a bank had 2-3% overhead, Fannie Mae ran on only .2% overhead. Fannie Mae also had the advantage of being able to borrow money more cheaply than a bank because it was a quasi-governmental entity. With these factors working in its favor, Fannie Mae could turn a nice profit on a 1% spread. One percent of $100 billion in loans is $1 billion, after all.

By 1985, Lynch realized that mortgage-backed securities could be a huge industry.

Lynch suggests this approach when analyzing whether a risky, yet promising stock is worth the investment: if things go right, how much can I earn?

In 1990, fear of the effects on the economy of the first Gulf War depressed Fannie Mae's stock price. A housing stall was feared, but did not materialize. Fannie Mae fell from $42 to $24, but then rose back to $38. The rebound continued the following year, when Fannie Mae raised to $60 a share. Even in 1992, when the stock was selling for $69/share, its P/E ratio was 11, which was better than the average P/E on the market of 23. Since Fannie Mae would still grow at the rate of 12-15%, it was still undervalued and still a good pick.

Chapter 19

Chapter 19 Summary and Analysis

Lynch bemoans the fact that he missed investing in the mutual fund industry. The Great Correction of 1987 allowed him to give them a try. There was a great fear at the time that the mutual fund industry would collapse. Lynch bought mutual funds at low prices. When mutual funds are popular, it is often better to invest in the companies that sell the funds than to invest in the funds themselves. When interest rates decline, bond and equity funds attract more cash and the companies that specialize in these funds do very well.

Chapter 20

Chapter 20 Summary and Analysis

New restaurants and fast food establishments are created every year. Historically, restaurant stocks have been some of the biggest earners of all time. Shoney's rose 168 times. McDonald's price multiplied by 400. Kentucky Fried Chicken rose 27 ? times its initial offering price.

The investor who missed the restaurants of the 1960s didn't have to worry. In the 1970s he could have done very well investing in Dairy Queen, Wendy's, Luby's, Taco Bell, Pizza Hut, and Long John Silver. In the 1980s, Cracker Barrel, Chili's, Sbarro, and Chi-Chi's were excellent restaurant opportunities.

Restaurant chains, like retailers, typically have 15-20 years of fast growth as they expand. Restaurant companies take time to expand across the country. Slow and steady expansion is better than overexpansion. If a restaurant expands by more than 100 stores a year, it is asking for trouble. A pace of 30-35 new units per year is much more realistic.

Lynch looked at Au Bon Pain as a niche restaurant. It served fresh-baked croissants for breakfast, lunch, and dessert. It went public in 1991 for $10/share and by early 1992 had doubled to $20. Nine months later, though, the price fell to $14. This was 20 times its 1993 earnings. Anytime a 25% grower can be found for 20 times earnings, it is time to buy.

Chapter 21

Chapter 21 Summary and Analysis

A prudent investor should review his portfolio every six months and ask the following questions: 1) is the stock price still a bargain compared to its earnings? And 2) is the company doing anything to increase earnings?

Asking these two questions can lead to one of three conclusions: 1) the company's financial situation has improved and I should buy more, 2) the company's situation has worsened and I should sell or 3) the company's situation is unchanged and I can either leave the money there or put it into another company with better prospects. With this strategy in mind, Lynch re-examined the 21 picks he made for Barron's at the six-month point.

As a group, the 21 stocks did very well in an average market. Lynch read the quarterlies of the 21 companies. Some of his research led him to companies he liked better than the original 21. He recommended investing more in some companies and selling others.

20 Golden Rules

20 Golden Rules Summary and Analysis

This section is a summary of Lynch's most important lessons learned through two decades of investing.

Get the investor's edge to outperform the experts by investing in companies or industries you know and understand. An amateur can often outperform the professionals by ignoring them. In every industry, an amateur who does a little homework can find great growth companies long before a professional. Never invest in a company without understanding its finances. Never own more stocks than you can handle. An amateur can do quite well owning only five companies.

The key to making money is being patient. Sometimes even a successful company may not see an increased value in its stock for many years. Eventually, though, a successful company will show a long-term gain in value. Long shot stocks, on the other hand, almost always fail. "Hot" stocks in "hot" industries are usually risky. Established companies in non-growth industries make better investments. When investing in a small company, always wait until it turns a profit to invest.

