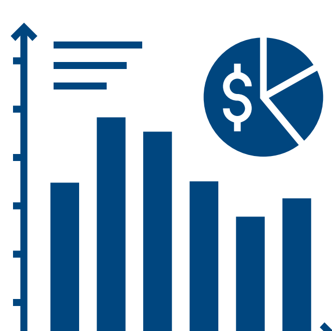
Special Research Report

10 TIPS TO SAFER, MORE CONSISTENT PROFITS

What are the secrets the "pros" use in managing their investment portfolios? How do you know when to take a loss? Pulling on the inside tips that the best professional money managers use, this exclusive report helps you improve portfolio profits… while reducing both risk and anxiety in the biggest bear markets.



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10 Tips to Safer, More Consistent Profits

Investing can be distressing at times… even for the pros. It has become more so with the bursting of back-to-back bubbles in technology and real estate investments and the washouts that ensued. The overconfidence that preceded the market peaks and led to extremes in 2000 and 2007 gave way to distrust and nervousness. Now as investors increasingly seek guidance, they are presented with media headlines that pull them in all directions.

For the sake of safety and more stable profits, it may be time to relearn some of the proven tenets of investing. Relying on sound technical and monetary analysis, like that provided by InvesTech Research, is a critical step in making more informed investment decisions. Also in the *InvesTech Research* newsletter, we offer a simple portfolio strategy that focuses on sector exchange-traded funds (ETFs). Whether you follow our Model Fund Portfolio or invest in individual equities, here are some straight forward and timeless tips that will help you improve your portfolio management.

TIP #1: Try to separate your emotions from the market.

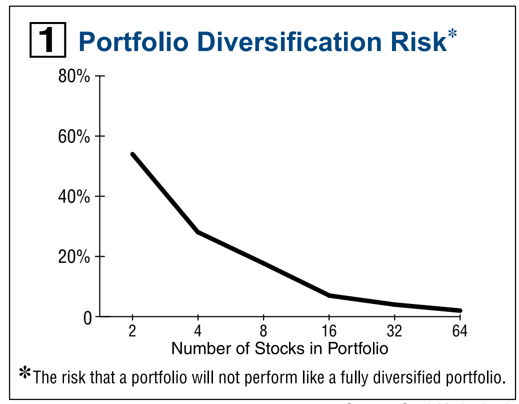
Do you ever find yourself scrambling to buy a stock when the market is up 250 points, or near panic and ready to bail out on a big down day? Relying on objectivity and a good historic perspective reduces the chance that you'll get burned by a knee-jerk decision, but you have to separate emotions from the market to prevent it. That means ignoring media headlines. Let's face it, drama sells magazines, but doesn't help you remain objective.

One needs to recognize that there are certain classic conditions that mark nearly every best and safest buying opportunity in the stock market. There are also key bear market warning flags, which appear in the final stages of aging bull markets and allow you to keep your feet on the ground when euphoria reigns supreme. That's why learning to track InvesTech's technical models is so valuable. When making a decision to purchase or sell a stock or fund, ask yourself, "What is my reason for doing this?" If the answer is based on fear –of loss or of being left behind– then you might not be making the right decision.

TIP #2: Diversify, but don't overdo it.

Everyone's heard about the benefits of diversification, but at what level have you gone too far? If you hold too few stocks, there's the risk that one or two bad choices could devastate your portfolio. On the other hand, too many stocks can increase the complexity and make a portfolio nearly impossible to track and keep balanced. Historical studies have shown that there is a fairly narrow range in the number of stocks needed to provide adequate diversification safety.

