Smart Investors Don't Go To Cocktail Parties

Although folks love to talk about their investment successes when they get together for drinks, you can bet that the conversations will never turn to times when things didn't work out. Rewind the clock to 1999 and it seemed like there was absolutely nothing else to talk about but hot stocks. Those were the euphoric days of the New Economy, a time when brilliant new concepts propelled shares to unsustainable heights and for a while more than a few people were convinced that the stock market no longer needed to pay attention to reality.

And then the bottom fell out. Hot companies whose shares traded well into the triple digits either vanished or ended up as penny stocks. Over the decade that followed, the leading averages fluctuated widely, but were largely unchanged after all was said and done.

Among the lessons learned is the fact that the single most important factor behind stock price valuation is underlying profits. The best companies are those that are growing consistently. Both growth and consistency are critical to the equation. Over time, the rate of growth will probably be reflected in an increasing stock price. But consistency of progress is equally important because it reinforces investors' confidence in the likelihood that future results will see more of the same.

With that said, however, not all of the best companies are great investments. Why? Because valuations should bear a reasonable relation to the companies' fundamentals. A company growing at 10% a year could reasonably be selling at 20.0 times earnings. That relationship is referred to as the Price-to-Earnings Growth Ratio or PEG. If that same company has a PEG of 30 or even 40, it's being priced close to perfection. In such a case, investors are expecting everything to go right, though that rarely happens. When there's a disappointment, bad things like big stock price drops may follow.

But there's more. Years ago, few companies were willing to comment on earnings estimates analysts had come up with. Indeed, there was a time when companies did not have to report quarterly. Imagine waiting six months or a year before hearing what's going on.

These days, the situation's dramatically different. Not only are company spokespeople willing to comment on the future, but many issue periodic guidance on the numbers they are expecting. Even so, don't hold your breath expecting that these pronouncements are without risk. The reality is very much otherwise though some companies intentionally understate their expectations to ensure that they do at least as well, if not better, than the guidance they have provided.

The upshot of guidance is what's referred to as the whisper numbers. Those are the numbers that Wall Street analysts think are more likely than what's been put out as the official forecast. When the actual results fall short of both the whisper numbers and the company's guidance, things can get ugly. It's even worse when both earnings and revenues miss the target.

After proper investigation into the fundamentals, it's important to consider the industry involved, the company's financial condition, and the related price action of the stock. By that I don't mean venturing into the arcane world of technical analysis, which is Wall Street's version of voodoo, but simply taking a look at a price chart to make sure the price is not plunging while the financials appear to be in order. If that's the case, it's likely that the fundamental analysis is flawed. If, on the other hand, the stock is just doing nothing special, it just may be waiting for Wall Street to take notice. That's a good thing, far better than getting hot tips at a cool party.