If you invest $1,000 in a stock, the most you can possibly lose is $1,000. With some wise investing and patience you might earn $10,000 or even $50,000. Wise investing is a marathon, not a sprint.

Avoid the stock market if you are susceptible to selling everything in a panic. Stock market declines are going to happen. A decline is often an excellent opportunity to find a bargain.

Generally, for every ten companies you research, you will find one worthy of investment. There are always companies overlooked by Wall Street. Not studying a company before investing is like playing poker without looking at the cards.

Characters

Investors

Fund Managers

Analysts

CEOs

Objects/Places

St. Agnes School

This is the school the amateur 7th grade investors attend. Lynch uses them to make a point that even a novice investor can be successful if they make wise investment choices and sticks to areas in which they are knowledgeable.

Magellan Fund

The Magellan Fund is a fund created by Fidelity Investments in the 1960s. Peter Lynch managed Magellan from 1977 to 1990. By managing Magellan, Lynch became the premier fund manager in the U.S. Magellan outperformed the S & P index each year.

Barron's Roundtable

This was an annual meeting in which the top fund managers and investment analysts met to make investment recommendations for an annual issue of *Barron's Magazine*. Lynch's 1991 and 1992 recommendations form the basis of this book. The book highlights how he made his selections and how he reviewed and tracked them to make further recommendations.

P/E Ratio

The P/E ratio provides a way to measure a stock's value. P is the numerator and represents the stock's price. E, the denominator, represents earnings. Earnings are calculated by dividing the net income of the company over the previous 12 months by the number of outstanding shares.

Retail Stocks

Retail stocks are a favorite of Lynch. Retailers can be anything from nurseries to fast food restaurants. Lynch likes up and coming retailers who are methodically expanding their chains across the country. The potential investor need not get in on the ground floor. The pattern for a successful retailer is that they have consistent growth over many years. A Wal-Mart investor could have waited five years to watch their growth before buying and made an incredible return on investment. The investor could have done very well even waiting ten years after Wal-Mart first made the market. Lynch recommends visiting the mall and looking for new, successful businesses that might be worth additional research.

Savings & Loans

During the late 1980s and early 1990s, the reputation of S & Ls was terrible. The federal government was forced into a $500 billion bailout after many S & Ls overextended themselves through risky loans. Investors did not want to go near them. Lynch saw an opportunity to invest in an overlooked market. Despite their terrible reputation, there were still many solid, reputable S & Ls that acted as S & Ls should: they loaned money conservatively to residential home buyers.

Master Limited Partnerships

MLPs were largely overlooked by Wall Street because of a bad association with limited partnerships and some tax requirements. MLPs were companies with very good dividends. Their drawback was that, because of IRS rules, they would be disbanded in 1998. They were tricky investments, but Lynch found some worth a try.

Cyclicals

Cyclicals are industries in which a pattern of fluctuation follows a pattern from boom to recession and then back again. Examples of such industries are steel, paper, autos, chemicals and airlines. Wall Street is well aware of the cyclical patterns, which makes capitalizing on them difficult. Wall Street investors try to predict cyclical trends earlier and earlier. Cyclicals act in reverse of ordinary stocks: a low P/E ratio is normally regarded as good. With a cyclical, a low P/E ratio means that the cyclical is likely near the end of its prosperous run. A high P/E ratio, on the other hand, though normally bad in a stock, can be a good sign for the future performance of a cyclical.

Privatization

Privatization is the process whereby a country sells a nationally-owned entity to the public whereby the company becomes privately owned. Examples of privatization are the British government's sale of British Airways and the Mexican government's sale of the Mexican phone company. Privatization in the United States is relatively rare because the types of businesses that are normally privatized started out that way. Privatization often provides an incredible investment opportunity. Investors in the Mexican phone company made as much as 800 times their investment.

