

**PORTFOLIO APPRAISALS
and
PORTFOLIO MANAGEMENT
TOOLS & GUIDELINES**

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PORTFOLIO APPRAISALS

The following is an explanation of our appraisal format.

THE COLUMNS

The first column ("#"), for easy reference, shows the number of the security position; and the second column ("Amount") shows the number of shares of stock or principal sum of bonds in that position.

The third column ("Code") shows the "ticker" symbol, if available, by which pricing and other information on the security is retrieved on quote machines and computer-accessed commercial data bases. If the code begins with a dot (.), there is no "ticker" symbol for the security, and so the symbol assigned is for access to the position in our own local computer network only. (Because the process cannot be automated, securities preceded by a dot are only infrequently manually repriced.) If the code is in lower case letters, and not preceded by a dot, the security's price is retrievable via our computer quotation equipment, but the security's income rate is either fixed or nonretrievable via computer. (In this case, the income rate will be only infrequently manually adjusted.) If the code or symbol is appended with a number, it signifies more than one position in the same security in the same portfolio. The numbering is in the chronological order of the acquisitions of the positions in the portfolio.

The fourth column ("Reg") is called the "Registration" column. It may be used to designate either the ownership or physical location of a specific security, if different from the majority of those in the account. Special ownership may be indicated in a number of ways: by initials; by "Mr," "Mrs," and "Jt" (Joint); by designations such as "J/m" (John custodian for Mary) and "J/I" (John's IRA); or in other ways that seem appropriate for the particular portfolio. If most of the securities in a portfolio are held by our clearing firm, a "#" indicates a position not held by us; and, if most of the securities are held by the client, a "*" indicates any that are held by our clearing firm.

The fifth column accommodates the name of the security and, in the case of multiple positions in the same security, indication of the chronological sequence of the acquisitions of each position. "DRP" indicates that the security is currently held on a dividend reinvestment program.

The sixth and seventh columns show the *Value Line* "timeliness" rankings and *Standard & Poor's* "quality" ratings, respectively, if available. If an *S&P* "quality" rating is not available, but a *VL* "safety" or "financial strength" rating is, either of the latter may be incorporated in the *S&P* field. Investment trusts may be assigned a "+", "=", or "-" in the *S&P* column, depending upon our assessment of whether the weighted-average quality of the securities in the trust is "above-average," "average," or "below-average," respectively. For this latter purpose, we classify ratings of A+, A, A- for stocks and AAA, AA, and A for bonds as "above-average," B+ for stocks and BBB for bonds as "average," and all lower classifications for both stocks and bonds as "below-average."

The eighth column shows the date of purchase. If the position has been accumulated over a period of time, such as with a dividend reinvestment plan, the date field may show the years over which the shares were so accumulated. If the security was acquired as a gift, the date furnished should be the date acquired by the donor (not the donee). In the case of inherited securities, the date should be the date of death of the individual from whom the securities were inherited or, if the alternate valuation was used in the payment of estate taxes, the date six months after the date of death.

The ninth column shows the "actual" price paid for the security, adjusted for splits and/or stock dividends. If the security was acquired as a gift, the price should be the price paid by the donor. In the case of inherited securities, the price should be the per share price used in the estate evaluation.

The tenth column shows the total cost of the security, inclusive of commissions, but exclusive of accrued interest on bonds at the time of purchase. In the case of a gifted security, the cost should be the donor's basis; and, in the case of an inherited security, it should be the date-of-death valuation or, if used in the payment of estate taxes, the alternate valuation.

The eleventh through the fourteenth columns show, respectively, current price, current value, unrealized gain or loss, and unrealized percentage gain or loss.

The fifteenth column shows the current indicated dividend per share of stock or the income rate per bond; the sixteenth column shows the total income per year on the position; and the last column shows the current yield - i.e., the current annual income divided by current value.

Totals are included at the bottom. The total in the gain/loss column represents the net total gains and losses on all securities for which a cost is available. If no cost basis is included for one or more issues, the total in the gain/loss column will not be the same as the difference between the totals in the current value and cost columns.

