The Motley Fool

MILLION DOLLAR PORTFOLIO

HOW TO BUILD AND GROW A PANIC-PROOF INVESTMENT PORTFOLIO

DAVID AND TOM GARDNER

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HarperCollins e-books

For our mother

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PREFACE

The concept for this book draws its origins from a meeting Tom had in New York with one of the world's great commercial leaders, Lew Frankfort, the impassioned chief executive of Coach. With a near 30-year tenure at the business, Frankfort is widely—and correctly—credited with transforming a troubled leather goods business into the world's leading handbag company. In its eight years in the public markets, Coach stock has turned a $10,000 investment into $150,000, earning investors 40% returns *per year*.

What Lew told Tom at that meeting in February 2007 changed The Motley Fool forever. Few companies do enough customer research, he said. Instead, they develop new products and services solely on the experiences, insights, and instincts of their internal team. "That won't work indefinitely," he cautioned. "You've got to be more obsessed with researching customers than with generating ideas. To be great for generations, your intuition alone about what customers want today *will not suffice*. Talk to them every day. Listen to them. Make an eternal effort of gathering and analyzing as much information about them as you can."

Tom returned to Fool Global Headquarters in Alexandria, Virginia, and we immediately created our Customer Insights division, headed by Ginni Bratti. She and her team now spend every day meeting with investors in face-to-face focus groups, over the phone, through video interviews, at member events, via surveys, and in our online community at fool.com. Today, we're inundated with customer statistics, comment lists, audio and video files, and memories of breaking bread (and uncorking wine) with our members from Minneapolis to Bermuda, Shanghai to Copenhagen, Stockholm to San Francisco, and beyond. Every day we listen and therefore learn more about what you—our fellow Fools—need to become better investors.

Just months after forming the Customer Insights team, we leaned heavily on customer feedback to design the most successful service in The Motley Fool's 15-year history, *Million Dollar Portfolio*, which is the origin of this book. By listening, we heard that investors like you want to:

1. View our best recommendations across all investment philosophies
2. Study how we build an active portfolio of stocks
3. See us invest alongside you
4. Get a clear picture of our performance against the stock market
5. Talk to other smart investors online

Million Dollar Portfolio (mdp.fool.com) is our answer to these and thousands of other requests from people like you. We now manage, in full view, $1 million of our own hard-earned capital. That money is allocated into the best investment ideas drawn from the research of dozens of analysts across our newsletter services and thousands of investors throughout our community. The portfolio includes value investments, dividend-payers, and growth stocks, as well as small-, mid-, and large-cap stocks from domestic and international markets. We announce all of our investment decisions before purchasing any stock, giving our members the opportunity to transact before we do. And we welcome both positive and negative feedback in the lively, ongoing, unedited interaction among our members online (which no other investment company in the world offers). Together, we are thrashing the market's average return.

This book distills all of that thinking into 11 chapters that will teach you how to build your own million-dollar portfolio using our very best strategies across all stock-investing disciplines. What you will find in these pages are philosophies that in certain scenarios stand in direct opposition to one another. The principles needed to invest effectively in domestic mid-cap growth stocks do not perfectly replicate those needed to win with international small-cap turnaround stocks, of the sort that Motley Fool star investor Bill Mann has uncovered for years. Don't let these contradictions throw you. The more you invest, the more you'll come to realize just how many roads there are to prosperity for disciplined investors.

As students of the great masters—from Ben Franklin and Ben Graham to Warren Buffett and Peter Lynch—we're committed to teaching the timeless principles of successful investing using plain language. We want you to enjoy every page of this book and to leave these pages equipped to lay a permanent foundation for your financial independence. It is through the habit of continual saving, the discipline of regular investment, the deployment of fifth-grade mathematics, the use of a collection of superior investment strategies, and the power of your imagination that you will meet with enduring success.

What you will find in this book is the unveiling of the core strategies that have led our newsletter services to beat the market substantially. The ambitious aim of this work is to assemble these competing investment approaches into a single strategy that will help you take your portfolio to $1 million and beyond.

Here's a quick peek at the performance of some of our investing newsletters:

	RETURNS	S&P 500 (OVER COMPARABLE PERIOD)
Stock Advisor	53%	11%
Hidden Gems	24%	2%
Income Investor	16%	9%
Rule Breakers	11%	−1%

As you read, remember that the greatest investors in history are multifaceted. They're like the brilliant performer Frank Miles, who at our company's annual meeting in 2008 juggled knives, torches, bowling balls, and stun guns—before twirling by on a unicycle. If they were baseball hitters, they'd draw walks, spray the ball to all fields, hit for power, and bunt. If they were composers, they could play all four families of musical instruments in the symphony. You see, the true master investor could never be categorized solely as a growth or value or income or even a domestic investor. Because the truly great investor can do it all. So, too, we believe, can you.

