HOW TOP CLUBS DO IT

BUY HOLD & SELL

by the editors of *Better Investing*

No one knows for sure all the reasons some investment clubs are more successful than others. But based on conversations *Better Investing* recently had with leading clubs, one common element many of them share seems to be discipline — not only in how they decide whether to buy, sell and hold stocks, but also in how they operate.

Most of the clubs *Better Investing* talked to — which included vintage clubs, model clubs run by NAIC chapters and ones that performed well in this year's NAIC Investment Club Earnings Survey — relied heavily on that old friend, the Stock Selection Guide. Strict use of the SSG doesn't necessarily lead to investment success. After all, it doesn't tell you everything you need to know about a company.

But there's no denying that the form provides an orderly process for decision-making that can carry over into meetings.

The SSG "drives the portfolio review portion of all our meetings," says Bruce Wagner, president of the 63-year-old Mutual Investment Club of Detroit. "The review process is structured, with a completed SSG always a part of it, although the final decision is very much a judgment call by the members."

More than 87 percent of the investment clubs responding to this year's earnings survey say they use NAIC stock study tools, the same percentage as in the 2002 survey. Clubs saying they used the association's tools reported a 2.6-percent lifetime advantage to the S&P 500 index. Clubs that answered "no" to this question had a 1.0-percent lifetime disadvantage.

Tough Year

A total of 418 clubs participated in this year's survey. The average club responding to it (last year's numbers in parentheses) has:

- 14.4 members (14.3).
- Total assets of $105,589 ($98,463).
- Club monthly deposits totaling $706 ($660).
- Been organized for 10 years (8 years).

Clubs that chose to participate filled out surveys and attached their portfolios by June 10, 2003. The survey assessed the rate of return for the most recent 12 months ended April 30, 2003. The lifetime performance, defined as the annualized rate of return, was also calculated. NAIC has conducted this survey for about 40 years.

The association conducts the survey in conjunction with Value Line. The data provider judges the portfolios and honors three investment clubs. The winners of the 2003 Value Line Investment Club Portfolio Awards will be announced in the December issue of *BI*.

Value Line's decisions are based on a variety of criteria. The most important one is a club's investment performance over time; others include how long the club has been operating, the number of stocks in its portfolio and the portfolio's diversification.

Clubs are also selected by NAIC for the Honor Roll. These are the ones participating in this year's survey that have the highest lifetime rates of return and have been in operation for more than eight years.

Participating clubs in the 2003 survey had a rough year. They reported an average loss of 9.7 percent for the most recent 12 months ended April 30, 2003; meanwhile, the S&P 500 index was up by 2.9 percent.

This was the third time since 1995 that respondents fared worse than the S&P 500; 1996 and 1998 were the other years. (Since this survey is tied to the Value Line contest, clubs that fared poorly might not tend to send in their results.) Clubs in the 2002 survey had an average loss of 3 percent.

Older clubs also took a tumble. The lifetime rate of return for participating clubs more than 110 months old was 8.5 percent, down from 10.5 percent last year.

Good Stewards Investment Club, Garland, Texas. Pictured are, left to right: Ed Wilson, Troy Moore, Lindy Watkins, Chad Meese, Carlton Bailey, Mary Bailey, Juanita Frolik, Jim Frolik and James Duty. Not shown: Tommy Darter, Paul Hankins, Monteene Knighten, Donna Nance, Jeff Rearick, Josh Rearick and Cathy Wingo.

But when factoring in the younger clubs, lifetime performance of the respondents exceeded that of the S&P 500. Their lifetime performance was 1.7 percent, compared with –0.4 percent for the index when matching the clubs' years of operation to the index's performance during those years. That's a 2.1-percent lifetime advantage to the S&P 500. Since 1995, the lifetime annual rate of return for participating clubs was less than that of the S&P 500 in only 1998 and 2001.

Editor's note: This survey is nonscientific. Investment clubs volunteered to participate in the survey and pay a processing fee, as opposed to being randomly selected for participation. Survey figures mentioned in this article therefore are not considered as reliable as data taken from random, scientifically conducted surveys. NAIC does not claim that the results are representative of its membership.

