The Inner Circle Users Guide

by

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Dear Inner Circle member,

I created our Inner Circle to serve the needs of my friends and long-time readers. These investors recognize that building a conservative, well-balanced portfolio is the key to successful investing. They appreciate the value and proven success of our investment approach.

However, they want more advice than we can provide in our newsletters. They want two-way communication, and to be able to have input into the advice they receive from us.

In addition to reading what we have to say in our newsletters and Hotlines, these investors want to be able to pose questions to me and my staff on individual investments, and on investment techniques and philosophies. That's what we do in our weekly Inner Circle Question & Answer sessions, which we generally send out on Tuesdays.

All our Inner Circle members get to see all the questions we've dealt with that week, and our answers.

Some of these questions cover matters we have raised in our reports or regular publications. Others concern stocks or investing matters that members have come across in their dealings with friends, brokers and business associates.

The questions we deal with each week cover a wide range of stocks. Some of these stocks have fatal flaws that make us advise investors to sell and avoid them. Others concern long-time favourites of ours, which we often view as buys, and how these favourites might fit in a particular portfolio.

However, many Inner Circle questions deal with unfamiliar stocks that we see as borderline cases. These stocks often have some appeal, but not enough for us to want to recommend them. When that's the case, we of course say so.

A large number of stocks also fall in a grey area. Though we wouldn't advise buying them, they are 'OK to hold' in our view. In other words, if you want to hold these stocks, we can't voice any strong objection, but it's not something we recommend.

Sometimes we find new favourites

Our Inner Circle includes many experienced, successful investors. Others are business people who occasionally come across intriguing new companies. Some are active traders or institutional investors who often hear from brokers who have stocks to recommend.

On occasion, they ask about stocks that we analyze and recommend as buys for the first time in an Inner Circle Questions & Answers. In most cases we will eventually recommend these new discoveries as buys in one or more of our newsletters. However, the key question for you in deciding whether to buy a new recommendation of ours is, "How would this stock fit in my portfolio?"

Remember, our advice can only give you above-average results when you follow it on a consistent basis. To do that, you need to integrate it into a balanced, diversified portfolio.

> If you think of and plan your investments as a portfolio, your investment results will become more consistent, less time consuming, and more satisfying than ever before.

Portfolios make life easier

When you try to pick a handful of stocks that will all beat the market, you really are asking a lot of yourself. No one has ever been able to consistently pick stock-market winners over long periods, even among people who devote their entire lives to it. But that shouldn't surprise you.

> After all, if you could always guess right about the stock market, you could acquire ever-larger sums of money to invest, from lenders and investors, not to mention your own profits. Eventually you'd acquire control over a large proportion of all the money in the world. And nobody ever succeeds in that.

On the other hand, it's relatively easy to acquire a balanced, diversified portfolio of mainly high-quality stocks, spread out across the five main economic sectors. You'll still experience a wide variation in results among your holdings. But you'll find that at the worst of times, you won't lose much by holding a portfolio answering that description. When times are good, this kind of portfolio will pay off nicely.

Start with this essential decision

The first thing you need to do is to decide how much of your money to put in equities (that is, stocks and mutual funds that invest in stocks), and how much to put in fixed-return investments such as bonds and money-market instruments.

> Some investors try to base their bond/stock split on how they expect these two to perform. This requires the kind of foresight that no investor has. Far better to base the split on your own needs and on the characteristics of these investments.

For one thing, your equity holdings are bound to produce higher profits over long periods than your fixed-return investments. That's because returns on equities are related to business profits, while returns on fixed-return investments are related to business interest costs. Business profits have to exceed business interest costs in the long run. Otherwise, everybody who owes money would go broke, and that's not likely to happen. That's why most investors should hold a substantial portion of their money in stocks, most of the time.

However, returns on your stocks are generally more volatile than what you earn on fixed-return investments (that includes short-term bonds and money-market funds). That's because returns on stocks are related to 'a residual', as academic investors like to refer to it. In this case, the residual is the portion of gross profit that's left over after a company pays its interest costs.

Though fixed-return investments are less profitable than equity investments, they can help to stabilize your portfolio's value. They serve as reserves that you can use to buy more stocks when prices are down. For that matter, when stock prices are down, you can use your reserves for personal spending, to avoid having to sell at a low.

The right equities/fixed return split varies widely from one investor to another, of course. It depends on your financial circumstances and your temperament. A great deal depends on how long you have to go before you will begin depending on your portfolio for income. If you must take cash from your portfolio on a regular basis, you have an incentive to maintain some cash reserves or hold investments that regularly generate cash.