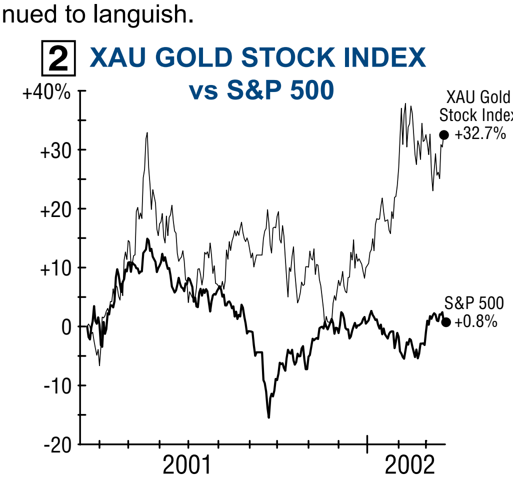
As one increases the number of stocks in a portfolio, the risk that overall performance will be dominated by a single position is reduced. Graph 1 shows that this risk is relatively high in a very concentrated portfolio, but declines quickly with each addition (assuming that the stocks are not related and come from substantially different industries). Related positions should be treated as a single stock. By choosing 16 to 32 unrelated stocks in a portfolio (positions larger than 3% but smaller than 6%), you realize most of the protective benefits of diversification.



Source: *Stock Market Logic*

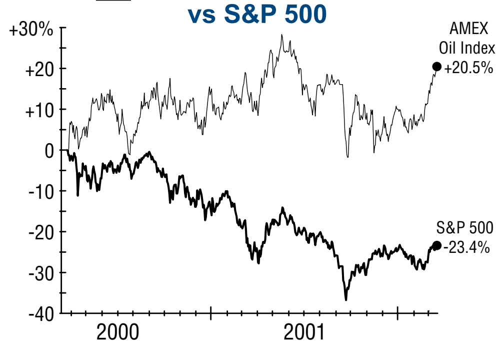
If investing in mutual funds or ETFs, how many are needed? Funds that target a single sector, such as technology or gold, may reduce the risk from a single volatile stock, but they provide virtually no diversification benefits for the overall portfolio. Treat sector funds like individual stocks. In the InvesTech Model Portfolio we hold positions in at least six of the ten sectors at all times. For mutual funds, selecting three to four well-diversified funds, with different investment objectives and stock holdings, should provide all the safety you need.

Another way to capitalize on diversification protection is by holding defensive hedges that often move contrary to the general market indexes. Graph 2 shows that the gold stocks of the XAU Index held up quite well during the crisis in September 2001. And they actually yielded solid profits in the early months of 2002 while the market continued to languish.



Also, the energy stocks in the Amex Oil Index (graph 3) followed their own path after the S&P 500 peaked in March 2000 – ignoring the early stages of the bear market for more than a year. Likewise, they held up well in the first nine months of the 2007 bear market.

3 AMEX OIL INDEX vs S&P 500



Just one caveat… be sure to reallocate periodically. Don't let one position, even a good one, become large enough to dominate your portfolio.

TIP #3: Stock selections should focus on value and growth.

Fads come and go on Wall Street, but those companies that typically turn in the best performance over the long run are the ones that are initially bought at reasonable values. One of the easiest ways to avoid valuation risk is to look for companies selling at Price-to-Earnings ratios that are at a discount to their historic norms or industry averages. Buying companies with high P/E ratios based on their historic growth is setting up one's portfolio for disappointment. We're not saying avoid companies with double-digit revenue and earnings growth, just don't pay too high of a premium for them.

TIP #4: Don't buy what you don't understand.

This is an old Warren Buffet and Peter Lynch principle that apparently fell out of favor during the bubble years, but it's definitely back in vogue now. In the late 1990s, as the market headed higher, everyone wanted to be on the leading edge of the technology revolution. And let's face it, sizzle sells! Buzz words may sound great, but unless you're an insider, you won't know if the company is an industry leader or off somewhere in left field. Redback Networks was a hot item during the 1990s technology craze and this business description came from the company's website:

> **About Redback**
> Redback Networks Inc. enables carriers and service providers to build profitable next-generation metro broadband and optical networks. The Company offers a strong product portfolio that includes industry-leading subscriber management and optical platforms, as well as a comprehensive set of network provisioning and management software. These solutions deliver superior performance and scalability, reduce operations costs, and expedite the management and deployment of new services within metro networks.
> **www.redbacknetworks.com** - 3/20/02

Sounds like the hottest thing since Microsoft, but what did the company really do? When you peeled back the jargon, it sold routers and really had nothing unique or proprietary to justify a stock runup like that shown in graph 4. While this phenomenon may be primarily related to the tech sector, investors were similarly blindsided by high yielding mortgage products just a few years later. There's a good lesson to learn here… if you don't understand it, don't buy it!

4 REDBACK NETWORKS INC.

TIP #5: Save the gambling for Las Vegas.

Most investors at one point or another have 1) dabbled in stock options, 2) bet on a cheap $2 stock, or 3) taken a flier on a bankrupt company. One might initially consider this investing, but it's really just speculating, and speculating is gambling.

The simple rule to remember is –and we know you've heard this before– don't speculate with money you can't afford to lose! If the temptation is too great, you might consider another alternative… just take the cash to Las Vegas, where you can at least get some enjoyment out of losing it.

TIP #6: Treat cash and bonds as investment alternatives.

They're no longer considered just 4-letter words in the aftermath of the last two Wall Street bear markets. In fact, cash and high quality bond investments can offer investors a welcome safe haven. For instance, bonds provide healthy gains when interest rates are falling, while a bear market in stocks actually means a bull market in cash. In other words, just by avoiding the washout of a big bear market, you can buy more stocks with the same amount of money once the bear ends. There eventually comes a time when it's prudent to hold cash and bonds in preference to stocks or equity ETFs. And one certainly shouldn't feel like a wimp when retreating to these investments if conditions warrant.

TIP #7: Think in fractions – it doesn't have to be "all-or-nothing."

This is a secret even professionals tend to forget. Making a decision in a particular stock or fund doesn't have to be an "all-or-nothing" affair. For instance, are you nervous about a stock that has run up too far, too fast? Then sell one-half of the shares. You'll feel better and more secure about holding the remaining position a while longer.

Can't bring yourself to dump a stock that hit an air pocket and lost 50%? Stepping in or out gradually makes the decision more palatable – and allows you to be more objective with what's left.

The same is true for the overall market. We are not market timers, and we don't jump in or out of the market on a whim… or with 100% of our portfolio. In most cases, we find ourselves incrementally changing portfolio allocation based on our key indicators – a concept that is used by the best professional money managers.

TIP #8: Have your own "Red-Flag" checklist.

Everyone tries to avoid investment mistakes. Yet even when practicing the best due diligence with stock selection, one can occasionally have an unexpected accident demolish a portfolio position. Such occurrences aren't completely avoidable, but taking extra steps to identify a potential problem is clearly time well spent. With this in mind, we suggest using the following "Red-Flag" checklist in your own stock screening process:

InvesTech Research "Red-Flag" Checklist

- ☑ Is stock float < 85% (too much insider ownership)?
- ☑ Is revenue from intangibles (rather than product sales)?
- ☑ Is historic revenue consistent among data sources?
- ☑ Do quarterly earnings contain "extraordinary" items?
- ☑ Has debt soared in recent years ("acquisition" accounting?)
- ☑ Are there red-flag footnotes in financial statements?
- ☑ Are there any articles (last 3 years) questioning accounting?

To step briefly through these criteria, one should be cautious about investing in stocks where insiders and majority owners hold large blocks of stock, as they may have a very low cost basis and could dump shares if the company faces problems. Also, revenue should come from valid long-term sources, and financial figures should be clear and viewed consistently throughout the industry. While we typically use operating earnings for comparison, write-offs are important and should be clearly understood. Be wary of companies that repeatedly have to write off large losses. Avoiding companies with soaring debt should be a key part of any core selection process, and it's even more important when bankruptcy risk is high as it is following a recession. Finally, be diligent in searching for anomalies in financial statement footnotes, any hint of accounting problems or reasons that short-sellers might find the stock irresistible.