As always, some of the participating clubs have interesting and clever names, including:

- Group of Ordinary Financial Strategists
- Baltic to Boardwalk
- Nothing But Net

SSGs Lead the Meetings

Several of the clubs interviewed by the editors of *Better Investing* rely heavily on Stock Selection Guides to make their buy, hold and sell decisions. Reviewing SSGs is also an integral part of having an orderly meeting structure.

The Mutual Investment Club's secretary assigns three or more SSGs on current holdings for each meeting, with the aim of reviewing every company in the portfolio once a year. The $5.8 million portfolio has about 35 stocks, so the process takes the entire year.

"Assignments are made alphabetically as club member names and our stock holdings come up on the list," Wagner says. "Because we have more stocks than members, you can count on getting new stocks to study every year.

"We find that's a good way to involve all our members in the portfolio and to learn from one another's judgments and experiences."

TOP HOLDINGS OF CONTEST FINALISTS

Percent of combined assets of portfolios of eight finalists in 2003 Value Line Investment Club Portfolio Awards.

1. Pfizer (PFE)	5.5 %
2. Garmin (GRMN)	5.5
3. Medtronic (MDT)	5.4
4. Lowe's (LOW)	4.1
5. Johnson & Johnson (JNJ)	3.3
6. Microsoft (MSFT)	3.1
7. Harley-Davidson (HDI)	3.1
8. Stryker (SYK)	2.7
9. Amgen (AMGN)	2.7
10. General Electric (GE)	2.5
11. PolyMedica (PLMD)	2.3
12. Biomet (BMET)	2.3
13. Apollo Group (APOL)	2.3
14. Family Dollar (FDO)	2.3
15. Home Depot (HD)	2.2
16. FactSet Research (FDS)	2.0
17. CDW (CDWC)	2.0
18. Cardinal Health (CAH)	1.9
19. O'Reilly Automotive (ORLY)	1.5
20. Wal-Mart (WMT)	1.5
21. Health Management Associates (HMA)	1.5
22. Capital One Financial (COF)	1.5
23. Fossil (FOSL)	1.4
24. Paychex (PAYX)	1.4
25. Cisco Systems (CSCO)	1.4

Pfizer, Garmin, Medtronic Top Choices of Leading Clubs

In our annual look at the portfolios of the eight clubs nominated for this year's Value Line club performance survey, we see that Pfizer still tops the list. Pfizer is held by five of the eight finalists and would represent 5.5 percent of a combined portfolio that reflects the holdings of all eight investment clubs *(see table at left)*.

The portfolios have a strong emphasis on health-care stocks, with five of the top 10 holdings coming from this sector. Home improvement seems to be a prevailing theme as well: Six of the eight hold either Home Depot or Lowe's.

Many of the companies are found in *Better Investing's* Top 100, with a few exceptions. Two of the top clubs have large positions in Garmin. Garmin develops and markets global positioning products and exhibited strong price performance during the first half of 2003. FactSet Research was among the better-performing stocks of 2002 and has bolstered the performance of three of the leading portfolios.

The average expected sales growth for the combined portfolio is approximately 12 percent, according to Value Line. The average Financial Strength rating is "A" and the average EPS predictability is 82.9.

A number of recent Stock to Study candidates are found among the top holdings, including Biomet (September 2003), Harley-Davidson (May 2003) and Health Management Associates (April 2003).

Wagner notes a simple procedure the club uses to help ensure the monthly assignments are done.

"Our secretary gives members a two-month notice in the club minutes," he says. "If I had an SSG report due on GE for the October meeting, for example, I'd see the assignment in the August and September meeting minutes. If I don't give my report at the October meeting, the next set of minutes would report my SSG as overdue — easy for all members to notice since both the company's name and mine would be shown in bold type.

"This is definitely one place where members don't like to see their name in lights. It's amazing how effective that simple procedure is."

Members also are encouraged to bring SSGs on other companies of interest to the meeting.

"Sometimes there are more SSGs on new companies than current holdings," Wagner says. "After all the SSGs are presented, we have an open discussion on what changes to make in our portfolio. And with all the SSG talk that precedes it, there's always a fresh flow of ideas and thinking to help spark the discussions. We do much more buying than selling, usually adding to an existing holding, but we don't blindly follow what the SSG tells us."

(Editor's note: Companies mentioned in this article are not meant as buy or sell recommendations. A Stock Selection Guide study should always follow for any company being considered for investment.)