PORTFOLIO QUALITY INDEX (PQI)

At the bottom of the appraisal, there appear three indices - a "Portfolio Diversification Index" (PDI), a "Portfolio Growth Index" (PGI), and a "Portfolio Quality Index" (PQI). These indices are an attempt to measure the portfolio's conformance to the three principles of our own investment philosophy of maintaining a *broadly-diversified* portfolio of the common stocks of *high-quality, growth* companies.

The indices apply only to the common stocks in the portfolio. For purposes of our portfolio index computations and presentations, securities that are not common stocks are simply ignored.

We shall here explain each index in the order of the increasing mathematical complexity of its definition and derivation. The simplest to define and derive is the "Portfolio Quality Index" (PQI) which appears at the bottom of the page, on the extreme right.

Probably the easiest way and, in our opinion, the best way, of indicating the "quality" or "safety" of a common stock portfolio is to take a weighted-average of the value of the stocks in the portfolio that are classified by *Standard & Poor's* as "above-average (A+, A, A-)," "average" (B+), and "below-average" (B, B-, C, and D). In the absence of an *S&P* rating, we may use a *Value Line* "safety" rating, if available (#1 & #2 = "above-average," #3 = "average," and #4 & #5 = "below-average") or a *Value Line* "financial strength" rating (The set of *Value Line* "financial strength ratings" is as follows: A++, A+, A, B++, B+, B, C++, C+, and C. Because of their similarity to *S&P* ratings, to minimize confusion in exhibits, we usually show "financial strength" ratings in lower case: a++, a+, a, b++, b+, c++, c+, and c.)

To arrive at an appropriate classification for common stocks without a *S&P* rating, we surveyed all of those securities covered by *S&P* for a 12-month period, noting the initial ratings received by those issues that went from a non-rated to a rated status when they first became rated, and noting those ratings carried by those issues that were dropped back from a rated to a non-rated status just before they lost their ratings.

Our analysis revealed the following: The modal (most common) rating for stocks when initially rated was a "C," while the median (mid-point) rating for such stocks was a "B-." For stocks becoming non-rated, both the mode and the median were ratings of "D." Our PQI does not discriminate among stocks rated as low as "B," "B-," "C," and "D"; but, if it did, it appears that non-rated stocks would most legitimately be consigned to the lower end of this "below-average" spectrum. In any event, "non-rated" issues clearly belong in the "below-average" category.

As a frame of reference, both the Dow-Jones Industrial Average and the *S&P* 500 Stock Composite are made up of approximately 40% stocks that are rated "above-average," 20% that are rated "average," and 40% that are "below-average."

To construct our "Portfolio Quality Index" (PQI), stocks with "above-average" quality ratings are assigned a score of 1.0, those with "average" ratings are assigned a score of 0.5, and those with "below-average" ratings are assigned a score of 0.0. Each score is weighted by the total value of the securities in the portfolio with that score. The percentage figure arrived at relates the quality of the portfolio being measured to the quality of a portfolio made up of all the stocks in the *S&P* 500 and the Dow-Jones Industrial Average. Using this index, a portfolio made up entirely of "above-average" issues receives the highest possible score of 100%; the *S&P* 500 and the Dow-Jones Industrials each receive "average" scores of about 50%; and a portfolio made up entirely of "below-average" stocks would receive a score of 0%. The PQI, then, is an approximate measure of the quality of a common stock portfolio, expressed as a percentage of the quality of a portfolio consisting of all "above-average" stocks, and also relating the portfolio to the quality of stocks in the two most popular stock market indices.

The question may be raised as to whether the precision of the index might be increased if the system of weights discriminated among the individual ratings in the above-average group and among the individual ratings in the below-average group, rather than lumping them together, each in its respective category. In other words, should a portfolio not receive more credit for quality for an A+ than for an A-?

Though the precision of the index might, admittedly, be enhanced, we have concluded that the utility of the index could actually be diminished by so doing. At any given time, the number of issues available for ownership that meet criteria for both high-quality and a good potential for growth is not so large as to permit adequate diversification if the hurdle rates are set too high for either. By not over-emphasizing what we consider only marginal differences in quality among the top three ratings, one should be less motivated to under-emphasize the very important other two objectives of broad diversification and a good potential for growth.