Since the creation of The Motley Fool in 1993, our greatest pleasures have come when we recognize that our work is an adventure into things we cannot yet see. No one knows what's next. We can merely calculate the probabilities. And so, the art and the mysteries of commerce and investing richly reward the adventuring spirit and the prepared mind. One meeting in New York with the CEO of Coach has changed the fate of The Motley Fool. We hope this book will change yours.

—David and Tom Gardner

A NOTE ON THE FINANCIAL COLLAPSE OF 2008

OCTOBER: This is one of the peculiarly dangerous months to speculate in stocks in. The other are July, January, September, April, November, May, March, June, December, August, and February.

—Mark Twain

On September 29, 2008, the S&P 500 cratered 9%—the worst single day for the broad-market index since the crash of 1987. And yet that was merely one in a series of steep declines in 2008 that wiped out more than five years of market gains. In fact, at its low, the S&P 500 touched prices unseen since May 1997. That's 11 years of 0% returns!

Having endured that, you may well be scratching your head as to why you'd ever read an investment book. Who wants to buy stocks when the market is fragile and faltering? The answer might surprise you: *Warren Buffett, the world's greatest investor*. One of our top analysts at The Motley Fool, Anand Chokkavelu, discovered something fascinating about Buffett. He had around $45 billion sitting in cash at the end of 2004. And 2005. And 2006. And 2007. In fact, at one point, Buffett had 20% of the asset base of his company, Berkshire Hathaway, in money market funds. But when the market crumbled, he adapted. In the four weeks ending with October 13, Buffett put $20 billion to work in the world of equities.

You see, for long-term investors, now is precisely the time you should be reading an investment book and determining what to do with your savings. But the last thing you'll want to do is to invest without fully understanding the risks you're taking. The lesson from the Mark Twain quote that leads us in to this chapter is simple: *Do not speculate* (the same as the mantra of Hettie Green, America's first female mogul investor). And so let's stay out of speculation mode by reviewing together exactly what happened with this market crash, and then we'll wend our way through the book, assembling the ideal approach for building your everlastingly rock-solid stock portfolio.

SO, WHAT HAPPENED?

For answers, we turned to Fool analyst Matthew Argersinger. What started out as a "subprime" mortgage problem in late 2007 quickly snowballed into a full-blown financial crisis in 2008, laying waste to multibillion-dollar investment banks like Bear Stearns and Lehman Brothers. AIG, the largest insurer in the world and a former Dow component, was forced to take more than $120 billion in emergency loans from the U.S. government and to give up 80% of its ownership equity to taxpayers just to keep its doors open. Fannie Mae and Freddie Mac—the structurally flawed backbones of America's $12 trillion home mortgage market—imploded under massive losses. Washington Mutual became the largest U.S. bank failure in history.

By the end of the month, the financial sector was literally falling to pieces. Within days, the U.S. government abandoned CPR techniques and reached straight for the defibrillator. When on October 3 the U.S. Congress committed to spend up to $700 billion to purchase distressed assets and buy stakes in America's largest banks, the total investment by U.S. taxpayers crossed the $1 trillion mark. That's the largest bailout of any kind in history! Yeesh. Just let that sink in for a moment. . . . Now that you have, the natural question is:

HOW DID IT ALL HAPPEN?

You can point to three overarching themes: cheap money, leverage, and greed. Let's take 'em one by one.

Cheap Money

In general terms, sharp increases in the availability of money can often lead to unsustainable booms in the prices of securities, real estate, and commodities. In the wake of the economic recession that ensued after the dot-com bust and September 11, the Federal Reserve, under then-Chairman Alan Greenspan, reduced interest rates to 1% and held them there for over a year. With interest rates at historic lows, the cost of all types of loans—mortgages, auto loans, credit cards—shrank dramatically. Cheap money allowed homebuyers to purchase pricier houses than they could otherwise afford while flexing more spending muscle at the shopping mall. At the same time, access to cheap credit allowed public companies, as well as private equity players, to borrow money and buy up other companies at extremely high valuations.

In short, all of this cheap money fed higher asset prices. That eventually contributed to a speculative boom in real estate, to massive debt-fueled consumption on the part of consumers, and to an explosion in leveraged buyouts.

