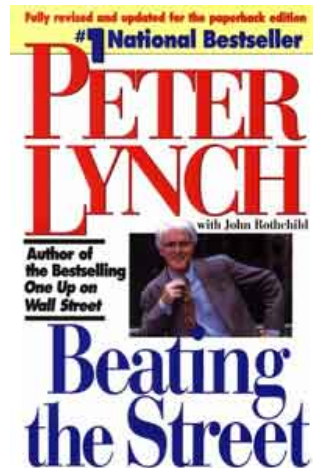


Beating The Street



By
Peter Lynch

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The Big Idea

Peter Lynch ran the Fidelity Magellan Fund for more 20 years, during which time Magellan was the number one ranked general equity fund in America. His books *One Up on Wall Street* and *Beating the Street* are filled with his accumulated wisdom and in *Beating the Street* he gives a fairly detailed account of how he did his analysis.

The first thing that will strike new investors as strange is that Lynch's methods are actually so simple that mostly an amateur could use them entirely unchanged and with the same results. Lynch does not use any gimmicky computer programs, either to pick stocks or optimize the portfolio for volatility. Each and every company invested in by Magellan was considered on its own individual merits, and the managers of Magellan generally did their very best to completely avoid investing in anything that consensus opinion from the average Wall Street analyst declared was a good thing.

Lynch sums up his points in *Beating the Street* with a number of humorous "Peter's Principles", which appear here. Do take the time to read *Beating the Street* in its entirety though, as he makes a number of very interesting points throughout.

Peter's Principle #1

When the operas outnumber the football games three to zero, you know there is something wrong with your life.

This first point comes from the preface, where he is talking about how busy he was, regretting being unable to spend time with his family since he was too busy trying to keep current on a few thousand stocks.

Peter's Principle #2

Gentlemen who prefer bonds don't know what they are missing.

This one gets a going over in this FAQ in the separate "Bonds vs Stocks" article, Lynch just pointed out that bonds are an inferior investment to shares.

Peter's Principle #3

Never invest in any idea you can't illustrate with a crayon.

A class of seventh graders at an American primary school did a social studies project on stocks, the kids had to do their own research and dig up stocks for a paper portfolio. They sent their picks to Lynch, who later invited them to a pizza dinner at the Fidelity executive dining room, illustrating their portfolio with little drawings representing each stock. Lynch just loved this because it illustrates the principle that you should only invest in what you understand, the kids portfolio consisted of toy manufacturers, makers of baseball swap cards, clothing manufacturers and outlets, Playboy Enterprises (a couple of boys chose that one), Coke, and other stocks of that ilk. With a portfolio notably lacking in glamorous technology ventures and entrepreneurial risk taking they went for solid stocks with excellent profits, their portfolio returned 69.6% against a background of a 26.08% gain in the S&P500 in 1990/91.

Peter's Principle #4**You can't see the future through a rearview mirror.**

Chapter 2 of the book talks about "weekend worriers", those pundits that always have a thousand reasons why the economy is bad and it is not a good time to invest in stocks. He points out that even he is guilty of this, appearing on the prestigious Barren's panel on the state of the economy to prognosticate and outdo the other panelists on why the market is about to crash. He also notes that none of the people on the Barren's portfolio are anything less than the top experts on investment, managers of the biggest and best funds and all highly respected, obviously even with all the doom-saying they still find some time to invest. Lynch advocates looking at stocks for their own value, not to go in for top-down analysis in some futile attempt to predict the state of the economy and their effects on stock prices. The market crashes when stocks are way over valued, and doesn't usually crash again until stocks have become over valued again. His point comes down to the old saying, "buy in gloom, sell in boom". When the experts are bearish is the time to buy.

Peter's Principle #5**There's no point paying Yo-Yo Ma to play a radio.**

Bonds vs Bond funds, Lynch ponders why people invest in bond funds, with all their administrative fees, when any fool can go to a broker or the American Federal Reserve bank to buy a 3-year treasury note, or T-bill from \$5000, and other notes for \$1000. The returns on the direct investments are better than the managed funds because a T-bill is always a T-bill, there is nothing to manage or research. Bond funds are very popular in America, but Lynch really can't figure out why!