Similarly, because the factor of "safety," by our standards, is utterly absent in securities with below-average S&P ratings, giving any of them any weight whatever might imply a degree of safety which we do not believe would be present.

We like to give securities and portfolios what we call a "Great Depression Test." We ask ourselves what we think would probably happen to a security or to a portfolio in the event of an economic or monetary calamity, of the severity of that experienced in the 1930s. In general, we think that companies with above-average quality ratings would probably survive; we think those with below-average ratings probably would not; and we regard those with average ratings as toss-ups.

PORTFOLIO GROWTH INDEX (PGI)

At the bottom, in the middle, of the portfolio appraisal page, we have the "Portfolio Growth Index" (PGI).

The PGI is based entirely upon *Value Line* "timeliness" rankings. This index is applied only to common stocks in the portfolio that are rated by *Value Line* for "timeliness." In other words, unlike the case with *Standard & Poor's* "quality" ratings used in the calculation of the Portfolio Quality Index, no assumptions are made about the "timeliness" of unranked common stocks. All unranked securities are simply excluded from the computations. The PGI is an attempt to measure the collective growth potential of just those issues that carry rankings. Only in the case where all of the securities in the portfolio carry a *VL* "timeliness" ranking will the PGI characterize the entire portfolio.

As with the PQI, the PGI is an average, weighted by the total current value of the securities in each *VL* "timeliness" group. The choice of numbers to which each weighting is assigned, however, is a bit more esoteric.

A VL "timeliness" ranking will be a #1, #2, #3, #4, or #5, with #1 being the highest and #5 being the lowest. At any given time, there are 100 each of #1s and #5s, 300 each of #2s and #4s, and about 900 #3s. Because of the nature of distribution, the implication is that the appreciation potential for a typical #2 is nearer the appreciation potential of a typical #1 than it is a #3; and, similarly, the depreciation potential of a typical #4 is nearer that of a #5 than it is a #3. To be more specific, in the *Value Line* spectrum of rankings, an average #2 must be exactly three times farther above the average #3 than it is below the average #1; and, similarly, the average #4 must be exactly three times farther below the average #3 than it is above the average #5.

To address this distribution disparity, we have utilized the following convention: Because a #1 is the highest ranking assigned, the collective value of all those securities rated #1 is scored at 1.0; and, because a #5 is the lowest ranking assigned, the collective value of all those securities rated #5 is scored at 0.0. Being in the middle of the pack, all the #3s are assigned a score of 0.5. Finally, because the 300 #2s, on average, score higher than 90% of the remaining 1500 ranked below #1 and above #5, they receive a score of 0.9; and, because the 300 #4s, on average, are in the bottom 10% of the spectrum of stocks ranked below #1s and above #5s, they receive a score of 0.1.

Using this scheme, a portfolio comprised entirely of VL #1s would score a PGI of 100%; a portfolio of all #2s would score 90%; a portfolio of all #3s would score a 50%; a portfolio of all #4s would score 10%; and a portfolio of all #5s would score 0%. All other portfolios will be a current value-weighted average of these scores that falls within the two extremes.

PORTFOLIO DIVERSIFICATION INDEX (PDI)

To measure the degree of diversification of a common stock portfolio, we have devised and utilize the "Portfolio Diversification Index" (PDI).

Our desire for such a yardstick is predicated both upon the generally accepted importance of broad diversification as a cornerstone of prudent portfolio management, and upon recognition of the fact that diversification is a function, not only of the number of issues in a portfolio, but also a function of the *size* of each individual holding, relative to the whole. For example, a portfolio with equal amounts of money represented in each of ten different issues is moderately well-diversified. However, a portfolio with even as many as one-hundred issues decidedly is not well-diversified, if half of the portfolio's total value is in just one issue. As an example, the PDI addresses the question of which portfolio is better diversified, a three-stock portfolio with relative positions of 50%, 25%, and 25% or a four-stock portfolio with relative positions of 55%, 15%, 15%, and 15%.