Excess Leverage

But if money and credit were the flames that lit the fires of the credit ka-boom, excess leverage was the gasoline. As asset prices rose and money stayed cheap, both consumers and companies took on enormous amounts of debt. Consumers refinanced their houses and borrowed trillions against their homes' equity to satisfy increased spending habits. At the same time, corporations—particularly banks and financial institutions—levered up their balance sheets with new types of asset-driven securities and derivatives. Some of these securities, like those tied to subprime mortgages, offered extremely tantalizing yields. And most of them—thanks to "sophisticated" financial engineering and the blessing of myopic credit agencies—came with triple-A credit ratings. They were simply too good to pass up (and too good to be true). Besides, the prevailing belief at the time was that housing prices rise without interruption, *always*.

Greed

Underpinning all of this excessive leverage and wanton risk-taking was pure, unadulterated greed. By the late stages of the housing bubble, mortgage lenders like Countrywide were giving mortgages to people who had no business buying a home. But that didn't matter because—under the new financial securitization schemes—new loans were simply packaged into highly rated securities and sold off to investors. Mortgage lenders weren't getting paid to underwrite a good mortgage; they were being rewarded for writing just *any* mortgage. On the other side of the table, Wall Street banks like Bear Stearns and Lehman Brothers were making a killing writing and selling securities and derivative instruments based on those dicey mortgages. And banks, hedge funds, and insurance companies were more than happy to lever up on these high-yielding securities to boost their returns. Meanwhile, executives at each of these firms were pulling in hundreds of millions of dollars in salaries, bonuses, and stock options. Finally, let us not ignore that a subset of consumers speculated in real estate to a ridiculous extreme, expecting that they could endlessly flip their properties onto eager buyers at inflated prices.

It didn't take long before homebuyers, having bought more house (or houses) than they could possibly afford, simply stopped making their monthly mortgage payments and walked away from their properties. Suddenly, those coveted mortgage securities that no bank could seem to get enough of were worth a whole lot less (some bordering on worth-*less*). Credit froze as banks curtailed lending and rushed to de-lever their debt-choked balance sheets. Hedge funds that had borrowed heavily to invest in these now defunct securities rushed to sell other stocks to meet margin calls. Prices for all types of assets plunged. Wall Street and the mortgage industry's house of cards came tumbling down, destroying trillions of dollars in stock market wealth in the process and leading to the largest government rescue in American history.

That's the most succinct way we can explain what happened. Next question…

WHAT IS THE FOOLISH INVESTOR TO DO?

It's never a good feeling to see the values of 401(k) accounts, IRAs, and brokerage accounts get thrashed. In times like this, it's best to take a deep breath, stop obsessing over the day-to-day gyrations in the market, and get some perspective on the current crisis.

Bear markets—commonly labeled as a decline in a market index of 20% or more—emerge every five years or so. The average length of a bear market is 15 months, with an average decline of just over 33%. As this book went to press, the S&P 500 had fallen more than 40% from its peak back in October 2007, showing that this bear comes from the grizzlier side of the forest.

That said, it also means—at least from a historical perspective—that, by now, we are probably most of the way through this particular bear market. And the average bull market that rumbles in afterward usually lasts for five years and yields 166% in cumulative gains. **So avoid the urge to sell your stocks recklessly.**

Better still, bear markets have a tendency to create serious bargain prices in top quality stocks. After all, the business of most public companies has nothing to do with real estate speculation, and there are loads of companies that have no leverage whatsoever. Why, we ask, should a company like Netflix see its stock fall 50 percent just because bankers and a small population of land speculators ruined their financial lives through short-term greed?

In our opinion, if you're making regular contributions to your brokerage portfolio or retirement account, you're now picking up good stocks on the cheap. If retirement is still more than a decade away, and you've got extra cash on the sidelines that you won't need for the next three years or so, allocate even more money to stocks during these tough times. Above all else, **stick with a plan and *keep* investing**.

And while you're at it, stay far away from companies that are lining up for their piece of the government's bailout package. While companies like AIG and Citigroup spend valuable time soaking up taxpayer money—de-leveraging their tattered balance sheets and deluding shareholders—good companies can reinvest in their business, gobble up weakened competitors, and grow their market share. These are the companies that will deliver huge rewards once the market turns and the economy gets back on its feet.

Finally, Fools looking to make money in both bull *and* bear markets should check out our *Motley Fool Pro* service. Using long-short strategies and options for protection, *Pro* is designed to boost your returns in up, down, flat, and topsy-turvy markets like 2008. You can take a look at that entire service by visiting motleyfoolpro.com.