Fannie Mae

Fannie Mae is the nickname of the Federal National Mortgage Association. Fannie Mae was a government entity that was privatized in the 1960s. This single company meant more to Lynch's success as Magellan's fund manager than any other. During the 1980s, customers of Fidelity Investments made $1 billion in profits from Fannie Mae. Fannie

Mae gained success through buying mortgages from banks and S & Ls, packaging them, and selling them as "mortgage-backed securities." Fannie Mae kept expenses low and volumes high and turned a very nice profit for itself and its investors.

Themes

Invest in what you know

Lynch's overriding theme throughout the book is investing in what one knows. He demonstrates this first in the 7th grader exercise. The 7th graders did very well in their mock investments by choosing companies they were familiar with, from fast food restaurants to Nike to Disney to the Gap. Lynch suggests that an amateur investor can be just as knowledgeable about a particular field as a Wall Street analyst and perhaps even more so. For example, those who visit malls frequently often have insight into new retail stores and trends of which a Wall Street analyst may not be aware. The shopping mall regular may be able to pick out a new, popular chain with great potential like the Body Shop. Likewise, regional fast food chains on the move might be spotted early, as they are on their way to national expansion and great success. Taco Bell, Sbarro, and Chili's provide excellent examples of such companies. A savvy shopper may have seen the popularity and potential of Wal-Mart or Costco long before they made huge gains in the stock market. Another example of this theory would be the plumber who tracks the prices of copper. He may have insight into the copper business that the average investor or the average Wall Street analyst doesn't have. This can help him make shrewd and timely investments. Knowing what one invests in is demonstrated by Lynch's adage that one should "Never invest in any idea you can't illustrate with a crayon." He feels investors too often invest in business in which they know absolutely nothing about. The first step in making knowledgeable investments is knowing about the company and exactly what they do.

A wise stock investment will outperform a bond or CD

Stock market performance makes the news every day, whether on CNN or in the Business section of the newspaper. When the market goes down, investors get nervous. The constant fluctuation in the market scares many potential investors from ever considering an investment in the stock market. Many stick to bonds or certificates of deposit (CDs) because of their certainty of performance and complete lack of risk. Traditionally, stocks were the investment for younger people with income that could be put at risk while bonds were the investment for older retirees who would live off of the interest. This dynamic has now changed, however, as the average lifespan has increased. A 62-year-old today may well live another 20 years. Living off of the interest of an investment may not suffice for that length of time. A bond or CD will return a given interest rate over its life, when it matures; the investor receives the initial investment amount. When adjusted for inflation, this investment will likely have depreciated significantly over a ten year bond lifespan.

Lynch suggests stocks as an alternative for even a conservative investor. He suggests investing in stocks that have 10 to 20 year histories of raising dividends. Historically, stocks average an 11% return—3% in dividends and 8% in increased value. Stocks make a better investment than bonds or CDs because they appreciate in value and pay a dividend. An investor with a good plan and some conservative dividend-paying stock picks will do exponentially better with a stock portfolio than with a bond. The dividend rate will increase steadily over the course of the investment. To demonstrate that such an investment is relatively impervious to the fluctuations of the market, Lynch runs the numbers assuming that the stock picked by the investor loses half of its value the day after it is purchased. Assuming such a catastrophe, the stock would still outperform a bond over a ten year period.

Always track your investments and perform periodic re-evaluations

Lynch recommends never owning more stocks than one can comfortably handle. What he means by this is that the amateur investor should only own as many stocks as he has time to analyze and track over the course of a year. An amateur investor can do very well in the market owning only five stocks. Continuing research is always very important to doing well in the market. The buy-it-and-forget-it approach is not recommended. Reviewing a stock means more than just looking at its price every day. Properly analyzing an investment every month or every quarter involves looking at quarterly reports and doing some research into the market and into the industry of the company. Periodic research may turn up good facts or bad about the stock. If a review indicates that the company is doing well yet its price is still low, it may be reason to purchase more. As Lynch often states, sometimes the best stock to buy is one already owned. If the news is bad, it may be time to sell or hold on for better news. He advocates always thinking about the future not the past. Past performance is never really indicative of future performance. Another reason Lynch recommends frequent research is that often his research into one company will lead him to another company worthy of an investment. In fact, whenever Lynch speaks to a CEO about his business, he always ends the conversation by asking the CEO which competitor he most admires.