As with our PQI and PGI, in calculating our PDI, we exclude from our computations all assets that appear in the portfolio that are not common stocks. Though the ownership of such other financial assets as U. S. Treasury bills, bank certificates of deposit, and municipal and corporate bonds all help to diminish the effect on one's aggregate finances of a catastrophic event's befalling one common stock, the concept of diversification, in its conventional use, is applied only to one specific asset class at a time. The distribution of assets among different asset classes is referred to

as "asset allocation" rather than "diversification." Our PDI, then, isolates, and pertains only to, the common stocks in a portfolio, even if other financial assets appear in the portfolio appraisal.

Our methodology is quite straightforward. The computer first totals the value of all the common stock positions in the portfolio; it then combines multiple positions in the same security, calculates the percentage of each entire holding to the whole portfolio, internally arranges all of the holdings in the order of largest to smallest, and ranks each holding with the number, N , representing its relative position in the list. The size of each holding, as represented by its percentage of the whole, is then divided by $N!$. (This is known as N "factorial" where $N! = 1 \times 2 \times 3 \times \dots \times N$.) Each resulting quotient is subtracted from 100%, and the final remainder is the PDI.

Essentially, the portfolio starts off with a theoretical perfect raw score of 100 points and then is penalized for each position, with the size of each penalty's being a function of the size of the position and the relative ranking of this size in the portfolio. When applied to the examples given above, the four-stock, 55%-15%-15%-15%, portfolio with a PDI of 34% comes out slightly better diversified than the three-stock, 50%-25%-25%, portfolio with a PDI of 33%, despite the former's greater dependence upon its largest position.

The purpose of diversification in a common stock portfolio is to protect against what is known as "specific" risk - the risk that some unique calamity might befall just one company, but not necessarily others. Diversification among companies does not afford protection against "market" risk - the possibility that the whole stock market might collapse. Using this rationale, it might be argued that one need only measure the relative size of the largest holding in a portfolio to measure the degree of the portfolio's vulnerability to specific risk.

The concept of risk, however, entails two dimensions, only one of which is the "magnitude" of the potential loss. The other is the "probability" of loss. Given two portfolios, the first with positions distributed as 50%-40%-10%, and the second with positions of 50%-30%-20%, in spite of the fact that both portfolios have three positions, and the largest position in each is 50%, the "probability" of a more serious loss in the first portfolio is greater than in the second, because of the size of the second position. It is the purpose of the $N!$ in our formula to try to deal with this probability function.

At the extremes, the formula provides that a portfolio with just one security earns a PDI of 0%. Clearly, such a portfolio is completely undiversified. To be perfectly diversified, and so receive a score of 100%, however, a portfolio would need an infinite number of issues with only an infinitesimal amount of money represented in each issue. A portfolio with 50% of its value in one stock, but perfectly diversified with respect to the other half, would receive a PDI of 50%. If a portfolio has 50% of its value in each of two stocks, the formula generates a PDI of 25%.

The following tabulation illustrates the maximum, or optimum PDIs that could be achieved with portfolios of varying numbers of issues which, in turn, assumes that, in each configuration, the amount represented by each company is exactly the same:

<u>Number of Issues</u>	<u>Relative Amount in Each Issue</u>	<u>Portfolio Diversification Index</u>
1	100 %	0%
2	50	25
3	33 1/3	44
4	25	57
5	20	66
6	16 2/3	71
7	14 2/7	75
8	12 1/2	79
9	11 1/9	81
10	10	83
12	8 1/3	86
15	6 2/3	89
20	5	91
25	4	93
30	3 1/3	94
40	2 1/2	96
50	2	97
100	1	98
∞	0	100

In an effort to establish a benchmark for our PDI, we surveyed all (43) of the "actively managed" mutual funds (excluding index funds), categorized by *Morningstar* as "Growth" funds, each of which had total net assets of less than \$100 million.

Our rationale for using the under-\$100 million funds is that these funds presumably are better able to "optimize" the number of issues they hold and the size of each position. Larger funds must hold larger numbers of issues simply to reduce the "market impact" of their trades when they buy or sell. Smaller funds, then, possess a degree of "flexibility" not characteristic of larger funds.

In examining these 43 mutual funds, though the range was from 5 to 100 issues, the average was 53 and the median was exactly 50.