LOOKING AHEAD: HOW CAN THE FOOLISH INVESTOR AVOID THE NEXT FINANCIAL COLLAPSE?

First, it's important to acknowledge that there will be more credit crises and more bear markets in our future. But there are some important warning signs and crucial steps we can take to prepare our portfolios for the eventual calamities.

Focus on living within your means. Most of the people who found themselves in the direst of straits in 2008 are those who spent themselves silly and ended up with too much credit card debt and mortgages worth more than the value of their homes. Setting a reasonable budget and keeping a rainy-day savings account handy will keep you investing in the market and prevent you from having to dip into your retirement accounts at the worst possible times.

Watch out for excessive leverage. Right before its collapse, Lehman Brothers' assets-to-equity ratio (a common measure of leverage for financial companies) was 25 to 1. AIG's was 11 to 1. Compare that to Berkshire Hathaway's ratio of 2 to 1. Stick to companies that have low assets-to-equity and low debt-to-equity ratios, and high interest-coverage ratios.

Be skeptical of long periods of low volatility. How volatile has 2008 been in the markets? Think back to the most terrifying roller coaster ride you've ever been on. Now multiply that experience by 10. So far, there have been a total of 37 days when the market closed up or down by more than 2%—and that doesn't count intraday moves of that magnitude. In 2007, there were just 17 such days. In 2006, there were only *two* such days. Like the calm before a storm, persistently low volatility markets are strong signals of complacency among investors and markets. That's usually a signal that stormy waters might be just around the bend.

Look out for bubbles. Market bubbles are crystal clear in hindsight, but difficult to spot when inflating. Yet you might have had at least an inkling that things had reached silly proportions when profitless dot-com companies were awarded billion-dollar valuations in the late ’90s, or when hundreds of people camped outside during the real estate boom just to get a shot at the latest luxury condo offering. When your next door neighbor or coworker starts boasting about the latest can’t-lose, get-rich-quick scheme, it’s time to get skeptical. Stick to a steady investment plan and don’t chase hype.

Stick with great companies with little to no leverage. Great companies will survive and thrive through any market cycle. This book will help you find them.

And now, let’s start assembling your portfolio for the future!

CHAPTER 1

GETTING STARTED

Americans make three primary investment mistakes.

A startlingly large portion of our populace stands on the market's sidelines forever, missing out on the greatest builder of wealth available to the average (law-abiding) citizen. Many Americans just never save—or invest—anything. This is the greatest mistake of all. No matter your age, the best time to start investing is now.

The second biggest investment mistake is waiting too long to start. It turns out that financial independence can't be achieved as quickly as everything else in our lives: 90 seconds in the microwave oven, one-click buying on a Web site, or speed dial on our mobile phone.

The third biggest investment mistake is the subject of this book. People with this affliction might have money put away and may have purchased some mutual funds and even a few stocks. They've recognized the value of getting started, allowing the returns to compound over time. They make us proud. But they often have one tragic flaw: They are wildly unsuccessful pickers of stocks.

PICKING *GOOD* STOCKS

Investors often pick the wrong stocks and build the wrong kind of portfolio. They lack any coherent strategy. When the stocks they buy inevitably drop—at least temporarily—these folks cash out their shares and take a loss, running from the market altogether. Or they invest in bad stocks and stay with them for too long, "just hoping to get back to even." These strategies combine the damaging elements of desperation, blind optimism, and greed.

But even the most comically inept investor is in a far better situation than the non-investor or the late-comer. Because while the first two groups need to undergo a near-religious conversion before they see the light, a bad investor just needs a bit of strategy and guidance to accompany an existing practice and passion. This stuff is eminently teachable. It's what this book is for.

Think about how hard it is for many of us to get past those first two mistakes. The odds are stacked against an early start at successful investing. Most Americans begin their professional careers saddled with credit card debt and student loans while trying to pay for all that life entails, often on a relatively small starting wage. There's not a lot of cash floating around.

And even in the unlikely event that their couch cushions were overflowing with $20 bills, most people wouldn't know how to properly put the found money to the best possible use. Our high schools and universities have failed miserably to educate their students about how or why to invest. For the most part, no one has stressed the importance of saving and the value of investing, so they wander relatively blindly (or at least shortsightedly).

These are thorny, sometimes seemingly insurmountable issues and we by no means intend to belittle or gloss over them. In fact, previous Motley Fool books and countless Fool.com articles have provided advice and step-by-step guidance on how to work through them. That's our mission.

Once you're ready, we're here to inspire you to not only invest, but to invest *well*. There are two components to investing well: