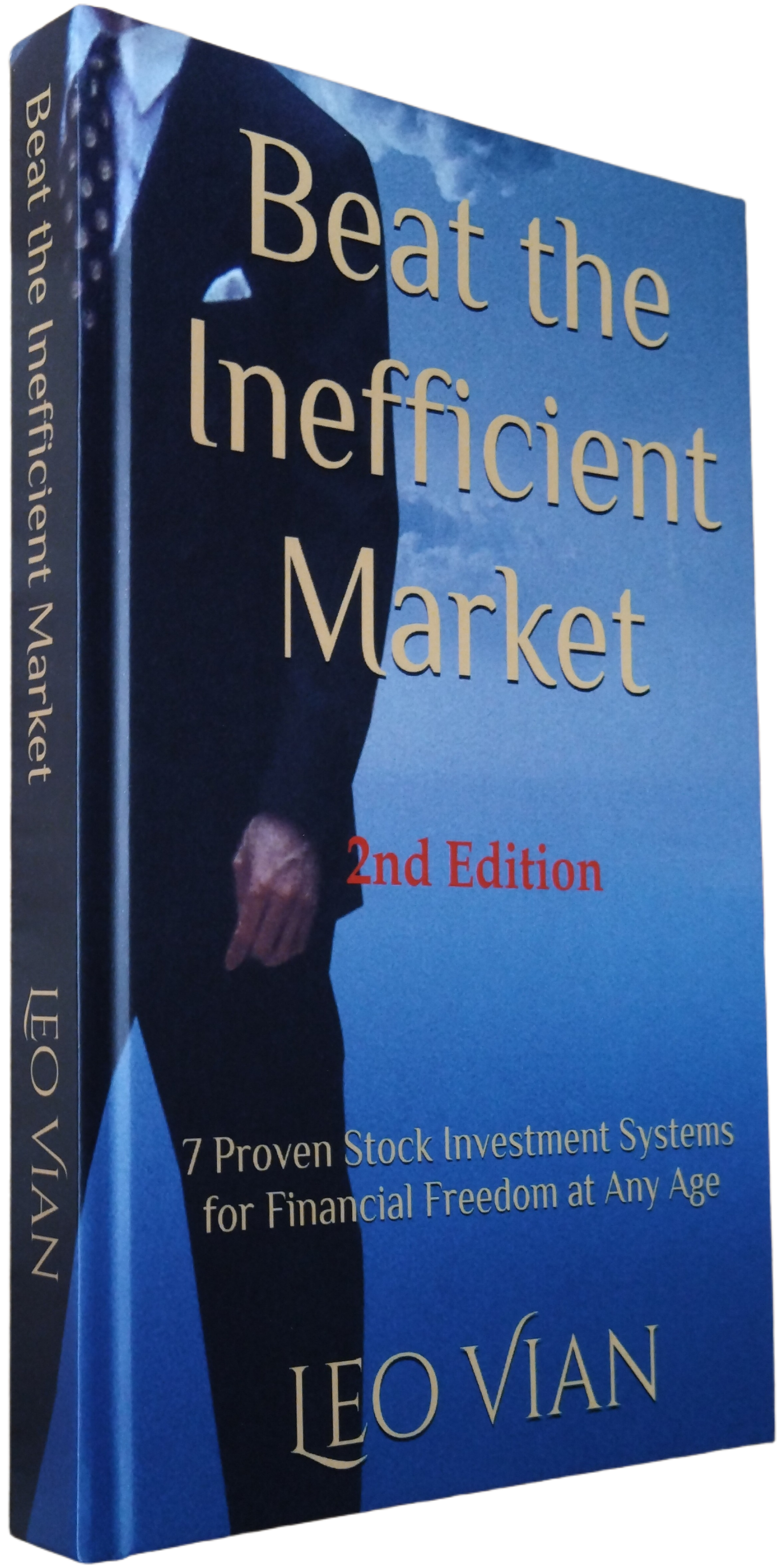

Beat the Inefficient Market
2nd Edition
7 Proven Stock Investment Systems
for Financial Freedom at Any Age
LEO VIAN
Beat the Inefficient Market
LEO VIAN

Beat the Inefficient Market

7 Proven Stock Investment Systems
for Financial Freedom at Any Age

Second Edition

Leo Vian

Book Sample

Purchase the full book here:

- Amazon USA
- Amazon UK
- Amazon Canada
- Amazon Australia

Disclaimer:
This book is written for informational purposes only; it does not constitute a solicitation, offer, advice, counselling, or recommendation to invest as such it is not intended to incentivize the purchase of assets in any way.

Contents

PRAISE FOR THE FIRST EDITION

The following testimonials were received for the first edition of this book. This new second edition has been thoughtfully updated to be accessible and enjoyable for readers of all ages, including teenagers. We are proud to share the positive feedback from earlier readers.

Sandra Moss

Author

Innovative Investment Insights

"Beat the Inefficient Market; Investing in Stocks" by Leo Vian is a good addition to investment literature. With fresh theories and methodologies, this book stands out from the crowd. It's a compelling read for both beginners and seasoned investors, offering accessible insights backed by experiments. Leo Vian's courage to challenge conventional wisdom and present original ideas makes this book a valuable asset. Prepare to conquer the stock market with newfound knowledge and inspiration. A good addition to an investor's bookshelf.