I believe it is fair to infer from this study that mutual fund managers, and so probably all money managers, on average, conclude that, for purposes of diversification, the "optimum" number of issues to have in a growth common stock portfolio is approximately 50.

The PDIs for the 43 funds ranged from a low of 74% to a high of 97%, with an average of 91%.

In conjunction with the 50-issue/91%-PDI results determined above, it is interesting to note, from the preceding table, that, if a portfolio has equal positions in each issue, (1) a 50-issue portfolio will achieve a PDI of 97%, and (2) a PDI of 91% is achieved with just 20 issues.

To put the foregoing in simpler terms: It appears that a degree of diversification equivalent to that of the average mutual fund of under \$100-million probably will be achieved with a maximum of 50 issues and actually can be achieved with as few as 20 issues.

OTHER DIVERSIFICATION CONSIDERATIONS

There are, of course, factors other than the degree of company concentrations, as measured by the PDI, relevant to the implementation of a sound policy of diversification. First, the index quantifies portfolio diversification only by company and not by industry. A two-stock portfolio equally dependent upon a food stock and an energy stock, for example, is probably better diversified than a two-stock portfolio equally divided between two energy stocks.

Second, the degree of diversification needed in a portfolio also depends, to some degree, upon the nature and quality of the stocks in the portfolio. If a portfolio is made up of large, high-quality, multi-national corporations, which are themselves each broadly diversified, a fewer number of issues is needed for good portfolio diversification than is required if the portfolio is comprised of small, single-product, speculative companies.

Third, in a taxable account, the cost basis of securities in which one is heavily concentrated also needs to be taken into consideration. The cost of diversifying, in terms of what must be paid to Uncle Sam to do so, needs to be weighed against the magnitude of the risk of not doing so.

Finally, a company's prospects might be taken into consideration in determining the need and extent to diversify. Presumably, if a company's prospects are problematic, weak, or deteriorating, there is a greater urgency to diversify out of a heavy concentration in that company than there is if the company's prospects are well-defined, promising, and improving.

Of most importance, however, it is to be recognized that the whole purpose of portfolio diversification is to address, not what we know, but what we do not know, and cannot know, about the future prospects of the individual companies we own. While our degree of confidence in the law of large numbers (and so a broadly diversified portfolio) may justifiably be high, the frequency with which investors are disappointed by the performances of individual common stocks is far greater than many people realize. The best insurance we can procure that the catastrophic performance of an individual issue will not have cataclysmic consequences for the whole portfolio is broad diversification for that portfolio.

A SECOND FORMAT

We frequently print a portfolio in a second format in which it may appear, at first glance, that the securities are listed at random. The listing is not random, however; we call this second ordering "sorted by sale."

In this latter format, you will notice that the portfolio is sorted from the companies with the lower *Value Line* "timeliness" rankings at or near the top to those with the higher *VL* rankings at or near the bottom. Securities with no *VL* rankings may be grouped at either the top or the bottom, or there may be some at both the top and bottom. With five possible *VL* groupings, this makes a total of up to seven categories.

Within each of the above categories, the securities are then ordered from the largest percentage loss at the top of the category to the largest percentage gain at the bottom of the category.

The rationale for this "sort-by-sale" format is as follows:

If one were seeking to weed out the weaker issues in his list to replace them with stronger issues, these weaker issues would more likely be those with the lower *VL* rankings which are the ones nearer the top of the list. Similarly, if one wanted to raise money from the portfolio, it would probably be wise to focus greater attention on those issues with the lower *VL* rankings nearer the top of the list.

If the account is a taxable account, the ordering by percentage gain and loss can also be useful. If one has two *Value Line* #3s - one with a 20% loss and the other with a 20% gain - from a tax point of view, it might be more advisable to sell the one with the 20% loss. By doing so, there should be some tax benefit, while selling the one with the 20% gain could entail some tax liability.

The reason for using percentage gain and loss, as opposed to dollar gain and loss, in the ordering, is that, by starting from the largest percentage loss and working to the largest percentage gain, within any *VL* category, one is able to maximize the proceeds of sale for any given dollar level of gain or loss.

