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FINANCIAL JARGONS TO KNOW

Asset Stripping- The term was first coined in the UK in the late 1960s to describe the practice of taking over a company, splitting it into parts and selling them for a profit. It was a derogatory label since it implied no effort on the part of the acquirer to develop the company. By the late 1980s asset stripping was more in tune with the spirit of the times, so when the practice once more swept through the corporations of the UK and the United States of America, it was more likely to be called " financial restructuring"

Backwardation- In a futures, market the price of a contract for future delivery of, say, a commodity usually trades above the spot price because the notional interest received from holding cash rather than the underlying commodity pushes the spot price above the futures price. This is a backwardation, also known as an inverted market.

Delta – For speculators, one attraction of options is that they offer lots of Leverage. However, the price changes of options do not follow changes in the price of the shares over which they have rights penny for penny. The price relationship between shares and their options is measured by an option delta. This indicates the amount that the price of an option will move for a given change in the price of its underlying stock. Say that past observations had measured the delta as .6. Then a 10p change in the price of the shares could be expected to produce a 6p change in the price of the option. For a call option Delta will always be

LESSONS OF THE MASTERS

In any pursuit there are some people who bring genius to the activity in question. But genius, almost by definition generally lies beyond the scope of analysis. This is not to say it cannot be analyzed, but to question whether analysis will bring much benefit to those who aspire to emulate by way of imitation. You cannot play the tenor saxophone like Charlie parker or tennis like John McEnroe simply because you have figured out how they did it.

With investing it is a bit different. At the margins of the distribution curve for investing ability there are players who could not be described as geniuses, even if – on the evidence of the previous essay – we might wonder if they are just not supremely lucky. Their record almost inevitably attracts close scrutiny, so predictably what makes them tick has become the subject of a cottage industry of investment writing, although a good chunk of it seems to get bogged down in irrelevant detail.

Much is made, for example, of the fact that two undisputed masters, Warren Buffet and Sir John Templeton, both make a virtue out of operating well away from the hurly-burly of Manhattan.

Leaving flippancy aside, there are lessons to be learned from the masters which can bring benefit to lesser mortals. These can be summed up in simple headings that could constitute a checklist for success in most occupations. Effectively the new principal went up. You can't do anything with this new principal. But like the house you live in, you can feel good that its price went up.

Technical skills:

These are too often taken for granted, yet they are crucial. For instance, the "how to do it" books written about both, or by, the masters pay too little attention to gathering the humdrum accountancy skills needed to understand a balance sheet. But without them, the idea that someone can buy shares with confidence is fanciful. The fact is that investment as far as shares are concerned, is written about in the language of accountancy.

It requires the knowledge and experience to assess qualitatively the profits that a company generates, to question for example whether they depend too much on capitalizing expenses into the cost of inventory or offsetting charges against allowances already provided for.

This is the approach followed by Warren Buffet.

Now comes an important question, for successful investing is it better to know a lot about a little or to know a little about a lot? Mr. Buffet is clearly in the lot about a little in school. He makes a virtue out of knowing a little about whole rafts of US industry. He has never owned a technology stock, for example. But as he told "Adam Smith's Money World", a business TV program: " I don't have to make money in every game. I mean I don't know what cocoa beans are going to do. You know there are all sorts of things that i don't know about and that may be too bad. But why should i know about all of them?"

Junk Bond- A colloquial term for a high yielding or non investment grade bond. Junk bonds are fixed- income instruments that carry a rating of 'BB' of lower by S&P's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment- grade bonds.

Bellwether Stock- Just as a bellwether sheep is the one in the flock that all the others follow, so a bellwether Stock is the one that is supposed to lead a market. It follows, therefore, that such stocks will be the ones with big capitalization, which can also reflect signs of which way the economics in which they trade are heading. In the UK Vodafone and BP Amoco fulfil this role as do, for example Microsoft, General Motors and General Electric in the United States and Mitsubishi and Nippon Steel in Japan.

Bearer security - A security for which evidence of ownership is provided by possession of the security's certificate. The issuer keeps no record of ownership. A Eurobond is generally issued in bearer form. It was common for US Treasury and municipal authorities to issue bearer

Benjamin Graham's approach

Alamy

Now let's look at the approach adopted by Benjamin graham called the "Bargain Issues". The aim of this approach was to choose a diversified group of common stocks, all of which sold for less than the per share balance- sheet value of a company's current assets minus the combined value of its current liabilities, debt and provisions should be greater than the stock market value of the entire company.

In John train's apt phrase, this was like buying a furnished house for less than the price of the furniture.

After all in this exercise the buyer doesn't pay for the fixed assets of the business the lands, building plant and equipment. Assuming that someone somewhere will believe there is even a half-decent return to be made on those assets, then the stock value of those assets will eventually rise.

At its extreme this approach does not eve require its acquirers to know the names of the companies. All they need to know is that the stocks satisfy a quantitative criterion and that their activities are diversified to remove business risks. This is just the power of computing power, which is why Mr. Graham's bargain issues, and similar approaches, are less successful now than they were in Mr. Graham's day

Not that today's outstanding investors have much time for efficient markets, as we also discovered in the second essay. Indeed, many of them have little truck with the whole paraphernalia of portfolio theory, the development of which is closely tied to the concept of market efficiency.

Hedge Funds realized that they could raise their returns as long as the market's returns were greater than the cost of borrowing. But there is also portfolio theory saying that there is a positive correlation between risk and reward. It also says that the risks and rewards within a single portfolio stem largely from the overall risks and returns being offered by the market. From this it follows that the returns which result from picking specific investments – stocks, currencies, or whatever – are a small part of the total.

The Mental Approach:

Contrast the following two quotations: "As a student of human nature, I have always felt that a good speculator should be able to tell what a market will do with his money before he does". And "By arguments, examples and exhortations we hope to aid our readers to establish the proper mental and emotional attitudes towards their investment decisions… We hope to implant in the reader a tendency to measure or to quantify...The habit relating what is paid to what is being offered is invaluable trait in investment. "

The first quote belongs to Bernard Baruch, famous trader on the NYSE. The second comes from Benjamin Graham's the intelligent investor, one of the most widely read books on investment ever published. They encapsulate each end of the investment spectrum. On the one hand there are investors as poker players, looking to trade off the hopes and fears of the market to make a turn; on the other hand there are investors as savers, knowing that investing only when the odds are stacked firmly in their favour combined with the wonders of compounding will bring satisfactory returns in the long run.

Both approaches have something to commend them, although it is obvious that Mr. Graham's "good value" approach has more to offer an investor of limited resources. But even such a cautious approach has its difficulties, as Mr. Graham acknowledged when he wrote that the investor's chief problem was likely to be himself. The continual urge to do something – anything- scuppers the best laid investment plans.

"It was never my thinking that made big money for me. It was always my sitting. Men who can be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money." This quote would do justice to Warren Buffet at his most avuncular. Yet the author was more Jesse Livermore, a contemporary of Messrs Baruch and Kennedy, who made and lost several fortunes in a frenzy of dealing before he killed himself. He would have known.