Harvey Stills

Investor

A Definitive Guide to Mastering the Stock Market

"Beat the Inefficient Market: Investing in Stocks" by Leo Vian is an exceptional book that stands as a definitive guide for anyone seeking to navigate the complexities of the stock market. Leo Vian's expertise in investing shines through in this comprehensive and invaluable resource, making it a must-read for both beginners and seasoned investors.

What sets this book apart is its clarity and accessibility. Leo Vian skillfully breaks down complex investment concepts into easily digestible pieces, ensuring that readers can grasp the fundamentals and build a strong foundation in stock market investing. The book is written in a conversational style that engages the reader from the very first page.

"Beat the Inefficient Market" is not just a theoretical guide; it is a practical handbook that equips readers with actionable strategies and insights. Leo Vian provides a step-by-step approach to analyzing stocks, making informed decisions, and building a well-diversified portfolio. The book is filled with real-world examples that illustrate the principles, making it easy to apply the concepts to one's own investment journey.

One of the most valuable aspects of this book is its focus on beating the inefficiencies of the market. Leo Vian's approach is grounded in evidence-based investing, challenging traditional notions and exposing common pitfalls. His emphasis on long-term investing and maintaining discipline resonates with readers looking for a sustainable approach to wealth building.

Moreover, "Beat the Inefficient Market" empowers readers to take control of their financial future. Leo Vian emphasizes the importance of educating oneself about the market and making well-informed decisions rather than relying on external sources. The book instills confidence in readers to navigate the market with a clear and rational mindset.

As a seasoned investor myself, I found "Beat the Inefficient Market" to be a refreshing and enlightening read. Leo Vian's insights and strategies have transformed the way I approach investing, leading to better-informed decisions and improved portfolio performance.

In conclusion, "Beat the Inefficient Market: Investing in Stocks" by Leo Vian is a five-star masterpiece that deserves a place in every investor's library. Whether you're a novice looking to start your investment journey or an experienced investor seeking to refine your approach, this book is an indispensable resource. Leo Vian's expertise and passion for investing are evident on every page, making this book a must-read for anyone seeking financial prosperity through the stock market. Prepare to be enlightened, inspired, and equipped with the knowledge to navigate the market with confidence and success.

Brett G.

Reviewer

A Fantastic Resource!

"Beat the Inefficient Market: Investing in Stocks" is a groundbreaking and refreshing guide that brings a new perspective to investing in the stock market. Authored by Leo Vian, this book is a must-read for both novice investors and those who have experienced setbacks in their stock market journey.

What sets this book apart from others in the genre is its originality. Leo Vian presents a wealth of investment methodologies, financial theories, and views that are entirely unique. Unlike other investment books that seem to echo the same advice, "Beat the Inefficient Market" dares to break free from convention and presents fresh and innovative ideas. By challenging traditional investment wisdom, Vian offers readers a transformative approach to navigating the stock market.

One of the book's standout features is the extensive use of experiments to back up its claims. Leo Vian provides a solid foundation for his theories by conducting thorough experiments, ensuring that the concepts presented are not mere conjecture but have been tested and proven. This emphasis on empirical evidence lends credibility and authenticity to the book, making it a reliable resource for readers.

"Beat the Inefficient Market" caters to a wide range of readers. It appeals not only to seasoned investors seeking new strategies but also to beginners who may be skeptical about investing or have struggled in the past. Vian's writing style is clear, accessible, and engaging, making complex concepts easy to understand for readers of all levels of expertise. With practical advice and actionable tips, the book empowers readers to take control of their investments and make informed decisions.

Leo Vian's passion for investing shines through every page of this book. His enthusiasm is contagious, inspiring readers to view the stock market as a realm of opportunity rather than an insurmountable challenge. By instilling confidence and providing readers with the tools they need to succeed, "Beat the Inefficient Market" encourages individuals to embrace the world of investing and unlock their financial potential.

"Beat the Inefficient Market: Investing in Stocks" is a game-changing book that offers a fresh perspective on stock market investing. With its original ideas, backed by experiments, and its ability to cater to a diverse audience, Leo Vian has created a true standout in the investment genre. Whether you are a beginner or an experienced investor, this book will equip you with the knowledge and confidence to navigate the stock market efficiently. It is a must-read for anyone seeking to achieve financial success through strategic investments.

INTRODUCTION

Have you ever wondered how people make money in the stock market? Or maybe you've overheard people talking about "investing" and felt unsure about what it really means? The stock market is like a giant marketplace where people buy and sell small ownership pieces of companies, called *shares*. But here's the exciting part: the stock market isn't perfect! This means there are always opportunities for smart investors—whether you're a teen just starting out or an adult planning for the future—to succeed.

This second edition of *Beat the Inefficient Market*, now subtitled *7 Proven Stock Investment Systems for Financial Freedom at Any Age*, is designed to teach you how to navigate the stock market and build wealth. Building on my previous book, *Beat the Inefficient Market: Investing in Stocks*, which was written for adults, this updated edition is tailored for teens and for adults who want to learn investment strategies in an engaging and easy-to-understand way. Whether you're a beginner or have some experience, this book will guide you through practical systems to grow your money.

Think of this book as your personal guide to mastering investing. We'll explore seven unique Stock Investment Systems that range from simple strategies anyone can follow to more advanced techniques that require creativity and skill. Each system builds on the last, offering more potential for profit while gradually increasing the level of involvement required.

Systems Overview

- **Systems One through Four**: These are like following a recipe when baking cookies. You don’t need to be an expert—just follow the steps carefully, and you’ll see good results! These systems use straightforward investment formulas that are easy to understand and apply, even if you're new to investing.