Peter's Principle #6**As long as you're picking a fund, you might as well pick a good one.**

At the time Lynch wrote his book, there were more American mutual funds than there were listed companies! The majority of fund managers would rather be part of the Wall Street herd than do any serious research of their own. Despite the argument for a fund being that you are entrusting your money to a professional who will spend more time doing research than you ever could, the level of analysis in all but a minority of funds is very shallow, and tends to be the corporate equivalent of keeping up with the Joneses. Funds with big entry fees are not necessarily any better than funds without, the fund that comes out of nowhere and gets the top ranking one year is probably just highly leveraged in something that happened to do well that year, and will fail the next. In their quest to invest conservatively most managers buy stocks that have already been bought up to expensive levels, shunning investing in out-of-favor industries. Lynch gives a number of tips as to what to look for in a good fund, but his main point is that the majority of funds are duds. Often it takes as much research to find a good fund as it takes to find a good stock, perhaps more research since there are more funds than stocks.

Peter's Principle #7**The extravagance of any corporate office is directly proportional to management's reluctance to reward shareholders.**

Excellent companies are thrifty. They seek to maximize returns by running their operation efficiently and seeking to be the best at what they do. Companies that buy themselves glamorous skyscraper office towers with indoor waterfalls and gold plated toilet seats, award executives with fat salaries not linked to performance, corporate jets, massive advertising campaigns aimed purely at sprucing up the corporate image, changing a sensible old name to something flashy and techy and other such excesses are not companies you want to invest in. To Lynch, such behavior indicates the management may well be far too concerned with self-aggrandizement rather than

trying to maximize returns for shareholders. Some of the very best investments Lynch has made are cyclical companies in difficult industries that turn out to be the last man standing when all their rivals have gone broke, leaving the market all to them, and the credit goes to thrifty policies which ensure that these companies become the lowest cost competitors in the market.

Peter's Principle #8

When yields on long-term government bonds exceed the dividend yield of the S&P 500 by 6 percent or more, sell your stocks and buy bonds.

Lynch recommends this as a kind of value-contrarian-safety type of strategy, making the claim that when this situation occurs you should enjoy the "risk-free" investment of bonds, they are either yielding exceptionally well or the stock market is over-valued. Either way they make more sense than stocks at that time, this is the only exception to Lynch's assertion that stocks are always better than bonds.

Peter's Principle #9

Not all common stocks are equally common.

A direct attack on the efficient-market dartboard method of stock picking. Lynch spends this chapter talking about asset allocations in Magellan, pointing out that while this fund, with more than one billion dollars invested was into over 1400 stocks at the time he was referring to, many of these were small investments, nice companies but too small for an organization like Magellan to own much. Really good stocks are not that common, Lynch's favorite stocks made up substantially larger proportions of the portfolio than others, but the other stocks held were held because they were also great companies, just too small for \$100 million purchase orders. Many of these smaller companies are totally ignored by most funds, which prefer to buy well-known stocks rather than research something not well known. This leads to great opportunities for small investors, because it means that it is perfectly possible to find small stocks trading at very low valuations, often below book value. You won't find Newscorp trading at below book any time soon, but such purchases are quite easy in very small companies. Lynch doesn't so much think that funds ignore small stocks because of the inability to make large purchases, he puts this down to copycat fund managers not wanting to stick their necks out. Although a dreadful stock in many ways, no fund manager has ever been fired for buying IBM: it is said that IBM has "disappointed the market", not that the fund manager screwed up. I have read a few books recently that very sternly advocate the efficient market hypothesis, dart boards and all, if you want to cure yourself of such nonsense just look at the results of Magellan!

Peter's Principle #10

Never look back when you're driving on the autobahn.

He's referring to the time he was doing a research trip in Europe and while traveling at 120mph (just shy of 200kmh) he noticed in his rear view mirror that some guy in a Mercedes was tailgating him about 3" from his rear bumper. I'm sure this incident has deep significance for investors, but I guess I'm too much of a philistine to see it.

Peter's Principle #11

The best stock to buy may be the one you already own.

Many stocks which later became major holdings started out as minor purchases by Magellan. Often it is unnecessary to run around looking for the perfect stock, you may already have it in your portfolio, so buy more! It goes back to principle number 9, the number of really brilliant companies is finite, so when you do have one it might be better to buy more than to go out to find something else.

Peter's Principle #12**A sure cure for taking a stock for granted is a big drop in the price.**

Like many people who trade shares with great initial success, Lynch had attained something of a God complex thinking he was immune to the lumps and bumps of the market. He is referring to the shocks of 1978 and 1987, where big falls provided the necessary kick in the pants to remind him of who the real boss is. This point should be made to everyone who just got a Sanford account in the middle of the last bull market, sometimes good luck can mask bad skill.