Style

Perspective

Peter Lynch is perhaps the most successful mutual fund manager of all time. Lynch managed the Magellan Fund from 1977 through 1990. During that time, Magellan was the top-ranked general equity mutual fund. *Time* Magazine called Lynch the "#1 money manager." Lynch's first book, *One Up on Wall Street*, instructed potential investors to invest in subjects and areas in which they are knowledgeable. After retiring from Magellan, Lynch devoted his time to assisting nonprofit corporations with their investments. He wrote *Beating the Street* to help the average investor make better investment choices.

Lynch's intended audience could be any investor, from a seasoned pro to an absolute beginner. The beginner will appreciate the step-by-step method Lynch takes in explaining the basics of investing and then explaining his own methodology for researching a company for potential investment. The seasoned investor will likely appreciate learning Lynch's methodology and exactly what goes through his mind when choosing a company in which to invest. Lynch intends for his reader to come away from his book with a better idea of how to choose profitable stocks and invest. The reader should not be afraid of investing in the stock market, despite its sometimes volatile nature. As Lynch demonstrates, investing in stocks over the years has always been more profitable than other investments despite the markets normal ups and downs.

Tone

The tone of *Beating the Street* is subjective. His analysis of past performance of the Magellan Fund is interspersed with personal insights and opinions on his methodologies of investing. Despite its sometimes cumbersome subject matter, the author does a good job of making it accessible to even a novice investor. This is perhaps best illustrated by the first chapter of the book where Lynch recounts the stock market exercise learned by a group of 7th graders. If 7th graders can have success picking stocks by choosing investments in industries they understand, then certainly an adult can too.

Structure

The book is divided into twenty-one chapters. The first three chapters provide some background information about investing and choosing stocks. Chapters four, five, and six highlight Lynch's years managing the Magellan Fund, explaining how and why he picked certain stocks and tracking the growth of the Fund. He explains what made Magellan so successful all of those years. The rest of the book details exactly how Lynch chose the 21 stocks he recommends for *Barron's Magazine* annual 1992 Roundtable investment recommendation issue. The structure of the book allows someone with little to no experience picking stocks and making investments to learn something about his methodology. The novice investor reading the book learns the basics first and then gets an inside look at Lynch's methodology on a pick by pick basis.

Quotes

"Never invest in any idea you can't illustrate with a crayon." Chapter 1, p. 27.

"You can't see the future through a rearview mirror." Chapter 2, p. 41.

"The extravagance of any corporate office is directly proportional to management's reluctance to reward the shareholders." Chapter 4, p. 86.

"The best stock to buy may be the one you already own." Chapter 6, p. 129.

"A sure cure for taking a stock for granted is a big drop in the price." Chapter 6, p. 131.

"Never bet on a comeback while they're playing 'Taps.'" Chapter 6, p. 138.

"If you like the store, chances are you will love the stock." Chapter 8, p. 152.

"All else being equal, invest in the company with the fewest color photographs in the annual report." Chapter 11, p. 190.

"...try to find a reason that the next year will be better than the last. If you can't find such a reason, the next question is: why do I own this stock?" Chapter 14, p. 224.

"Unless you're a short seller or a poet looking for a wealthy spouse, it never pays to be pessimistic." Chapter 15, p. 232.

"Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and stock mutual funds altogether." 20 Golden Rules, p. 304.

"If you don't study any companies you have the same chance of success buying stocks as you do in a poker game if you bet without looking at your cards." 20 Golden Rules, p. 305.

Topics for Discussion

Why are stocks a better investment than bonds or certificates of deposit?

Discuss three specific ways that research helps an investor make better decision.

Discuss how an average consumer has an advantage over a Wall Street analyst in choosing a retail stock.

What is the pattern of a cyclical stock and when should an investor consider buying one?

Name the five basic types of funds and describe each one.

What are the effects when a company buys back its own stock?

Describe how a recession can be good for an investor.

Explain how to find a good company in a lousy industry.

What is the "January Effect" and how can a good investor take advantage of it?