- **Systems Five through Seven**: These are more advanced—like becoming a master chef. They allow you to experiment, use your creativity, and develop your own strategies. While these systems offer greater potential rewards, they also require more time, effort, and critical thinking.

Making Financial Concepts Easy

Investing might sound complicated at first, but this book breaks down complex financial concepts into simple explanations with relatable examples. For instance:

- **What is a share?** Think of it like owning a small slice of pizza from your favorite restaurant. When you buy shares in a company, you're buying tiny pieces of ownership in that business.

- **What does "risk" mean?** Imagine riding a bike downhill—it's fun but comes with the chance of falling. Similarly, investing offers opportunities to grow your money but involves risks you need to manage carefully.

- **What is "diversification"?** Picture a fruit basket with apples, oranges, and bananas. If one fruit goes bad, you still have others to enjoy. Diversification means spreading your investments across different companies or industries so you're not relying on just one.

By using analogies like these—and real-world examples—investing becomes accessible and engaging for everyone.

Who Is This Book For?

Whether you're saving your allowance or planning for retirement, this book is for anyone who wants to understand how the stock market works and how to make it work for them. Teens will find clear explanations tailored to their level of understanding, while adults can dive deeper into advanced strategies that build on these foundational concepts.

Throughout this journey, you'll learn how to identify opportunities in the market, avoid common mistakes, and grow your wealth step by step. By the end of this book, you'll have the tools and confidence needed to become a smarter investor—no matter your age or experience level.

Let’s get started on this exciting adventure together!

A BRIEF INTRODUCTION TO THE STOCK MARKET

Common Share

Imagine you and your friends decide to start a lemonade stand together. If you divide the ownership into 10 equal parts (or shares), and you own 1 part, then you own 1/10 of the business. This is exactly how common shares work in the stock market!

When you own a common share of a company, you actually own a small piece of that business. For example, if a company has 1,000 shares in total and you own 100 shares, you own 10% of that entire company. Pretty cool, right?

As a shareholder (someone who owns shares), you can benefit in two main ways:

1. **Dividends** - These are like your share of the profits. When the company makes money, they might decide to share some of those profits with all the owners (shareholders). This is called paying a dividend.

2. **Share price increases** - As the company grows and becomes more successful, the value of your shares can go up. If you bought a share for $10 and later it's worth $15, you've made $5 profit (if you decide to sell it).

Owning common shares also gives you voting rights at shareholder meetings. This means you get a say in important company decisions, like who should be on the board of directors. The more shares you own, the more votes you have!

Here's an amazing fact: The average return (or profit) from investing in large US companies (those in the S&P 500 index) has been around 10.5% per year between 1923 and 2021. What does this mean? If you invested $100 in the stock market, after one year you might have about $110.50. And thanks to something called compound interest (where you earn returns on your returns), your money could double in just seven years!

Even if returns were lower—say 7% per year—your money would still double in about ten years. This is why investing in common shares has historically been one of the most profitable ways to grow your money over time.

About one-third of stock market profits typically come from dividends, while two-thirds come from share price increases as companies grow.

This book focuses mainly on common shares, which we'll simply call "shares" from now on. When you read about "shares" in newspapers or financial websites, they're usually talking about common shares.

Preferred Share

Preferred shares are a bit different from common shares. Think of them like making a deal with the company: "I'll give you my money to use in your business, and in return, you promise to pay me a fixed amount every year."

For example, if you buy a preferred share for $25 that pays 10% per year, the company promises to pay you $2.50 each year—as long as they're making enough money to do so. If the company has a bad year and can't pay, they'll be "in arrears," which means they owe you that money and need to pay it as soon as they can.

Preferred shareholders get paid before common shareholders—that's why they're "preferred." However, unlike common shareholders, preferred shareholders usually don't get to vote at company meetings. It's a trade-off: more reliable income, but less say in how the company is run.

Bonds

Bonds are different from shares. When you buy a bond, you're not becoming an owner of the company—you're becoming a lender. It's like loaning money to a friend, except in this case, you're loaning money to a company.

The company promises to pay you interest (like a thank-you for letting them borrow your money) and, after a certain number of years, they'll give you back your original money. This is called the bond reaching "maturity."

Bondholders get paid first if a company runs into financial trouble—even before preferred shareholders. However, like preferred shareholders, bondholders don't get voting rights.

Stock Exchange

A stock exchange is like a marketplace where people can buy and sell shares of publicly traded companies. In the old days, people had to go to physical buildings to trade stocks, but now most trading happens electronically.

Today, most people buy and sell shares from their homes using computers or even smartphones. It's as easy as shopping online—except instead of buying books or clothes, you're buying small pieces of companies!

Stock Derivatives

Stock derivatives are more complex financial products related to stocks. If stocks are like real apples, derivatives are like betting on what will happen to the price of apples without actually owning any apples.

For example, if you buy a Microsoft stock derivative, you don't actually own a piece of the Microsoft company. You're just making a bet on whether Microsoft 's stock price will go up or down.

This can be risky because if the company selling you the derivatives goes bankrupt, you might lose your money. Many financial experts consider buying derivatives more like gambling or speculation rather than investing.

If you're new to investing, it's very important to make sure you're buying actual shares of companies and not derivatives. You can check with your country's financial authority to confirm that the company you're dealing with sells real shares and not just derivatives.