However, you also need to consider the current level of interest rates, which determines what you can earn in fixed-return investments. Today, interest rates are exceptionally low. That alone is a good reason to downplay the role of fixed return investments in your portfolio.

Let me put it this way: Ten years ago, interest rates were much higher than they are today. They were closer to the 10% or more that the stock market generates on average each year in total return (capital gains plus dividends).

Back then, I used to tell my clients that if they were retired or close to it, they might want to hold between one third and two thirds of their investment funds in stocks, and the remainder in fixed-return investments. Back then, holding a third to two thirds of your portfolio in fixed-return, interest-paying investments made financial sense. It also had psychological advantages, since you know you'd receive steady income.

Today, a great deal has changed. Interest rates and inflation may stay near current low levels indefinitely. In that case, you'll make a modest return on your fixed-return investments. But interest rates and inflation could move substantially higher.

In that case, you could experience capital losses and a loss of purchasing power on your fixed-return investments. That's why my advice now is to hold a minimum of your money in fixed-return investments.

Next, pick sectors

After you've decided what part of your savings to put in stocks, remember to spread it out across the five main economic sectors. That way, you avoid overloading yourself with stocks that are about to slump simply because of industry conditions or changes in investor fashion. By diversifying across the sectors, you also increase your chances of stumbling upon a market superstar — a stock that does two to three or more times better than the market average. These stocks come along every year. By nature, their appearance is unpredictable; if you could routinely spot them ahead of time, you'd quickly acquire a large proportion of all the money in the world, and as we mentioned earlier, nobody ever does that.

Speaking very generally, stocks in the Resources & Commodities sector and the Manufacturing & Industry sectors are apt to expose you to above-average volatility, while those in the Finance and Utilities sectors involve below-average volatility. Shares of many Canadian finance-sector firms have been unusually volatile in the past few years, because of the turmoil in U.S. and world banking. However, profits of Canadian companies in Finance and Utilities tend to be more stable than profits in Resources or Manufacturing companies.

Consumer sector stocks are apt to fall in the middle, between the highly volatile Resources and Manufacturing companies and the more stable Finance and Utilities companies. Most investors should have investments in most if not all of these five sectors. The proper proportions for you depend on your temperament and circumstances.

Profit from our SI Ratings

After deciding on a sectoral breakdown, use our Successful Investor Ratings to choose stocks from our Portfolios supplements. You should invest mainly in stocks that are in our Average or higher SI Ratings. These are stocks most likely to survive a period of adversity and go on to thrive all over again when conditions improve.

Here's how we determine those ratings:

We have six Ratings. The top rating is Highest quality; next is Above average; next is Average; below that, Extra risk; below that, Speculative; and, at the bottom of the scale, our riskiest, lowest-quality Rating of Start-up.

We base our Ratings on a system we've developed over the years. We use it to assign 'quality points' based on nine key factors that successful investors use to determine a company's ability to survive a business setback and go on to greater success when conditions improve.

These nine factors and the points they earn are:

• One point for a long-term record of profit.

• One point for a long-term record of dividends.

• One point for industry prominence — two points for industry dominance.

• One point for an attractive balance sheet, with adequate equity and working capital, and manageable debt.

• One point for Canada-wide operations, or two points for multi-national operations. You may want to invest in firms that are concentrated geographically, but geographical diversification cuts risk.

• One point for being able to serve the needs of all shareholders. To merit this point, firms must be free of excess government regulation, free of too much dependence on a single supplier, and free of insider abuses.

• One point for freedom from business cycles.

• One point for the ability to profit from a secular trend, or two points for the ability to profit from two or more secular trends. Secular trends are longlasting trends such as the global move toward free trade, the rise of terrorism, the rising productivity available from modern technology, and so on. These trends go far beyond mere business cycles; they reflect ongoing changes in the world.

• One point for offering products or services that profit from habitual behaviour.

Here's how we then assign Ratings: Companies with 11 or 12 points fall in the top SI Rating: Highest quality. Those with eight to 10 points are of Above average quality. Six or seven points mean they are of Average quality. If a stock has just four or five points, it carries Extra risk (that is, more risk than average); two to three points, Speculative; one or no points, Start-up.

Unlike computerized risk assessments, our SI Ratings demand many judgment calls. But we find they give us a deep-seated measure that goes to the heart of a company's staying power, and yield few unpleasant surprises. When you come right down to it, that's what I try to provide in every aspect of my Inner Circle.

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