

Appendix #2

Stock Picking as a Hobby

This book has taken all the fun out of investing in the stock market, so now let's put some back in. Appendix #2 refers to stock picking as a hobby, which I believe it should be. To make stock picking a hobby, you need a small brokerage account funded with money that will not make or break you. It is just as exciting and more fun playing the market with a little bit of money than with a large portion of your savings.

I have a small account that I call "bingo money" in memory of my late Grandma Ferri. While washing clothes, she frequently found spare change in my grandfather's pants. That money went into a special jar labeled BINGO MONEY. Every Monday night she took the jar to the local church to play bingo. She never won a lot, she never lost a lot, but she had a great time.

Your BINGO account should be funded specifically for the purpose of choosing stocks. And playing the market should be limited to the small amount of money in the account. I suggest opening an account with a witty stockbroker, someone who is pleasant to talk to and will pick up the phone when you call. Don't worry about paying regular commissions rates. The cost of commission is your least worry in this account. You will have a hard enough time trying to pick a few winners. Inform your broker you have no interest in buying packaged products or insurance. That way you will not be approached with the latest limited partnership or other investment gimmick.

When you are ready to invest there are thousands of stock strategies to try. You can buy growth, value, small-cap, momentum, it really does not matter, and chances are you will flip from one strategy to another over time. Of course it is always better to stick with one strategy. That is how truly gifted stock investors become wealthy. But 99.9% of stock investors are not gifted, and their chance of success in any strategy is slim. Therefore, I recommend trying different ideas until you find a style you enjoy and understand. I do not recommend trading futures or options since the money can disappear quickly.

Tips on Using Brokerage Firm Stock Research

When you start working with a brokerage house, you will likely be introduced to stock ideas that have recently been touted by the firm's analysts. Unless these are household names like AT&T, Cola-Cola, or Microsoft, there are a few things you need to know about Wall Street recommendations.

Investment Banking Fees

Assume your broker called and recommended a certain small stock his firm just placed on their “buy list”. The broker says the firm believes the stock offers superior investment potential, and that the analyst is highly recommending the company. Should you believe this story? Maybe, and maybe not. Before we go any further, you need to know something about the real job of stock analysts and brokerage firms.

Stock analysts at brokerage firms wear many hats and serve many masters, but the one master that speaks louder than all others is the Investment Banking master. When a brokerage firm acts as an underwriter for a company issuing new securities, the firm makes a very handsome fee. The analyst plays an important roll in bringing in the investment banking business and selling the idea to brokers.

During a typical day, analysts attend meetings, write research reports, talk to the press, speak at various functions, and do a variety of other things. They also keep up on the companies they follow. As a rule, analysts are obligated to cover the biggest companies in their industry, such as those in the S&P 500. After covering the big boy, they don’t have a lot of time to look for promising young companies. Generally, analysts will not recommend a small company just because they think the stock price will go up. The way an analyst selects one small company over another is based on their firms’ investment banking relationship, or potential relationship.

As a rule, when it comes to covering a small company, there must be an investment banking relationship or potential relationship for an analyst to take notice. As small firm may have a wonderful income statement, a fantastic balance sheet, tremendous potential for growth, but if they are not looking to Wall Street for money, few analysts bother to issue research reports or put them on the buy list.

In addition, stock analysts tend to increase their coverage of companies who are currently in need of investment banking. A study by Columbia University concluded that Wall Street analysts generally provide greater coverage to investment banking clients and give them higher ratings overall¹. Paying for coverage and high ratings through investment banking fees is the nature of Wall Street. It has always been this way, and will always be this way.

How does the conflict of interest affect individual investors? Don’t buy a stock if your brokerage firm is involved in the underwriting. Those buy recommendations substantially trailed the stock market. One study found that stock recommendations relating to an investment banking relationships underperformed the market by a 14% over a two-year period following the offering. In contrast,

¹ Warren Boeker and Matthew Hayward, *Columbia University Graduate School of Business*, 1996

recommendations of analysts not involved in the relationship outperformed the market by 32% over the same period².

When a broker calls and pitches an unfamiliar stock, experienced investors learn to ask if an investment banking relationship exists. The broker is obligated to disclose the relationship if it is there. Unless you are familiar with the company from some other unbiased source, I recommend avoiding stocks where a relationship exists.

How good is Wall Street research? According to *The Wall Street Journal*, most analysts might as well be throwing darts. The Journal tracks the performance of analyst recommendations from various brokerage firms and publishes the results on a regular basis. For a five-year period ending June 30, 1998, ten out of fifteen brokerage firms surveyed were not able to achieve the returns of the S&P 500³. These results did not include trading costs, which would have lower the actual returns.

Summary

Picking stocks should be a hobby, and hobby money should be used. Your serious stock money should be in index funds as discussed in Chapter 12. If you are interested in learning about stocks, read a few good books on the subject and take a couple of college courses. Have fun, be safe, and don't confuse brains with a bull market.

² Roni Michaely and Kent L. Womack, "Conflict of Interest and the Credibility of Underwriters Analysts' Recommendation," preliminary paper Sunriver Oregon, June 19-22, 1996

³ Gorgette Jason, "The Pros Give Up Some Bragging Rights", Wall Street Journal, July 21, 1998, C1, Stock returns were based on each firms recommended list.