STOCK INVESTMENT SYSTEM ONE

Complexity of the System: very low
Profitability (approximate; on average): 7% annualized return (100% in 10 years*)

*Compounded profits

Compounding is like a snowball rolling downhill, getting bigger and bigger. When you invest money and earn returns, compounding happens when you earn returns not just on your original investment, but also on the returns you've already earned. For this to work, you need to keep your returns invested rather than spending them.

Have you ever wanted to invest in the stock market but felt overwhelmed by all the choices? What if there was a simple way to invest that didn't require you to become an expert on hundreds of different companies? Good news—there is! It's called investing in the stock market as a whole, and it's our first investment system.

What Does "Investing in the Stock Market as a Whole" Mean?

Imagine the stock market as a giant community garden where hundreds of different plants (companies) grow. If you were to invest in individual stocks, it would be like choosing specific plants to tend and harvest, hoping they produce well. However, instead of trying to guess which plants might thrive, you can become a caretaker of the entire garden—benefiting from the overall growth and bounty of all the plants within it. This is what investing in the stock market as a whole means: you're not depending on the success of just one or two companies but spreading your investment across many.

The easiest way to do this is through something called an index fund. An index fund is like having a collection of seeds from many different plants all at once. When you buy a share of an index fund, you're essentially acquiring a small piece of all the companies represented in that collection.

Why Index Funds Are Powerful

Index funds provide **diversification**, which means spreading your investment across multiple companies and industries to reduce risk. For example, if one company in the basket performs poorly, its impact on your overall investment is minimized because other companies may perform well and balance things out. This makes index funds less risky than investing in individual stocks.

Think of diversification like a fruit basket with apples, oranges, and bananas. If one fruit goes bad, you still have others to enjoy. Diversification means spreading your investments across different companies or industries so you're not relying on just one.

How Index Funds Work

Index funds track specific **market indexes**, such as the S&P 500 or NASDAQ, which represent groups of companies that reflect the overall performance of the stock market or specific sectors.

What is a Market Index?

A **market index** is like a shopping list of companies that represents a specific part of the stock market. Think of it as a recipe that tells the index fund which companies to include in its basket. This book focuses on indexes that represent the stock markets of entire countries.

For example, in the United States, there are three popular indexes:

- **S&P 500 Index** - Contains 500 large U.S. companies (as of 2025, these include companies like Apple, Microsoft, Amazon, and many others)
- **Dow Jones Industrial Average (DJIA)** - Contains 30 major U.S. companies that represent the overall economy

- **Nasdaq Composite Index** - Contains over 3,000 companies listed on the Nasdaq exchange, with many technology companies

Other countries have their own indexes too:

- **Canada**: S&P/TSX Composite Index (about 250 of Canada's largest companies)
- **Australia**: S&P/ASX 200 Index (200 largest Australian companies)
- **United Kingdom**: FTSE 100 Index (100 largest UK companies)

(There are also indexes for specific industries like technology or healthcare, but these don't represent the whole market, so they're not what we're focusing on in this system.)

Why This Matters for Teens and Adults

For teens just starting out, index funds are a fantastic way to learn about investing without taking on too much risk. They allow young investors to benefit from the overall growth of the economy without needing deep knowledge about individual companies. For adults, index funds offer a reliable way to build wealth over time with lower fees compared to actively managed funds.

Whether you're saving for college or retirement, index funds are accessible and easy to manage. They require less time and effort than picking individual stocks while providing steady returns over the long term.

By investing in index funds, you're not just buying into individual companies—you're buying into entire industries and economies. This approach makes investing simpler and more predictable for both beginners and experienced investors alike.

ETFs: The Easiest Way to Invest in an Index

The most popular way to invest in an index is through an Exchange-Traded Fund (ETF). An ETF is a special type of investment company that creates shares you can buy and sell just like regular stocks.

For example, if you want to invest in all 500 companies in the S&P 500 Index, you could buy one share of the SPDR S&P 500 ETF (ticker symbol: SPY). As of March 2025, one share costs around $500 (prices change daily). That's much cheaper than trying to buy shares in all 500 companies separately!

ETFs charge a small fee for managing your investment. For example, the SPDR S&P 500 ETF charges less than 0.1% per year (that's less than $1 for every $1,000 you invest). Some ETFs like Vanguard's S&P 500 ETF charge even less—just 0.03% per year!

Here are some popular ETFs for different countries:

- **United States**: SPDR S&P 500 ETF (SPY) or Vanguard S&P 500 ETF (VOO)
- **Canada**: iShares S&P/TSX Capped Composite Index ETF
- **Australia**: SPDR S&P/ASX 200 ETF
- **United Kingdom**: Vanguard FTSE 100 UCITS ETF

The Secret to Success: Time and Consistency

The most important part of this investment system is investing regularly over a long period of time—at least 10 years or more. This is because the stock market goes up and down in the short term, but has historically grown over the long term.

You can invest once a year, every three months, or even monthly—whatever works for your budget. The key is to keep investing regularly, even when the market goes up and down. In fact, when the market drops, you're actually getting more shares for your money (like buying pizza slices on sale!

Understanding Inflation

Inflation is when prices rise over time, making your money worth less in the future. It's like shrinking money—$100 today might only buy as much as $98 would next year if inflation is 2%.

This is important to understand because:

1. If you keep your money in cash (like in a piggy bank), inflation will make it worth less over time.

2. When planning your investments, you might want to increase how much you invest each year to account for inflation. For example, if you invest $1,000 this year and inflation is 2%, you might want to invest $1,020 next year to keep the same buying power.