This is not intended to be a comprehensive list, but it does provide a starting point for creating your own "safety" checks. And while triggering a flag might not automatically exclude a stock, it should prompt closer scrutiny and/or setting a tighter mental stop.

TIP #9: Always establish an exit strategy – the day you buy a stock.

One of the toughest decisions any investor has to make is deciding when to sell a stock. There isn't a seasoned investor alive who hasn't rationalized his or her way into holding a position until it became a dramatic loss. Trust us, nobody is immune – not even the "professionals." Almost every experienced investor has at least one of these problem stocks in their portfolio – a constant reminder of how hard it really is to abandon a failing position.

Why is it so hard to sell? One reason is because the minute you buy a stock, you form an attachment to it. If the price goes up, as it should, it provides a sense of accomplishment. And –with that profit– come immediate visions of even greater profit. On the other hand, if the price drops unexpectedly, selling means you've made a mistake. Consequently, human nature dictates that we rationalize holding stocks long after we should have either taken a profit or jettisoned them from our portfolio. The only way to break the psychological barrier is to try and remove emotions from the selling process.

Hence, planning an exit strategy is a critical part of *buying* a stock. Why? It forces you to make those difficult selling decisions when you can still be objective about your investment. A well thought out strategy gives you something concrete to fall back on when emotions run high. As others panic over a news release, an analyst downgrade or a falling stock price, that's when you want to avoid the herd mentality and rely on research and hard numbers. Here are 6 steps to help you in setting up your own "Exit Strategy" for the stocks in your portfolio:

6 Steps to Planning an "Exit Strategy"

1. List the reasons you are buying the stock.
2. Write an exit strategy the day you make the purchase.
3. Set an upside profit target for the stock.
4. Set your loss threshold.
5. Include other exit criteria.
6. Determine the maximum loss you are willing to tolerate.

First, list the reasons why you are buying the stock. What fundamentals attracted you to this company, and what are your expectations? These might include a low stock price compared to earnings or book value, double-digit revenue/earnings growth or a high dividend yield. The reason to record these factors is to help you later when you're trying to evaluate what to do with the stock once it's triggered your exit criteria.

Second, plan the strategy and write it down! Trust us, memory will fail you when the media is praising your stock and you're feeling smug, or conversely, when panic is running through your veins. This won't necessarily prevent you from holding the position past a prudent exit point. It will, hopefully, prevent you from fudging your criteria without realizing that you are actually re-rationalizing your reasons to hold onto the stock. In other words, it'll keep you from playing the *"Maybe I should hold it just a little longer"* game all the way down.

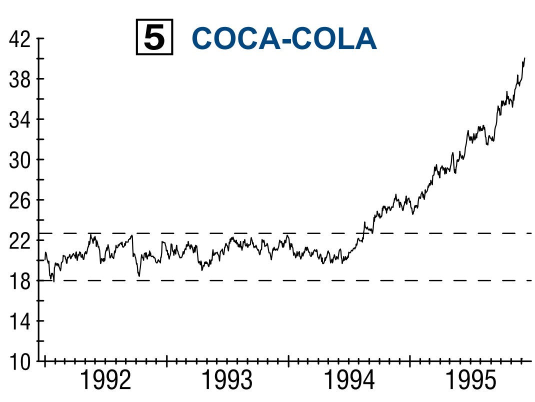
Next, set a profit target. It's important to address two cases – one if the stock goes up in value, and the other if it unexpectedly falls (which is covered in our next point). While planning for a loss may seem more important, it's a rare investor who hasn't ridden a stock up for a big gain, only to ride it all the way down again.

There's no scientific formula for picking an upside target. It might be a price where the P/E ratio or other valuation measure would be getting overvalued – perhaps 15% above the historic P/E norm. Or, it could simply be a point where the position has realized a sizable profit; one that you would feel comfortable locking in.

