It's All Relative

Two of the questions I hear regularly are "When to buy?" and "When to sell?" Those kinds of inquiries suggest that there's an absolute level at which a security is worth adding to one's portfolio as well as a price when it's time to say adios. It would be nice to think that the process could be that tidy, but it's not.

For starters, it's essential to understand that the word "absolute" is meaningless in the world of investing. The market is never "too high" or "too low". Wherever it is at any given moment is where investors think it should be. What's more, from the perspective of those who think in terms of absolutes, the averages have often stayed well below and well above what one might think of as a normal level for extended periods, sometimes years. So efforts to evaluate in this way usually prove to be a waste of time.

Short-term market movements are never predictable and anyone who claims otherwise is either a charlatan or someone who is a steady user of recreational drugs. Changes in psychology rule the day, the month, and perhaps a lot longer.

That doesn't mean worthwhile analysis can't point an investor in the right direction. It certainly can, but the key to what works is the understanding that worthwhile analysis of investments is based on relative probabilities. With a proper evaluation of fundamental information, it is possible to make relative assessments of likely future performance. The upshot of that analysis will be the probability that the performance of individual securities will be better than, the same as, or not as good as that of the market averages over a specified period of time.

The nuts and bolts of a productive analysis include such factors as the consistency and momentum of both prices and earnings, the current valuation compared with historical valuations, and the ability to generate steady free cash flow. These kinds of things can be scored and then ranked. Those that score well must then be scrutinized for subjective matters that may not lend themselves to objective analysis. The net result of this process will be a listing of candidates for additions to one's portfolio.

This is an ongoing process in which the rankings continue to change as new data is received. When the scores of those held slip below specified levels, it's time to sell and move on. Sometimes, they stay high for extended periods.

What is not included, and is most assuredly not helpful, are such things as target prices found in some of the financial websites and analyst recommendations (Buy, Sell, Hold). At best, target prices are the products of long-term earnings projections (which themselves are iffy) and normal valuations (which rarely occur). Similarly, Wall Street recommendations are nothing more than marketing gimmicks used by analysts to help sell large blocks of stock to major financial institutions. There is no substantial basis to believe that these recommendations are at all meaningful.

A disciplined approach with attention to detail combined with a reasonable amount of patience will serve investors well. Short of that, you may as well go to a casino.