The good news is that stock investments have historically grown faster than inflation, which is one reason why investing in stocks is a great way to protect your money's value over time.

Remember: The rules for each Stock Investment System in this book are guidelines, not strict obligations. You’re always free to make your own choices. These rules—including the more important 'hard rules'—are here simply to help you understand what makes each system work effectively.

INVESTMENT METHODOLOGY (SYSTEM ONE)

Key Principles

Investing in suitable index funds over an active investment period of at least ten years at regular intervals, once a year or more often.

Think of an index fund like subscribing to a streaming service bundle instead of buying individual songs or movies. Rather than picking individual stocks (like buying separate songs), you get access to the entire collection with one subscription. The streaming service (index fund) automatically updates its library, adding new hits and removing outdated content, while you simply enjoy the benefits of the whole collection with minimal effort.

Let's break down how System One works into simple steps:

Step 1: Decide Where You Want to Invest

First, choose which country's stock market you want to invest in. Most people start with their own country's market because it's familiar.

Example: If you live in the United States, you might choose the U.S. stock market.

This is like choosing which streaming platform you want to subscribe to—each offers different content libraries with their own unique advantages!

Step 2: Choose the Right Index Fund

Next, pick an index fund that follows the stock market index of the country you selected. Remember, an index fund is like a basket that holds many different stocks at once.

Example: You might choose the SPDR S&P 500 ETF (ticker symbol: SPY), which follows the S&P 500 index. This gives you a small piece of 500 large U.S. companies all at once!

As of March 2025, other popular options include Vanguard's S&P 500 ETF (VOO) or iShares Core S&P 500 ETF (IVV) , which have even lower fees than SPY.

Step 3: Plan Your Investment Schedule

Now, decide:

- How long you'll keep investing (at least 10 years)
- How often you'll invest (at least once per year)
- How much money you'll invest in total

Example: You might decide to invest for 10 years, putting in money once per year, with a goal to invest $100,000 total (or $100,000 in today's money if you're accounting for inflation).

Note: If you don't have 10 years to wait or want faster results, don't worry! We'll cover other strategies in later chapters (Systems Two and above) that might work better for you.

Step 4: Calculate How Much to Invest Each Time

Divide your total investment amount by the number of times you'll be investing.

Example: If you want to invest $100,000 over 10 years, investing once per year:
$100,000 ÷ 10 = $10,000 per year

Step 5: Make Your Investment

Now it's time to actually buy shares of your chosen index fund!

Example: If you're investing $10,000 and each share of SPY costs $500 (as of March 2025), you would buy 20 shares ($10,000 ÷ $500 = 20 shares).

Fun fact: The price of one share of an ETF like SPY is usually different from the actual value of the index it follows. For example, when the S&P 500 index might be at 5,200 points, a share of SPY might cost $520. You can't buy the index itself—you can only buy funds that follow the index.

Step 6: Consider Switching Systems (Optional)

You can switch to a different investment system at any time if your goals change. We'll explain how to do this later in the book.

Think of this like deciding to build a different type of sand castle after you've already started. You can always change your mind and try something new!

Remember, the beauty of System One is its simplicity. You don't need to be a financial expert or spend hours researching stocks. You just need to consistently invest in a broad market index fund over time, and let the power of the overall market work for you.

KEY TAKEAWAYS (SYSTEM ONE)

Let's review what we've learned about our first investment system! Think of this as a quick reminder of the most important points:

Three Simple Rules for Success

1. **Invest in the whole market at once**

The easiest and safest way to invest in stocks is to buy a piece of the whole market through an index fund. This is like getting a small piece of hundreds of companies instead of putting all your money into just one or two companies. The index fund should follow a stock index that represents at least an entire country's market.

2. **Use ETFs for simplicity**

Buying shares of an ETF (exchange-traded fund) is the simplest way to invest in an index fund. Remember, an ETF trades just like a regular stock, so you can buy it through any brokerage account. It's as easy as buying one thing instead of hundreds!

3. **Be patient and consistent**

The three "hard rules" of System One are:

- Invest for at least ten years
- Invest regularly (at least once per year, but quarterly or monthly would be even better)
- Choose an index fund that represents at least an entire country's stock market

Remember, System One is like planting a tree. You need to give it time to grow, water it regularly (add more investments), and choose a good location (the right index fund). If you follow these simple rules, your investment has a good chance of growing over time, just like that tree!

STOCK INVESTMENT SYSTEM TWO

Complexity of the System: low
Profitability (approximate; on average): 8.5% annualized return (125% in 10 years*)

*Compounded profits

A Smarter Way to Invest

System One taught us to invest regularly in index funds. System Two takes this idea one step further: invest more money when stocks are "on sale" (relatively cheap) and less money when stocks are expensive.

Think of it like shopping for your favorite snacks. If cookies normally cost $5 a package but are on sale for $3, you might buy more packages than usual. If they're marked up to $7, you might buy fewer. System Two applies this same smart shopping idea to stocks!

How Do We Know When Stocks Are "On Sale"?

Looking at the price alone doesn't tell us if stocks are cheap or expensive. That's because:

1. The world economy generally grows over time, so stock prices naturally tend to rise over many years
2. Inflation (when money loses value over time) also pushes stock prices higher

So how do we tell if stocks are actually cheap or expensive? We use something called the **Price-to-Earnings ratio**, or **P/E ratio** for short.

What is the P/E Ratio?