If the account is tax-deferred (an IRA or a qualified retirement plan) or tax-exempt (a non-profit organization), the ordering by percentage gain and loss may be of less significance. However, to the extent that Murphy's Law may hold in the securities markets, the ability readily to distinguish those companies that have done well for us from those that have not done so well may also be a useful guide in the management of the portfolio.

When using the measurement of percentage gain or loss, for other-than-tax purposes, however, it is imperative to realize that percentage gain or loss may be far more a reflection of the length and timing of the holding period than a reflection of attributes of the underlying company. If a stock has been held for a long time, it is much more apt to have a high percentage gain than is one that has been recently acquired. Similarly, if one buys a stock just before the stock market plummets, it may have a big percentage loss, while one acquired at the bottom of the 1987 stock market crash may still have a large percentage gain. Comparing these two statistics, however, would probably not tell us much about the relative future prospects of the two companies.

Nevertheless, we think our "sort-by-sale" is a very good starting point for the analysis of an investment portfolio.

VALUE LINE #3s: HOW MANY ARE TOO MANY?

We are frequently asked how one knows when the number of Value Line #3s in a portfolio has reached an unacceptable level. As with most matters that relate to the stock market, there is no unique answer to this question, either for all investors or even for the same investor under all market conditions.

Value Line says that, if you are an "aggressive" investor, you should sell all #3s as soon as they become #3s; but, at the very least, you should sell all stocks when they become #4s or #5s, even if you do not sell #3s. I am convinced that there is a happy medium between these two extremes.

If one had a random or average portfolio, or one in which securities were neither bought nor sold for a long period of time, statistics say that it would be invested about one-quarter #1s and #2s, about half #3s, and about one-quarter #4s and #5s. If one pursued a strategy of always selling only #4s and #5s, the probability distribution says that the portfolio would be invested about one-third #1s and #2s and two-thirds #3s. If one pursued a strategy of always selling #3s, as well as #4s and #5s, the portfolio, of course, would be invested 100% in #1s and #2s.

The mean between these latter two extremes is a portfolio that is two-thirds #1s and #2s and one-third #3s. As a starter, then, I would suggest that an individual might simply count the number of issues in his list and, if fewer than one-third of them are ranked #3 and the rest are #1s and #2s, not worry much about the list. On the other hand, if fewer than two-thirds of the number are #1s and #2s, a grooming of the portfolio might be in order.

Even if a portfolio has fewer than two-thirds of its number of issues in #1s and #2s, however, it is still apt to have more than two-thirds of its value in #1s and #2s. This is because the typical portfolio has usually accrued greater gains in its #1s and #2s than it has in its #3s. This is why the Portfolio Growth Index (PGI) is a useful tool. It takes into consideration, not only the number of issues, but the amount of money in each issue as well. If, however, a portfolio had equal amounts of money in each security and it was normally distributed among #1s and #2s only, it would have a PGI of 93%; if it were two-thirds #1s and #2s and one-third #3s, with equal positions normally distributed, it would have a PGI of 78%; and, if it were one-third #1s and #2s and two-thirds #3s, it would have a PGI of 64%.

The implication from the foregoing would be that, if the PGI is below 64%, the portfolio is probably in need of radical surgery; if the PGI is between 64% and 78%, it may be in need of some grooming; if the PGI is between 78% and 93%, it is probably in pretty good shape; and, if the PGI is above 93%, it is exemplary. (As noted above in the explanatory section on the PGI, a randomly selected, normally distributed, portfolio of #1s, 2s, 3s, 4s, and 5s has a PGI of 50%, while a portfolio of all #1s would generate a score of 100%.)

I think it is important to try to discriminate among #3s. For a host of reasons, there seem to be some #3s that are appropriate sales, as well as some that are appropriate purchases. Representing 900 issues out of the 1700 *Value Line* universe, #3s account for more than half (53%) of all the candidates considered. Because it encompasses so many issues, there is nowhere near the precision associated with the assignment of a stock to this group as there is to its assignment to any of the four other groups because the other groups are so much smaller. Though *Value Line* does not reveal its relative rankings within groups, there must be a vast difference between the prospects for two companies, each ranked #3, if one comes in with a relative rank of #401 in the ranking system, while the other comes in at #1399. Still, all we can know from *Value Line* is that they are both #3s.

