

## Dorsey, Pat – The Five Rules For Successful Stock Investing

*John Wiley & Sons, 2004, [Equity Investing] Grade* ★★☆☆

When I think of Morningstar I picture something similar to Moody's or Standard & Poor's, a correct, slow and slightly bureaucratic organization. This book gives a totally different insight. It takes a clear stance for the Warren Buffett "buy wonderful businesses at reasonable prices"-type of value investing (as opposed to the "Graham low multiple, cigar butt"-type). It's clear that the author Pat Dorsey, Director of Stock Analysis for Morningstar, but also Joe Mansueto the founder of the same firm, are great admirers of Mr Buffett.

If you choose this type of franchise investment you also per necessity have to focus your research effort on finding that wonderful business and securing that it stays that way. This is what Dorsey tries to do through this book's five rules. In short they are:

1. Do your homework – engage in the fundamental bottom-up analysis that has been the hallmark of most successful investors, but that has been less profitable the last few risk-on-risk-off-years.
2. Find economic moats – unravel the sustainable competitive advantages that hinder competitors to catch up and force a reversal to the mean of the wonderful business.
3. Have a margin of safety – to have the discipline to only buy the great company if its stock sells for less than its estimated worth.
4. Hold for the long haul – minimize trading costs and taxes and instead have the money to compound over time. And yet...
5. Know when to sell – if you have made a mistake in the estimation of value (and there is no margin of safety), if fundamentals deteriorates so that value is less than you estimated (no margins of safety), the stock rises above its intrinsic value (no margin of safety) or you have found a stock with a larger margin of safety.

After stating the rules Dorsey goes on to present a number of chapters to complement them. Topics like commonly made mistakes, descriptions of various types of economic moats, financial expressions, accounting, analysing companies and their management, how to avoid financial tricksters and valuation. I like the chapter on moats and there are a number of nuggets like "the bottom line about financial health is that when a company increases its debt, it increases its fixed cost as a percentage of total costs." That's why high financial and operational gearing combined with volatile sales is such a potential corporate killer.

Yet this is only half of the book. The second half is a one after another review of the economic characteristics of various corporate sectors. As this book is written about 10 years ago it's interesting to see which sectors that have changed the most during these years. Care to guess? Financials – naturally – but also media. Ten years ago we hadn't started to understand the effect that digitalization and Internet would come to have.

It's really hard to grade this book. It gives a sound, comprehensive and logically consistent investment strategy. But, this is a book for the retail investor. It will take the novel investor a long way, but as the book is so comprehensive the coverage of each topic is quite shallow. If you have some investment experience you will learn very little.

A practice where you buy undervalued stocks that you can own long term will serve the right person well if you got the stomach to stand the short term movement of markets. Above all this book reinforces the importance of being able to articulate ones investment strategy. If not, it's very easy to get frustrated when the markets move against you, this will make you move outside your core competence and will unavoidably lead to trouble. This book gets you started.

Mats Larsson, July 2, 2012