The P/E ratio tells us how expensive a company is compared to the money it makes. It's calculated like this:

P/E ratio = Price of the company ÷ Earnings (profits) over the last 12 months
For example, if a company is worth $100 million (its price) and made $5 million in profit last year (its earnings), its P/E ratio would be:

$100 million ÷ $5 million = 20

A P/E ratio of 20 means you're paying $20 for every $1 of yearly profit the company makes. It's like saying it would take 20 years for the company to earn enough profit to equal its current price (if profits stayed the same).

The lower the P/E ratio, the "cheaper" the company is considered to be from the perspective of this ratio.

P/E Ratio for the Whole Market

We can also calculate the P/E ratio for an entire stock market index like the S&P 500. This gives us a good idea of whether the overall market is expensive or cheap compared to its historical average.

For example, as of March 2025, the P/E ratio of the S&P 500 index is around 22, which means that, on average, you're paying $22 for every $1 of yearly profit that the 500 companies in the index make collectively.

How to Use the P/E Ratio to Adjust Your Investments

To decide if the current P/E ratio is high or low, we compare it to the average P/E ratio over the last 15 years. We use 15 years because that's typically long enough to include different economic cycles (good times and bad times in the economy).

Here's the formula to adjust how much you invest:

Adjusted investment amount = Unadjusted investment amount × (Average P/E ratio over last 15 years ÷ Current P/E ratio)

Let's see how this works with an example:

Imagine you want to invest $100,000 in U.S. stocks over 10 years, investing once per year
$10,000 per year).

- Current P/E ratio of S&P 500: 22
- Average P/E ratio over last 15 years: 24

Your adjusted investment amount would be: $10,000 × (24 ÷ 22) = $10,000 x 1.09 = $10,900

This means you should invest $10,900 instead of $10,000 because stocks are slightly cheaper than their 15-year average.

If stocks were expensive (higher P/E than average), you would invest less than $10,000.

Where to Find P/E Ratio Information

For the S&P 500 index, you can find current and historical P/E ratios at websites like:

- www.multpl.com/s-p-500-pe-ratio/table/by-year
- www.macrotrends.net
- Many financial news websites like Yahoo Finance or CNBC

If you're investing in stocks of countries other than the U.S., finding P/E ratio data might be harder. Since stock markets around the world often move in similar patterns, you can use the S&P 500's P/E ratio as a guide.

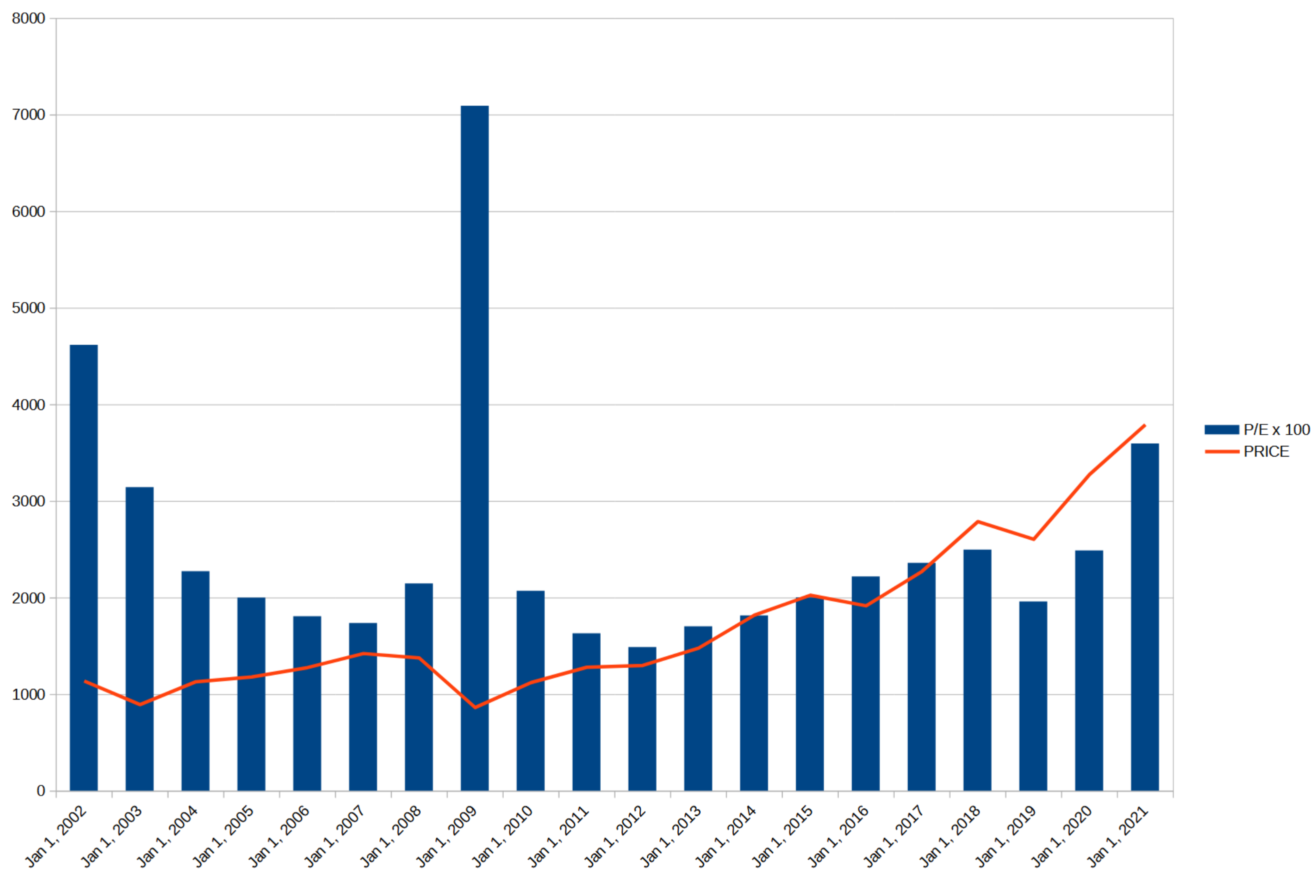
The chart below illustrates the relationship between the price and the P/E (price-to-earnings ratio) of the S&P 500 index. Please note the P/E values were multiplied by 100, so the relationship between the two values is much more noticeable on the chart.