Companies that become a #3 immediately after having been a #2, I believe, are usually likely to perform better than those becoming #3s immediately after having been #4s. The former are more apt to be near the high end of the #3 spectrum, while the latter are more apt to be near the low end of the spectrum.

It should be recognized that the *Value Line* "timeliness" ranking system is largely earnings-driven and non-subjective. With the exception of inputting estimates of earnings for the current quarter (which are usually Wall Street consensus estimates anyway), the *Value Line* analysts do not have any influence over the "timeliness" rankings assigned to the stocks they cover. If one reads their analyses over time, one might conclude that they are, themselves, more often trying to interpret the rankings than they are trying to determine them.

Trying to decide whether to sell, hold, or buy a #3, then, is not trying to second guess *Value Line*. It is a very integral and necessary part of utilizing the *Value Line* ranking system efficiently. If a company is rated #3, the real question that must be asked is whether the circumstances that have caused the company to go from a higher or a lower ranking to a #3 are more likely to be short-term or long-term in duration. All thriving companies stumble occasionally, and they should not be sold for that reason alone. Similarly, most declining companies experience occasional cyclical rebounds, and they should be neither purchased nor held for that reason alone.

Market conditions, too, can be an important consideration in determining how many #3s are tolerable in an account at any given time. If the market, overall, is somewhat speculative, those companies with above-average VL rankings will more likely be those with lower S&P ratings. It is frequently impossible to increase the PGI of a portfolio by selling #3s without downgrading either the PQI or the PDI, or both. When this is not acceptable, as in most cases, #3s must be held and/or purchased.

The foregoing notwithstanding, there does appear to be a high positive correlation between the performance of portfolios that do well over the long-term and portfolios that keep a high percentage of their worth deployed in *Value Line* #1 and #2 rated stocks.

PORTFOLIO TRADING FRUSTRATIONS

Selling securities when they are #3s obviously makes for a more active portfolio strategy than selling only #4s and #5s. Also, one of the more irksome aspects of this more active strategy is that one will occasionally find that a stock that was sold as a #3 (or even a #4 or #5) has become a #1 or #2 again, while the one purchased as a replacement has gone down to a #3 (or #4 or #5). Even more painful is the indication, now, that the replacement stock should be sold and the original stock repurchased again. Nor are any such combination of transactions likely to have generated for the investor any economic gain.

Such frustrations go with the territory. One should not, however, conclude from such a disappointment that #3s should never be replaced with #1s and #2s. One is faced with a similar dilemma in trying to decide whether to own a common stock in the first place. If one takes money that would otherwise have been in a savings bank and incurs a loss by investing in a common stock, he is decidedly disappointed and wishes he had never done it. If, however, he NEVER puts money, that he would otherwise keep in a savings bank, into a common stock, he will NEVER be a common stock investor, and he will NEVER reap any of those rewards reaped by common stock investing.

Clearly, incurring a loss in a common stock investment inflicts a pain; and selling, at a loss, a stock that subsequently goes back up, in which case the investor might have avoided ever experiencing the loss in the first place, inflicts a double pain. Bear in mind, however, that the whole theory of common stock investing and, in fact, the whole theory of capitalism is that the submission to pain (sacrifice, distaste, or discomfort) is the only source of the pleasure associated with the higher returns associated with the category of investments that inflict the pain.

We have made a survey of capital gain and loss statements of successful accounts over the years and have discovered the following: About 40% of security sales represent securities sold at a loss, while only about 60% represent gains. The size of the average gain, however, is about twice as large as the average loss. Putting these numbers together, one concludes that the dollar value of gains in capital gain and loss statements should be about three times the dollar value of losses in these statements. This figure is independently confirmed by the data as well. These, of course, are averages for many clients over long periods of time. The results for individual investors from year-to-year vary dramatically.

What I find intriguing about these observations is how much money one needs to lose in order to make a lot of money or, to put it another way, how many individual mistakes one needs to make in order to get things right in the aggregate.

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