

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## Should you buy a Hot Stock?

*By Gil Hanoch, September 7, 2006*

Did you ever get a stock tip? Do you know of a company that looks very promising? Before rushing to invest in the company, this article will point out a critical principle that many investors overlook.

First, a disclosure is needed: QAM does not buy individual stocks for its clients or for its members. Many academic studies show that most investors and professional money managers lose money when compared to market indexes. Therefore, QAM views individual stock selection as a speculative activity that may have entertainment and excitement benefits, but no expected financial benefits.

Note that this disclosure does not apply to stocks and stock options given by an employer. These may be held for a limited period, to reap the value of discounted pricing and tax benefits.

If you are considering buying a stock, whether for speculation or entertainment, you want to maximize your chances of making a profit beyond the market indices, to justify the risk taken. The following principle will help you avoid certain losses that many stock-pickers incur.

The value of a stock is negatively related to its price. Specifically,

- The more expensive a stock is, the less attractive it is.
- The cheaper a stock is, the more attractive it is.

Note the following implied and related points:

1. The stock price compared to the company's earnings (P/E ratio) gives one indication about whether a stock is expensive. This should be your first step in choosing a stock. A glaring warning signal about a dangerous stock is a high P/E ratio. If people would have used this single warning signal during the tech boom, they could have avoided most of their losses.
2. **The more the stock price increased recently, the less money you will get to make.** This is by far the most important point to remember. Not understanding this is a big reason people underperform the general stock market. Buying a hot stock is like buying a car after a huge sale ended, or when there is huge demand and the dealer is asking for an excessive price.
3. A poorly performing company may not be a bad investment. An important factor to consider is whether or not the company's stock price is low compared to the actual future earnings of the company. This requires correctly predicting the future earnings of the company. For the price to be low, most smart and hard working analysts in the world should disagree with your opinion about the future earnings and be wrong, while you should be right.
4. The earnings of a company may be distorted or stated based on different assumptions for different companies. A good analysis should include a detailed review of the footnotes of the company's financial statements and other information that is not highly visible.

### To Summarize

Because of all the difficulties in consistently finding good investments, you would be best putting your money in index funds and focusing on the best asset allocation, tax planning, estate planning, etc. If you cannot fight the urge to beat the market, please treat it as speculation or entertainment, and allocate to it a small amount (e.g., 5% of your money or less) accordingly.

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