Looking at the chart, we can see:

- The price of the index tends to rise more steeply when the P/E is increasing, and vice versa (Jan 1, 2012 – Jan 1, 2018).
- The price of the index can increase even when the P/E is falling. However, the price doesn't increase as quickly (Jan 1, 2003 – Jan 1, 2007).
- Sometimes there are rare exceptions when the price of the index falls even though the P/E is rising (Jan 1, 2008 – Jan 1, 2009). This usually signals a problem in the economy, as companies are making less profit, which increases the P/E (reported GDP on Dec 31, 2008, was -2.54%, showing the US economy was shrinking significantly). *

*Interestingly, investing less during this time also makes sense because it's better to reduce investments when the economy is really bad, as even strong companies in the index might not all survive the downturn.

Note: There's no such thing as a perfect investment formula. However, you could argue that a good investment formula isn't just one that works (outperforms the market), but also one that isn't unnecessarily complicated. This way, it can be used practically by anyone.



EXPERIMENT: COMPARING SYSTEM ONE AND SYSTEM TWO

Have you ever wondered if adjusting how much you invest based on whether stocks are cheap or expensive really makes a difference? Let's look at a real-world experiment to find out!

The Stock Market's Performance

First, let's look at how the S&P 500 index performed over 10 years:

Note: Performance refers to the profit from price changes only, while return includes both profits from price changes and dividends.

YEAR	PERFORMANCE	RETURN
2021	20.56%	28.71%
2020	15.73%	18.4%
2019	25.73%	31.49%
2018	-6.54%	-4.38%
2017	22.62%	21.83%
2016	18.58%	11.96%
2015	-5.40%	1.38%
2014	11.29%	13.69%
2013	23.10%	32.39%
2012	13.83%	16.00%

Notice that in most years, the stock market went up, but there were a couple of years when it went down. This is normal! Also notice that the "Return" column (which includes dividends) is almost always higher than the "Performance" column (which only looks at price changes). This shows how important dividends are to your total investment return.

P/E Ratios Over Time

Now, let's look at the P/E ratios of the S&P 500 index over the same period:

DATE	P/E RATIO	15-YEAR AVERAGE P/E	15-YEAR AVG / CURRENT P/E
Jan 1, 2022	23.11	24.92	1.08
Jan 1, 2021	35.96	24.53	0.68
Jan 1, 2020	24.88	23.34	0.94
Jan 1, 2019	19.6	23.01	1.17
Jan 1, 2018	24.97	23.22	0.93
Jan 1, 2017	23.59	23.65	1
Jan 1, 2016	22.18	25.16	1.13
Jan 1, 2015	20.02	25.52	1.27
Jan 1,	18.15	26.12	1.44

2014			
Jan 1, 2013	17.03	27.1	1.59
Jan 1, 2012	14.87	27.59	1.86
Jan 1, 2011	16.3	26.59	1.63

The last column is especially important. When this number is greater than 1, it means stocks are cheaper than their 15-year average. When it's less than 1, stocks are more expensive than average.

System One: Investing the Same Amount Each Year

In this example, an investor puts in $10,000 each year for 10 years, for a total investment of
$100,000

DATE	MONEY INVESTED	RETURN (end of year)	BALANCE (end of year)
Jan 1, 2021	$10,000	28.71%	$259,545.81
Jan 1, 2020	$10,000	18.4%	$191,651.63
Jan 1, 2019	$10,000	31.49%	$151,867.93
Jan 1, 2018	$10,000	-4.38%	$105,497.7

Jan 1, 2017	$10,000	21.83%	$100,330.17
Jan 1, 2016	$10,000	11.96%	$72,352.59
Jan 1, 2015	$10,000	1.38%	$54,623.61
Jan 1, 2014	$10,000	13.69%	$43,880.07
Jan 1, 2013	$10,000	32.39%	$28,596.24
Jan 1, 2012	$10,000	16.00%	$11,600.00

After 10 years, the $100,000 investment grew to $259,545.81. That's a profit of $159,545.81!

