4-7-1993

Individual Stock Selection: A Place in the Investment Portfolio; Participation in 1993 Acreage Reduction Program Looks Profitable

John A. Sondey
South Dakota State University

Donald Peterson
South Dakota State University

ECONOMICS COMMENTATOR

SOUTH DAKOTA STATE UNIVERSITY
No. 320 April 7, 1993

INDIVIDUAL STOCK SELECTION: A PLACE IN THE INVESTMENT PORTFOLIO

by John A. Sondey

Assistant Professor
Economics Department

Introduction

The way that Americans save and invest has changed markedly. With interest rates on savings and debt instruments at 20 year lows, mutual funds appear more suitable as an investment. The funds currently manage more than $1.5 trillion in assets - up from $50 billion in 1977. This past year, nearly $1 billion a day in new money flowed into funds.

In short, mutual funds are redefining investment, liquidity, and what we regard as money. Mutual funds are becoming the financial middlemen of choice, attracting money from individual investors, then pooling that money to buy foreign and domestic financial instruments. Risk is lowered and investors gain professional expertise in the management of their assets. The merits of the mutual fund as an investment vehicle are indisputable. However, funds should not be regarded as a complete replacement for individual stock selection. Rather, there is a complementary - rather than a substitute relationship - between the two avenues of personal investment.

Economic Cautions

With spring beckoning, the Clinton administration settled in, and the New World Order awry, the investment picture looks murky. Granted, recent statistics on US unemployment (7%) and new jobs creation indicate the economy is moving in the preferred direction. However, much of the developed world remains in recession, with flat or falling output and consequent weak demand for US exports. Adding to the uncertain investment climate is the

(Continued on page 2)

PARTICIPATION IN 1993 ACREAGE REDUCTION PROGRAM LOOKS PROFITABLE

by Don Peterson

Extension Economist
Marketing & Management

Participation in the government's Acreage Reduction Program (ARP) looks like the most profitable choice again for most South Dakota farmers in 1993. Two major exceptions are when ASCS established yields are significantly below expected actual yields or when there is a long term goal of building the base of a particular crop.

Using average yields as reported by the S.D. Crop and Livestock Reporting Service (SDCLRS), "average" expected costs of production and current harvest time prices, one concludes that participation in the ARP could make a difference between a positive return to labor and management or a negative return. However, since yields vary greatly across crop reporting districts, decisions should be based on farm specific evaluations not crop reporting district averages.

For the corn bases in the eastern one-third of the state, participation can increase returns over variable costs by 60-75%, compared to non-participation with 100% of the base planted to corn. In the central one-third of the state, benefits are even greater.

Soybeans look good on corn normal flex acres (NFA) but not as good on optional flex acres (OFA) when using SDCLRS average yields. Compared to corn on NFA, soybeans increased returns over variable costs by 4% to 7%. However, soybeans on OFA reduced returns.

The story is much the same for spring wheat land. Participation pays, boosting returns over expected operating costs by 80% to more than 90%, using average

(Continued on page 4)

volatile state of the Russian political structure. Stock markets tend to react negatively to increased uncertainty. For example, in 1992, generally conceded to be one of economic strengthening in the US, the Standard & Poor's 500 stocks traded in their narrowest range ever, from 394.5 to 437, a 10.8% variance. Nonetheless, on a historical basis, the average annual return on stocks since the mid-1920s (dividends included) approaches 12% - offering a superior return over investments in bonds and savings.

Belying the general inertia of the broader stock market averages is the inflow of money into stocks. With short term interest rates at less than 3% and long term US bond rates declining below 7%, the stock market appears to many as the only game in town, and mutual stock funds the preferred ticket of admission. Until market pressures force higher interest rates on "safer" investments (savings and bonds), the stock market will be the alternative of choice. The growing impact of mutual funds is inherent in the fact that institutions, rather than individuals, now hold the majority of corporate shares outstanding. Instead of holding a portfolio of individual corporate shares, many investors now prefer to maintain a portfolio of different funds.

A Pricey Market

The influx of fresh money has put upward pressure on stock prices. Stocks are currently selling at a pricey 2.4 times book value and 24 times earnings. Concurrently, the average yield on stocks has declined to 2.9%, a level when triggered previously, has signaled significant corrections in the overall market. Many market analysts feel that a serious correction of 10% - 15% is likely to occur in 1993.

The Rationale Against "Stock Picking"

If the stock markets are oversold, with demand for equities increasing faster than new stock issues, what then is the logic behind individual stock selection? Certainly, the funds offer the individual investor a diversity and a lower level of risk than stock picking. And, it appears that the feverish level of activity in the market, as reflected in the average daily volumes and mutual fund expansion, may have increased the element of risk.

Indeed, according to the "efficient market" hypothesis, it is folly for the individual investor to carefully study the market in order to gain above average returns. He or she would do just as well in selecting stocks by throwing darts at securities' listings in the Wall Street Journal. In this context "efficiency" refers to the speed which competitive markets absorb information and translate it into price changes. According to the strongest variant of the efficient market hypothesis, all information - that which has been publicly transmitted through the media, plus that which is privately held and kept from the public - is currently reflected in stock prices. After all, insiders do trade. Accordingly, personal market research would be a poor investment in time and effort and investors would be well advised to buy a fund which embraces the broader market.

The Rationale in Favor of "Stock Picking"

So far, we've examined the rationale for not investing in individual stocks and the perceived wisdom of limiting risk exposure through investment in broad-stanced stock funds. Under what circumstances then, would investment in individual stocks be economically rational? First, let's look at the risk inherent in the purchase of a particular stock. The "dean" of investment analysis, Benjamin Graham, provides us with some insight in his volume, The Intelligent Investor, published in 1973:

> "The investor must recognize the existence of a speculative factor in his common stock holdings. It is his task to keep this component within minor limits, and to be prepared financially and psychologically for adverse results that may be of short or long duration."

