MAKE MARKET FRENZY YOUR FRIEND

In Gene Marcial's new book, 7 Commandments of Stock Investing, BusinessWeek's "Inside Wall Street" columnist offers a counterintuitive method of picking market winners and profiting from a long-term approach. Marcial shares the perspective he has gained over 30 years of stock-picking, and he sheds light on the universe of corporate and stock market insiders, revealing how everyday investors can emulate their success. In this excerpt, Marcial describes his Commandment No. 1: Buy Panic.

Welcome to the world of panic, the big generator of market meltdowns. When panic grips the stock market, waves of selling overtake practically every stock. There is panic on the upside as well, which drives up stocks in a frenzy. Just remember: Panic can be your ally.

To take advantage of awesome declines, investors must plot a clear strategy to seize opportunities during a market panic, which usually comes out of the blue.

The first principle to which investors have to adhere is simple: Be prepared. Assuming that you're already invested in stocks and want to take advantage of the bursts of market activity, you need to have a cash reserve. Cash reserves should be from 10% to 20% of your portfolio.

The next step: Prepare two lists. The first list consists of stocks you want to own for the long haul. If you already have these in your portfolio, mark them as the stocks to buy more of when they tumble in price. The second list should consist of stocks you own but that have already produced handsome gains and that you'd be willing to sell to augment your cash fund when the market goes on a buying rampage. Armed with these two lists, an investor will know how to act when there's panic in the market.

This is not to suggest that you engage in short-term trading. On the contrary, the Buy Panic maxim encourages building a long-term
portfolio and, with an ample cash reserve, fortifying it whenever panic hits the equity market. When the market starts selling off, watch which of your favorites are getting whacked. Because you have owned these stocks for a while, you have an idea whether they are being unjustifiably pounded. Any drop of 5% to 10% or more should be enough to inspire you to buy more shares. If the stocks drop near their 52-week lows, that should also alert you to buy. Consider your cost at the time you first bought them. If their prices are lower than your original buying prices—or just about at that level—consider them a bargain.

Let us look at the flip side. If the market is rapidly pumping up, as it was on Sept. 18, 2007, when Federal Reserve Chairman Ben Bernanke cut the federal funds rate by a half a percentage point, you should sell the stocks you listed as potential profit sources.

How do you know which stocks are solid enough to keep and buy more of? You'll rarely fail if you concentrate on major big-cap stocks. Start with the 30 components of the Dow Jones industrial average, or the most widely held stocks, including IBM, Boeing, AT&T, American Express, Coca-Cola, and ExxonMobil.

During market meltdowns, these companies get hit as much as the small-cap stocks, and sometimes even harder. Although they have vast resources and are AAA-rated by the credit rating agencies, they are as vulnerable to the panicky swings as the small fry.

THE GOLDMAN STANDARD
A good example of a stock that challenged investors is Goldman Sachs, the premier U.S. investment bank. Even the Wall Street giant took a beating when the credit squeeze grabbed the headlines. If you played the panic game, you
easily could have piled up significant profits.

Shares of Goldman Sachs traded as high
as 233 a share in June, 2007. The stock was
knocked when the subprime mortgage troubles
erupted. The height of panic selling started on
Aug. 13, 2007, and Goldman’s stock tumbled
to 173.50 a share. In just a couple of days the
stock got pounded even harder, pulling it down
to 164. For the Buy Panic investor, that would
have been a perfect buying point. Knowing
Goldman Sachs’ background and resources,
would you have thought the company was in
danger of getting into serious trouble because
of the subprime mortgage mess? The stock be-
haved like it was in real trouble, and many in-
voters, including some institutional investors,
did sell the stock in their usual panicmy way.

At 164 a share, Goldman Sachs was a pure
bargain, selling at just 6.8 times projected 2008
earnings of $23.90 a share, compared with a
price-earnings ratio of 10 in June. A month
later, on Sept. 18, the market mounted a giant
unexpected rally, driven by the Fed’s federal-
funds rate cut. Goldman Sachs’ stock was
among the market’s giant winners. The stock
closed that day at 205.50. Just about a week
later, the stock continued to fly, to 210—and
rising. That was a $46 jump in just over a
month, had you practiced panic buying. On
Oct. 31, 2007, Goldman Sachs’ stock hit a 52-
week high of 250.70.

IMITATING THE PROS
Distress investing is another side of panic buy-
ing. The distress-investing player scouts for
companies whose businesses have practically
collapsed, driving their stocks way down.

Even though individuals don’t have the
resources of professional distress investors,
they can get into the game by imitating the pros.
Usually, you can find out what distress play-
ers are up to from their Securities & Exchange
Commission filings (sec.gov),
which categorically state their
intentions.

For instance, if you know that
an investment manager such as
Martin D. Sass focuses on distress
investing, you could screen filings
by M.D. Sass to determine what
stocks he’s been buying. Investor
service companies in Washington,
D.C., specialize in tracking filings
for these distress investors, and
invariably, newspapers and maga-
zines publish the information.

Sass, in particular, has become
an expert at investing in distressed companies.
In 1972 he founded M.D. Sass, an investment
outfit that manages several hedge funds and
investment portfolios. The company’s hedge
funds invest mainly in financial equities, real
estate securities, and risk-arbitrage deals. With
assets under management of $10 billion, Sass is
able to invest where most investors fear to tread.

One of Sass’s prized deals involved Leaseway
Transportation, which provides trucking
and related services in the U.S. and Canada.
An economic slowdown and fierce competi-
tion had forced the company into a financial
squeeze. Sass invested a total of $20.8 million,
on which he made a handsome 60% profit
when Leaseway was eventually sold to Penske
Truck Leasing.

In sum, opportunities abound if you are
alert enough during times of panic. True, you
can lose money. But by obeying the Buy Panic
commandment, your chances of winning are
considerably improved.

BUSINESSWEEK.COM  For more on Gene Marcial’s
7 Commandments of Stock
Investing, watch an online video series at businessweek.
com/go/tv/marcial

APPLE
Superior and sophisticated products are
pushing the company ahead of rivals

BOEING
The formidable aerospace
company isn’t saddled with
major financial problems

CVS
The formidable
store chain
still trades at a
moderate valuation

GENENTECH
At about 73, the stock of the
biotech behemoth trades at a
bargain price

JPMORGAN
CHASE
Has the muscle, energy, and
will to achieve its lofty growth
goals

PETROLEO
BRASILEIRO
Petrobras, one of the world’s
largest oil companies, con-
tinues to build its reserves and
other assets

PFIZER
Pfizer’s robust
pipeline of new drugs will
rekindle the company’s
growth

UNDervalued, these shares should deliver outstanding returns

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