Once the target is reached, you'll do two things. First, re-evaluate the stock and decide whether you should continue to hold all or a portion of the investment for further gains. Next, rewrite your exit strategy if you do continue to hold any part of the position. Later, we'll give you more hints about what to do once the stock hits your target.

Ideally, you should always try to keep losses small and let profits run. This has become a mantra for professional money managers, since one of the most common mistakes investors make is cutting their profits short. There's nothing more exciting than holding a stock that becomes what Peter Lynch calls a "tenbagger" (up 10-fold over its purchase price).

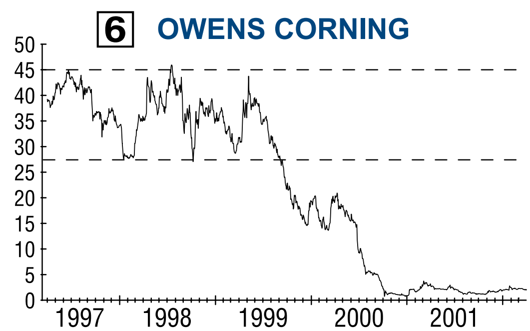
Sometimes, once a stock gets rolling, it really moves. Why is that? Because everyone who's watched the stock –waiting for a pullback to buy– has suddenly found themselves left behind, wanting to get on board. This is especially true if you purchase a stock that is reasonably priced and has been basing (trading in a range) for an extended time. Take Coca-Cola in 1994, for instance. The company had been trading between $18 and $23 for more than two years, then suddenly broke out above its resistance 5 . It rose throughout 1995 and 1996, hitting $68/share (a triple) before its first correction.



Fourth, set your "loss" threshold. This basically means deciding ahead of time what price the stock would have to hit before you say, "This is a mistake." Remember, small mistakes are always recoverable, but large ones are not. A 90% loss in a stock requires a 900% gain just to get back to the purchase price.

In choosing your loss threshold, we feel strongly that one of the best methods involves looking at a 6-month to 2-year chart of the stock. Try to find good support. That's a price the stock has hit multiple times and rallied. Hopefully, support is not more than 20% below your purchase price, or you may want to pick a more conservative threshold.

Why is this support level so important? If the stock breaks under this level, every investor who bought above the support price now has a loss and (just like you) is looking for a rally to get out even. Many a stock holding has turned into a debacle once the support level is broken. For example, Owens Corning 6 broke through its multi-year support level in 1999. Investors who took their loss immediately bailed out near $25 a share. Those who decided to hang on were left holding a $2 stock. Of course, that's not the fate for every investment that breaks important support, but one has to consider all the potential consequences in making good decisions.



Fifth, list your other exit criteria. With any stock, there are external events that can cause an investment to fall from favor. These may be industry specific, like holding oil stocks unless oil prices drop under $65/barrel, or selling banks if interest rates rise. One should also be aware of industry specific risks, such as asbestos liabilities, tobacco lawsuits, and the impact of bankruptcies on a bank's loan portfolio. More likely, however, these other exit criteria will be market specific. You may want to list an exit criteria as being one or more of InvesTech's proprietary models turning bearish.

Last, determine your maximum risk tolerance for each stock position! This is a critical step that can prevent disaster. Set a price that, if hit, will prompt you to sell the entire position, no matter what. This is your fail-safe strategy. It keeps you from riding the stock to a 90% loss, no matter how tempting it is to re-rationalize. You might even pick a ridiculously low price – *one you believe the stock will never reach.* At InvesTech our risk threshold is generally around -30%; and we will override that only in special cases, such as the temporary impact of the terrorist attacks on September 11, 2001.

TIP #10: Plan what to do if a stock triggers your exit strategy.