There is a speculative component in every investment decision, including mutual funds. The decision to indirectly invest in stocks through a mutual fund rather than directly, through individual stocks purchases, might reduce that risk component, but not eliminate it. However, it is the author's position that one's overall investment portfolio should include a more speculative component - that the desire to limit risk to the maximum extent possible may also reduce portfolio return. The unscientific case for some investment in individual stocks, rather than complete reliance on mutual funds for a portfolio's equity component, is as follows.

1. As noted, mutual funds themselves have innate risk. Sectoral funds which invest only in one area of the economy (say, technology) run the real risk of greater volatility than the overall economy. Conversely, index funds, which span the entire market (Standard and Poor's 500) run the risk of missing large returns which may occur in specific sectors.

2. There is reasoned risk taking and there is "kamikaze" behavior. Intelligent risk taking behavior occurs when a stock is well researched and an expected value calculation compared to the level of investment. On the other hand, it is considered wild speculation when an "investor" pounces on a hot stock tip like a cat on a mouse, all the while oblivious of the underlying fundamentals of the stock.

3. Different individuals have different preferences (abhorrences) for the same level of risk as they might for equal quantities of good X. Risk abhorrers should avoid risk whenever possible, while risk preferers can undertake a good deal more. What is essential is that the element of risk must be identified, quantified as much as possible and plugged into the expected value calculation before undertaking an investment.

4. Variability risk refers to the undulations of a security's price and dividends over time. Generally, there is a distaste for variability risk and a preference for securities with a more certain yield and end (of investment) value. Therefore, securities whose returns are highly uncertain will sell at prices that will earn their holders higher returns - a premium for willingness to incur greater risk. The historical excess of yields on stocks over yields on government bonds reflects the variability premium for higher risk undertaking.

5. Individual investors can reduce the risk in their hand-crafted portfolios through careful stock selection. A stock in an industry which performs well in inflation (real estate, gold mining) can be matched with one that performs well in periods of stable prices (banking).

6. Mutual funds are constrained in the amount of any one stock that they can hold as a percentage of fund assets. If stock X, which constitutes 5% of fund Y triples in value, the value of the fund will rise by 10%. If that same stock constitutes 20% of Investor **A's** portfolio, his asset value will rise by 40% (naturally, this weighted effect will be equally detrimental to **A** if the stock nosedives).

7. Some stocks are essentially ignored by Wall Street analysts, and hence excluded from funds. Peter Lynch, legendary manager of the Fidelity Magellan fund for 13 years, notes his interest in such issues in <u>One Up on Wall Street</u>, published in 1989.

8. Individual investors can and do outperform the market. Peter Lynch notes that 61.9% of the individual chapters of The National Association of Investment Clubs have bettered or equaled the S+P 500 over the course of their existence. Lynch advocates a "hands on" strategy of researching the stocks of companies that make products the investor is familiar with and enjoys. If a product interests you, check the track record of the producer's stock in the <u>Value Line</u> (at $55, its introductory offer is a bargain) or <u>Moody's Handbook of NASDAQ Stocks</u>, or some other compendium. Chances are strong that your local library has an adequate set of research tools for the aspiring stock selector. Per Lynch, 5 stocks in diversified areas provide an adequate portfolio while more than 10 may become a burden for a part time investor.

9. Individual stock selection is not for the squeamish. Lynch notes that in the past 70 years where stocks have outperformed bonds and money market instruments, there have been 40 declines in the market of over 10%, including 12 of over 25%. Therefore the serious stock picker must be willing to hang on during the inevitable downward plunge in order that his/her stocks might rise again.

SOUTH DAKOTA STATE UNIVERSITY
Economics Department
Box 504A
Brookings, SD 57007

10. Outperforming the averages is satisfying and provides what we like to call nonpecuniary income. Moreover, as one hones his/her stock researching skills, the money returns are more apt to grow than shrink.

<u>Summary</u>

Stock selection is not for the faint of heart nor the strongly risk averse. However, through reasoned stock choices and the acceptance of a greater element of risk, the careful investor can increase the return on his/her overall asset portfolio. As with all skills, there is a learning curve behind stock selection. Repeated analyses will refine these skills and increase one's efficiency (and returns) as an investor.

****

(Participation ... cont'. from p.1)
numbers. Where soybeans do well, soybeans look more profitable than wheat on wheat NFA.

With current contract prices for sunflowers, sunflowers look good on both wheat NFA and OFA. If a wheat base is put into 0/92, soybeans look like the preferred crop on the NFA and OFA with sunflowers on the 0/92 acres. When sunflowers or any minor oil seed are put on 0/92 ground, the marketing loan provisions for that minor oil seed are lost. Therefore, the oil seed should be controlled to protect its price. Foregoing the deficiency payment for the sake of the loan protection seems extra risky. Planting oats on flex acres may be profitable for producers, who have higher than average yields.

This article is intended to indicate only some general directions. Space does not allow for an analysis for every crop for every reporting district. Each producer needs to calculate his/her own decision numbers. All county agents in South Dakota have computer software which can facilitate calculations. For those producers with IBM compatible home computers, the software is available from the Cooperative Extension Service.

****

ECONOMICS
COMMENTATOR

EDITOR: Donald C. Taylor, Agricultural Economist

ECONOMICS DEPARTMENT
South Dakota State University
Box 504A
Brookings, SD 57007
Phone: (605) 688 - 4141

450 copies of this newsletter were produced at a cost of less than $100.