Peter's Principle #13**Never bet on comeback while they're playing "Taps".**

For those that don't get it, "Taps" is the name of that bugle tune they play at military funerals. This point deals with the idea of buying something just because the share price has fallen. Carefully investigate each purchase as if it were a new stock, ignore the history if the situation has obviously changed. As Lynch says, there is no shame in losing money on a stock. Everybody does it. What is shameful is to hold on to a stock, or worse, to buy more of it, when the fundamentals are deteriorating.

Peter's Principle #14**If you like the store, chances are you'll love the stock.**

One of Lynch's favorite stock picking techniques is to take his wife and kids shopping at a large shopping centre. There you can see for yourself what chains are doing well, before the annual report. Many shops that are starting out as franchises have not yet been noticed by the stock market, even if they are listed. To do this kind of research he'd give his daughters some pocket money and see where they spend it, which usually led him to a discount clothing store like the Gap (an American jeans store turned popular general clothing store), which was always packed with kids making big purchases. What better operation could there be than an extremely profitable store just going franchise that is about to expand all over the country? Lynch loves these stocks, retail operations that go absolutely wild after a few years listing producing what Lynch aptly names "Ten-Baggers" - stocks with a 1000% price increase or better! His kids also help him by telling him what drinks are popular these days, leading him often to some small operation making a niche range of products that gains similarly. Of course once he gets back to the office he always checks up on the PE ratio and debt levels, which is what stopped him investing in "The Body Shop", on a 40+ PE which was too rich for his tastes even with such rapid expansion. Clearly investing in this sort of thing beats buying some riverboat casino or speculative technology issue recommended by a generic Uncle Harry.

Peter's Principle #15**When insiders are buying, it's a good sign - unless they happen to be New England bankers.**

When management people make large purchases of their own stock with private funds, you know that the insiders feel the company is undervalued, or that something big is about to happen. The bankers comment refers to the silliness of the management of a number of Texas and New England banks who violated principle #13, buying substantial holdings almost right up to the day the banks closed their doors for good.

Peter's Principle #16**In business, competition is never as healthy as total domination.**

The name of this chapter is "Blossoms in the Desert", it is about Lynch's love affair with really good companies in really bad industries. The trouble with investing in really good industries is that it attracts the attention of many others who want a piece of the action, hordes of players show up to take a piece of the pie, and even with the big profits of the industry the competition ends up so fierce that even people in the best industry can end up losing money to the lower cost competitors. As Yogi Berra once said about a famous Miami Beach restaurant, "It's so popular, nobody goes there any more.", exactly the point that Lynch is making. Instead Lynch really likes terrible industries, airlines, steel, tire retreads, can making, textile companies etc. He doesn't buy every stock of course, he looks for the one with the lowest operating costs. When times get hard most of their competitors will fold, leaving them with a huge market share in an industry no one wants any more, and since their costs are so low they often make a profit, even in the bad years. What then happens one day is the industry improves, leaving this very low cost producer with virtually no competition in a market that suddenly has the potential for explosive growth. Companies of this sort bear in mind principle #7, they are more likely to take investors across the road for a deli sandwich than entertain them on a wine and dine junket, with a corporate reception consisting of a black phone saying "pick me up" at the entrance to their factory, executives and staff who's pay is linked to corporate profits, non-membership of trade unions for the workers - and the workers like it that way since their pay is better with this company, employee award plaques on the walls instead of expensive art and a board room in the floating loft above the factory floor.

As an example of how great industries can mean very poor profits, look at airlines. Because of the poor profits made it has now dawned on many people that the airline industry is not a good one to invest in. This wasn't always the way people thought of it though, just when technology was picking up and the first true "Jumbo Jets" were appearing, it looked like a great time to invest in airlines. Sure enough, passenger numbers have grown substantially, and will no doubt continue to do so. Airlines should have been the greatest of growth stocks, and yet they have stagnated. With the huge growth in ticket sales there have been many new airlines to take a piece of that, along with the increasing cost of fuel this competition has been ruinous. As a result, air travel is considered to be a rotten industry, the reputation comes not from the business itself but from the competition.

Peter's Principle #17**All else being equal, invest in the company with the fewest color photographs in the annual report.**

Still on austere companies that come to dominate lousy industries, Lynch has nothing but praise for companies that don't waste money. This extends to the annual report as well. Contrast the highly promoted tax dodge schemes with their glossy brochures and extensive advertising with the companies Lynch really likes, dull organizations that grow their profits steadily, unnoticed by Wall Street brokers until the share price has already increased 10 times over. Some of Lynch's favorite companies don't even have any photos at all in their report, going for a simple black and white text document that just sticks to the facts about expenditure and strategy. Lynch feels as if these companies actually feel themselves employed by the shareholders, not for themselves. Such companies would rather buy back their own stock and inflate the EPS than spend money on frivolities.

Peter's Principle #18**When even the analysts are bored, it's time to start buying.**

What efficient market? Lynch loves industries Wall Street is ignoring, for here is where the real bargains are. Giant conglomerates have a hundred analysts watching their every move, because they are so popular they are often bought up to silly price earnings ratios though, it is the whole phenomenon of the market buying what they are familiar with, rather than what is good. Savings and Loan companies went out of fashion for a while in America, because a few crooked entrepreneurial types bought a few out and got into a whole lot of trouble making vast loans to their mates for speculative commercial real estate. The result was a series of spectacular failures that ruined the image of the whole industry. Most brokerages stopped looking at S&Ls altogether, and nearly every one of them was sold down. For Lynch this was great, he realized that the actions of these 1980s Christopher Skase types had not damaged the industry as a whole, certainly it meant absolutely nothing to the earnings of many of these companies. As a result Lynch was able to make quite a few wonderful acquisitions of solid companies with excellent histories that paid great dividends, and he waited a while for the hubbub to calm down and for the industry to get noticed by Wall Street again. Warren Buffett also likes this technique, he bought American Express after a scandalous one-off fraud perpetrated against the company, which led to a massive sell-off in AMEX. If an event doesn't hurt the long-term earnings of a company, and it won't go broke as a result of this hit, then obviously a big selloff is a good time to pick up a bargain.

Peter's Principle #19**Unless you're a short seller or a poet looking for a wealthy spouse, it never pays to be pessimistic.**

This chapter talks about Lynch's strategy with cyclical stocks. Cyclical can be a great way to make a buck if you buy them at the bottom, so it helps to look for opportunity in depressed stocks, rather than think of all the reasons why a cyclical is going to take losses. When cyclical stocks are so crushed by the economy that it seems things could not possibly get any worse, cyclical usually hit their bottom. Lynch goes on to talk about PE ratios of cyclicals, advising that the time to buy these is when their PE is at a historic high, because Wall Street has caught on to cyclicals and often begins to discount them before the market as a whole tops. When a cyclical is sitting on a very low PE, along side record profits that have grown for many years, the market is anticipating a downturn. When a cyclical reaches a high PE on very low earnings, the price may be ready for an upturn because earnings will be at or near their nadir.

Peter's Principle #20**Corporations, like people, change their names for one of two reasons: either they've gotten married, or they've been involved in some fiasco that they hope the public will forget.**

This chapter deals with utilities, especially nuclear power providers who suffer a temporary setback (like General Public Utilities, once proud owners of Three Mile Island Unit Two), but also other power utilities such as Consolidated Edison, who made massive losses as the price of oil skyrocketed in the 70s energy crisis, and yet regulators refused to allow the company to pass on the price to energy consumers. Although regulators can be a real burden on utilities, they are also their guardian angels, trying to prevent them from going entirely out of business, as long as people still need electricity the government regulators will not allow the company to fold. As a result utilities can take massive hits in the share price, but in all but a very rare few there is a support level from which they bounce back, often very spectacularly several years after the event.

Lynch quotes some specialist utility analysts who have identified four distinct stages in a utility crash and recovery.

Stage one: disaster. Either the cost of fuel has gone through the roof or a major accident has occurred, a huge selloff follows, where the utility may fall to 20 to 30 percent of book value in one or two years. Those who regard utilities as safe bottom draw blue chips usually get something of a shock if their once-a-decade examination of their portfolio happens to coincide with this period.

Stage two: crisis management. An austerity budget is adopted and the dividend is reduced or eliminated. Costs are cut to the point that the company can survive the disaster. At this point Wall Street isn't paying attention any more, and stock prices remain very low.

Stage three: financial stabilization. The company, now as lean and mean as it will ever get can now turn a profit on the cash it receives from its bill-paying customers. Share prices by now have doubled, they are selling at 60 to 70% of book value while still reflecting great value in the eyes of typical "value investors".

Stage four: recovery. The company can now once again make a profit and pay a dividend. Shares now sell at full book value. Where it goes from here depends a lot on how regulators allow it to pass on costs to customers and the reception from the capital markets, because the company needs capital to expand.

Peter's Principle #21

Whatever the Queen is selling, buy it.

When governments in democratic countries privatize public companies, they nearly always offer such attractive terms that shareholders are almost guaranteed to make great profits. All over the world, in Britain, Mexico, France, Greece, Chile, Hong Kong and even America (not as many in USA as you'd expect, all of their great companies are already private), IPOs of major public corporations almost always pay off. Often these stocks are offered at well below book value, and with attractive installment payment plans.

At the end of the book, Lynch writes **25 Golden Rules of investing:**
(Which is interesting because I count 26)

1. Investing is fun, exciting, and dangerous if you don't do any work.
2. Your investor's edge is not something you get from Wall Street experts. It's something you already have. You can outperform the experts if you use your edge by investing in companies or industries you already understand.
3. Over the past three decades, the stock market has come to be dominated by a herd of professional investors. Contrary to popular belief, this makes it easier for the amateur investor. You can beat the market by ignoring the herd.
4. Behind every stock is a company, find out what it's doing.
5. Often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long term, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient, and to own successful companies.
6. You have to know what you own, and why you own it. "This baby is a cinch to go up!" doesn't count.
7. Long shots almost always miss the mark.
8. Owning stocks is like having children - don't get involved with more than you can handle. The part-time stockpicker probably has time to follow 8-12 companies, and to buy and

- sell shares as conditions warrant. There don't have to be more than 5 companies in the portfolio at any time.
9. If you can't find any companies that you think are attractive, put your money into the bank until you discover some.
 10. Never invest in a company without understanding its finances. The biggest losses in stocks come from companies with poor balance sheets. Always look at the balance sheet to see if a company is solvent before you risk your money on it.
 11. Avoid hot stocks in hot industries. Great companies in cold, nongrowth industries are consistent big winners.
 12. With small companies, you're better off to wait until they turn a profit before you invest.
 13. If you're thinking about investing in a troubled industry, buy the companies with staying power. Also, wait for the industry to show signs of revival. Buggy whips and radio tubes were troubled industries that never came back.
 14. If you invest \$1,000 in a stock, all you can lose is \$1,000, but you stand to gain \$10,000 or even \$50,000 over time if you're patient. The average person can concentrate on a few good companies, while the fund manager is forced to diversify. By owning too many stocks, you lose this advantage of concentration. It only takes a handful of big winners to make a lifetime of investing worthwhile.
 15. In every industry and every region of the country, the observant amateur can find great growth companies long before the professionals have discovered them.
 16. A stock-market decline is as routine as a January blizzard in Colorado. If you're prepared, it can't hurt you. A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic.
 17. Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and stock mutual funds altogether.
 18. There is always something to worry about. Avoid weekend thinking and ignore the latest dire predictions of the newscasters. Sell a stock because the company's fundamentals deteriorate, not because the sky is falling.
 19. Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you've invested.
 20. If you study 10 companies, you'll find 1 for which the story is better than expected. If you study 50, you'll find 5. There are always pleasant surprises to be found in the stock market - companies whose achievements are being overlooked on Wall Street.
 21. If you don't study any companies, you'll have the same success buying stocks as you do in a poker game if you bet without looking at your cards.
 22. Time is on your side when you own shares of superior companies. You can afford to be patient - even if you missed Wal-Mart in the first five years, it was a great stock to own in the next five years. Time is against you when you own options.
 23. If you have the stomach for stocks, but neither the time nor the inclination to do the homework, invest in equity mutual funds. Here, it's a good idea to diversify. You should own a few different kinds of funds, with managers who pursue different styles of investing: growth, value, small companies, large companies, etc. Investing in six of the same kind of fund is not diversification.
 24. The capital gains tax penalizes investors who do too much switching from one mutual fund to another. If you've invested in one fund or several funds that have done well, don't abandon them capriciously. Stick with them.
 25. Among the major markets of the world, the U.S. market ranks eighth in total return over the past decade. You can take advantage of the faster-growing economies by investing some of your assets in an overseas fund with a good record.
 26. In the long run, a portfolio of well-chosen stocks and/or equity mutual funds will always outperform a portfolio of bonds or a money-market account. In the long run, a portfolio of poorly chosen stocks won't outperform the money left under the mattress.