The 45-year-old, all-female Financial Femmes Investment Club of Grosse Pointe, Mich., doesn't have a strict procedure for decision-making, but the SSG is faithfully used for all its stock studies.

"Some of our members use the Investor's Toolkit (software) in conjunction with OPS (Online Premium Services) and other online services," report Financial Femmes members Sue Huige and Pat Elian, "and other members do it by hand getting information from either Value Line or Standard & Poor's."

The Financial Femmes also assign portfolio stocks to each member to watch during the year. "We always do a yearly review of our portfolio using the SSG as well as sharing any pertinent information on a monthly basis," Huige and Elian say.

"Our club agent speaks monthly with the club broker," they say, "who shares information regarding our portfolio as well as general information on the market and the factors affecting its performance. Members also share information from various media sources on the stocks they follow or other stocks in our portfolio.

The Mutual Investment Club's secretary assigns three or more SSGs on current holdings for each meeting, with the aim of reviewing every company in the portfolio once a year.

"Except for the meetings when we are doing the annual review of our portfolio, two or three stock studies are presented at each meeting. We frequently use the Stock to Study in *Better Investing* or another stock mentioned in the magazine and then do a comparison study of a competitor. Members contribute ideas about stocks to study as does the club broker."

Frank Mirth of the Pittsburgh Chapter's model club believes that having members follow three stocks is a good idea. One would be a stock they like, one would be a stock they have no opinion of and one would be a stock they didn't like. Mirth also notes that the first club he started about 20 years ago foundered for several years making highly speculative investments until it started doing SSGs.

The Good Stewards of Garland, Texas, also use the SSG extensively in their stock studies and meeting structure. Lindy Watkins started up the investment club with his four adult children in 2000.

Two people are assigned to develop a report on a new stock at every meeting, Watkins says. Although the club limits its holdings to 20 stocks and has 17 now, members still discuss new stocks every month.

The presentations, which include SSGs, are assigned three months ahead of time. "We require sales growth of 15 percent and a 3-to-1 upside-downside ratio (with a price) in the Buy zone," Watkins says. Then members discuss the companies and eventually vote on whether to add one of them to the portfolio.

"We've never bought a stock with a P/E of 30 or greater," Watkins adds. "I don't think we'd ever buy a stock like Krispy Kreme, even though it's been a wonderful stock, because of its (high) P/E."

The Dogwood Investment Club of Richmond, Va., might not use SSGs, but the club's meetings certainly are orderly. It strictly follows *Robert's Rules of Order*, says Don Jamison, the club's treasurer. "Old business, new business — everything down the line." The investment club, which formed in the 1960s, was recognized as a state winner in the Value Line contest last year.

The club pays attention to a company's price-earnings ratio and its capitalization. "We feel if the people are buying, they're going to buy from the largest," Jamison says. "We'd rather be on a big ship rather than a little one."

Mindful of Diversification

Maintaining a diversified portfolio also requires discipline. The largest holdings in the 31-stock portfolio of the Financial Femmes, who were featured in *Better Investing's* November 2001 issue *(see "Vintage Clubs")*, are Abbott Labs, Gentex, Harley-Davidson, Hershey Foods, State Street and Sysco. These holdings amount to 38 percent of the investment club's value, and no stock accounts for more than 10 percent of the portfolio.

"We sold 100 shares of Harley-Davidson in August of 2002 because we were concerned that it had become 15 percent of our portfolio," the club's Pat Elian says. "When tech stocks were the darlings of Wall Street, we allowed Cisco and EMC to become a high percentage in our portfolio. Since that experience, we are much more sensitive to a stock that reaches 15 percent of our total portfolio."

The Mutual Investment Club doesn't always act on positive SSGs; one factor in its judgment is how much stock it owns of a particular company. "There are many SSGs on companies in the Buy zone that we don't act on, just as sometimes there are SSGs in the Sell zone," Wagner says. "We take that into consideration, of course, but we always add our personal judgment on what's best to do."

"No matter who does AFLAC in our club, for example, it almost always comes up in the Buy zone," the club's president says. "But we have so much of it (more than 20 percent of total portfolio value) we hesitate to buy more."

Quentin Sampson

"If you do one SSG to buy, do three to sell" when considering divesting 100 percent of a club's holding in a stock.

The Mutual Investment Club's largest holdings are AFLAC, General Electric, Intel, Citigroup, Bank One and QUALCOMM. These six holdings account for 42 percent of the club's value.

The Chicago South Chapter's Harvey Model Club does basic monitoring of diversification, says Quentin Sampson, a club member who's also a National Association of Investors director. Stocks and industries both generally cannot constitute more than 10 percent of the club's portfolio. In addition, no member can own more than 10 percent of the club's valuation.

The Pittsburgh Chapter's model club also looks at diversification by industry. Diversification by market cap isn't much of a priority, but Mirth believes the portfolio has a pretty good mix in that regard.

The 15-member Dogwood Investment Club in recent years has pared down its portfolio from 18 or so stocks down to eight currently so that it could focus better on its holdings. "We want to get into the best sectors," Jamison says. "We don't want to (buy a stock) just because we don't have something (in that sector)."

The club currently has two health-care companies in its portfolio, Medtronic and Johnson & Johnson, and might be overweighted in J&J, Jamison says.

"We're trying to get our assets more equally distributed," he says. "With only eight stocks, we have room to get one or two in another sector. We don't want to get over a dozen holdings," but eight is as few as the club wants to hold. Other holdings include Liz Claiborne and Altria Group.

Selling's Tough — As It Should Be

The Mutual Investment Club usually is "slow to make the sell decisions," Wagner says. "We've been both helped and hurt by that." Technology stocks would be one example of this over the last few years.

The club recently sold a portion of its Linear Technology holding when the SSG showed the company to be in the Sell zone. "It's a wonderful growth company and we've held shares for a long time, with a cost basis of $10.15 and a current price of around $35," Wagner says. "So capital gains considerations were involved, too. Members were reluctant to sell the entire holding, so we sold a half of it, in essence getting more than our original investment out of it. Now we have 1,500 shares left, and any gain is pure profit."

The Harvey Model Club has a lot of discussion before selling a stock, Sampson says. "We do know selling is part of investing, though."

"If you do one SSG to buy," he recommends, "do three to sell" when considering divesting 100 percent of a club's holding in a stock. Most people sell too soon, he said.

Mirth agrees. "Try to use everything you can find before making sell decisions," he says. "Bad sell decisions are what kill you." Mirth uses NAIC's Challenge Tree process for selling; this is an orderly process for comparing the prospects of a current holding and a potential replacement.

The first stock the Good Stewards bought was ElkCorp, a shingles maker in Dallas. "Six months after we bought it, the price of oil went up, so asphalt was up," the club's Lindy Watkins says. The club sold it about two years later, taking a 10-percent loss.

"We hated to sell that, because it was a local company … but we felt they didn't have control over the price of oil, and we didn't think it would have as good a future as other stocks we could buy," he says.

The club's best performer has been PolyMedica Corp., a small-cap supplier of health-care products. When the club first looked at the company a couple of years ago, "it was in the Buy zone, but we also looked at Pfizer that month," Watkins says. "We decided to buy Pfizer because it was bigger, more stable." But the club looked at PolyMedica again about six months later when the stock's price plummeted after a subsidiary became the subject of a criminal investigation.

"We looked at it again and decided to buy it because of its great record of increased sales and profits," Watkins says. "The P/E was reasonable. The next day it dropped again to about $10 or $11. That's when we bought it, at its low." At press time the stock was trading for about $45.

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>
> **— Frank Mirth**

Remember Education

Amid all this discussion of buying, selling and holding, remember that a main benefit of being in investment clubs is the chance to learn not only about investing but also about operating a club. Mirth emphasizes the need to get all members of the investment club involved and making decisions.

"You want to make sure one or two people aren't making all the decisions," he says. For example, while Mirth is one of the model club's leaders, he passed a motion that prevents him from making motions or voting.

The Good Stewards, which has 16 members, apparently also requires all its members to participate to some degree. Family members who weren't participating enough left the club, Watkins says.

Another interesting component of the Pittsburgh Chapter's model club's educational thrust is that it discusses the *BI* Stock to Study from the previous, rather than the current, issue. This allows whoever presents an SSG for the stock to conduct additional research and further his or her understanding of the company. New members presenting SSGs can work on them alone or with partners — or by going through a group question-and-answer session led by Mirth.