It may not be necessary or seem prudent to sell the entire position all at once, but you certainly don't want to re-rationalize owning the stock if it's tumbling. Sometimes your strategy should be readjusted, particularly if weakness is due to a temporary event like the terrorist attacks of 9/11. If you do need to make adjustments, though, when and how far should you bend? We've listed below some of the actions you might consider taking when your exit strategy raises a red-flag:

What To Do if Your Exit Strategy is Triggered

- Determine the reason – is it the market, the industry, or your particular stock?
- Check if stock fundamentals have changed.
- Ask: "Would I repurchase the stock at the current price?
- Make exiting easier – think in fractions.
- If the stock hits your maximum loss threshold – Sell!

To begin, determine the reason your exit strategy was triggered. This is not rocket science. For instance, the entire market may be experiencing a severe bout of weakness. In this case, you should rely on InvesTech's monetary and technical models for guidance. If you are heavily invested when our leadership, breadth, or monetary models start deteriorating, then by all means cut back your exposure by selling part of the position, and tighten your sell criteria on the remainder.

If market indicators are stable or bullish, compare your stock to others in the industry. For example, if Merck is falling, what about Pfizer, Eli Lilly, and other drug companies? If all are in a funk, you might adjust your threshold to tolerate a larger loss to see if the industry weakness is temporary. But if the market and other industry stocks are moving higher, while your stock is headed south, then you've got a problem stock that most likely needs to be dumped.

Check your stock's fundamentals. Pull out your list of original reasons for buying the stock. Ask yourself, *"Have these changed?"* If the stock is up sharply, but the fundamentals have also accelerated so the stock's not overvalued, then perhaps you should increase your upside target. Just don't forget to raise your loss threshold as well.

Conversely on the downside, if the stock has fallen to your loss threshold and the company is revising its earnings lower, it's time to stick with the plan and cut your loss. When it comes to first hints of trouble, one should remember the "Cockroach Theory" – *If you uncover one, there's almost always more hiding!*

As you re-evaluate a position, ask this simple question: **"Would I repurchase this stock today based on its current price and fundamentals?"** If your stock has risen sharply, but you'd avoid buying it because it's overvalued, now's the time to sell at least part of the position and tighten your loss threshold for the remainder. On the other hand, if the stock is down, and you couldn't find a compelling reason to repurchase at this level, then why hold it?

Make your exit decisions easier – think in fractions. This very important point, discussed earlier, is one most investors never consider. An investment decision never has to be "all-or-nothing." Exiting half the position when an upside target is hit will make your decision on the remaining portion easier down the road. And it will prevent a single stock holding from becoming so large that it dominates your portfolio and reduces your diversification. Also, don't let tax decisions override your sound judgment. Taxes are the price of being right. Again, from the opposing viewpoint, if your stock is selling at a loss, then exiting half will keep you more objective in adjusting your exit criteria for the remainder.

Finally, what if the stock hits your maximum loss threshold? (Remember that ridiculous price you set as the last step in your exit strategy?) If it does, then seriously consider selling all of it! There aren't many times you should override your maximum loss threshold. And if you do, it should only be for a temporary period or small difference in price. Remember, this is the step that prevents your portfolio from suffering unrecoverable losses.

Revising your exit strategy.

What if your strategy has been triggered, you've gone through the list and still feel the strategy should be changed without selling your position? That's okay, assuming you are rationalizing for valid reasons – and not because you emotionally can't part with the stock. One caveat, however… never abandon your original exit strategy without writing down a revised plan for exiting the remaining position.

Summary

We are continually reminding ourselves of the basic tenets discussed in this report. These are not inherent to human nature. In fact, our emotions usually tend to pull us in precisely the wrong direction. Prudently allocating one's portfolio is vital to controlling risk and reducing portfolio volatility. Planning an exit strategy for stock holdings can help lock-in gains and protect against severe losses. Combining these two critical tips with the others listed in this report will provide the keys to taming investing anxiety and realizing safer long-term profits.