System Two: Adjusting Investment Based on P/E Ratio

In this example, the investor still plans to invest $100,000 total, but adjusts how much to invest each year based on whether stocks are cheap or expensive:

DATE	P/E ADJUSTMENT FACTOR	MONEY INVESTED	RETURN (end of year)	BALANCE $ (end of year)
Jan 1, 2021	0.68	$0	28.71%	$312,759.79
Jan 1,	0.94	$0	18.4%	$242,995.7

2020				2
Jan 1, 2019	1.17	$7,728.89	31.49%	$205,232.87
Jan 1, 2018	0.93	$9,299.16	-4.38%	$148,353.6
Jan 1, 2017	1	$10,025.43	21.83%	$145,849.98
Jan 1, 2016	1.13	$11,343.55	11.96%	$109,690.55
Jan 1, 2015	1.27	$12,747.25	1.38%	$86,629.43
Jan 1, 2014	1.44	$14,391.18	13.69%	$72,702.97
Jan 1, 2013	1.59	$15,913.09	32.39%	$49,557.25
Jan 1, 2012	1.86	$18,551.45	16%	$21,519.68

The table above shows how System Two works in real life. Imagine someone wants to invest $100,000 over 10 years. With System Two, they invest more money when stocks are cheaper and less when stocks are expensive.

Because stocks were generally on the cheaper side during this period, they actually finished investing all their money in just 8 years instead of the planned 10 years.

Quick note: The last investment ($7,728.89) is smaller than the others because it's just what was left of the original $100,000. If they had followed the formula exactly, that final investment would have been $11,739.80, but they only had $7,728.89 left to invest.

After 10 years, the $100,000 investment grew to $312,759.79. That's a profit of $212,759.79!

What If We Just Invested Equal Amounts Over 8 Years?

To make sure the better results from System Two weren't just because the money was invested earlier, let's look at what would happen if someone invested $100,000 equally over 8 years
$12,500 per year):

DATE	MONEY INVESTED	RETURN	BALANCE
Jan 1, 2021	$0	28.71%	$289,294.44
Jan 1, 2020	$0	18.4%	$224,764.54
Jan 1, 2019	$12,500	31.49%	$189,834.91
Jan 1, 2018	$12,500	-4.38%	$131,872.13
Jan 1, 2017	$12,500	21.83%	$125,412.71
Jan 1, 2016	$12,500	11.96%	$90,440.74
Jan 1, 2015	$12,500	1.38%	$68,279.51

Jan 1, 2014	$12,500	13.69%	$54,850.08
Jan 1, 2013	$12,500	32.39%	$35,745.3
Jan 1, 2012	$12,500	16%	$14,500

After 10 years, this approach grew to $289,294.44. That's better than System One, but still not as good as System Two!

The Results: System Two Wins!

Let's compare the final results:

SYSTEM	FINAL BALANCE	COMPARED TO SYSTEM ONE
System One	$259,545.81	N/A
System Two	$312,759.79	+20.50%
8-Year Equal Investments	$289,294.44	+8.11%

System Two resulted in 20.50% more money than System One! Even just investing equal amounts over 8 years instead of 10 years resulted in 8.11% more money.

This experiment shows that:

1. Investing earlier generally leads to better results (because your money has more time to grow)

2. Adjusting how much you invest based on whether stocks are cheap or expensive System Two) can significantly improve your returns

Think of System Two like a smart shopper who buys more when things are on sale and less when prices are high. Over time, this strategy can help your investments grow even faster!

INVESTMENT METHODOLOGY (SYSTEM TWO)

Key Principles

Investing in suitable index funds while investing more when the overall stock market is cheap and less when it's expensive.

Think of this like being a smart shopper: buying more ice cream when it's on sale and less when the price is high!

Step 1: Decide Where You Want to Invest

Choose which country's stock market you want to invest in. Remember, it should be at least one entire country's market.

Example: Canada

Step 2: Choose the Right Index Fund

Select an index fund that follows the stock market index of the country you chose.

Example: BMO S&P/TSX Capped Composite Index ETF (ticker: ZCN)

This fund tracks the S&P/TSX Capped Composite index, which contains the largest Canadian companies trading on the Toronto Stock Exchange. It represents about 95% of the entire Canadian stock market!

Step 3: Plan Your Investment Schedule

Decide:

- How long you'll keep investing (at least 10 years for regular investing)
- How often you'll invest (at least once per year)
- How much money you'll invest in total

Example: Investing for 10 years, once per year, with a total of $100,000.

What if you want to invest all your money at once?

You should only do this when the overall stock market is not expensive (it should be undervalued or at least neutral). If stocks seem expensive right now, start investing as if you were going to spread it out over 10 years, and then invest the rest when stocks become cheaper.

Why not just wait until stocks are cheap?

Because nobody knows exactly when stocks will become cheap, or if they will at all! While waiting, you might miss out on profits, and inflation will reduce the value of your cash. It's usually better to start investing some money now and save some for when stocks get cheaper.

Step 4: Calculate Your Base Investment Amount

Divide your total investment by the number of times you plan to invest.

Example: $100,000 ÷ 10 years = $10,000 per year

This is how much you would invest if stocks were neither cheap nor expensive.

Step 5: Adjust Your Investment Amount Based on P/E Ratio

Now, adjust your investment amount based on whether stocks are cheap or expensive:

Formula:
Adjusted investment amount = (Average P/E ratio over last 15 years ÷ Current P/E ratio) × Base investment amount

Example:
If you're investing in Canada but can't find historical P/E ratios for Canadian indexes, you can use U.S. data (S&P 500) since stock markets in developed countries often move similarly.

You can find current and historical P/E ratios for the S&P 500 at: www.multpl.com/s-p-500-pe-ra tio/table/by-year

Let's say:

- Average P/E ratio (last 15 years): 22.58
- Current P/E ratio: 21.03
- Base investment amount: $10,000

Adjusted investment amount = (22.58 ÷ 21.03) × $10,000 = 1.0737 x $10,000 = $10,737

Since the current P/E ratio is lower than the 15-year average, stocks are slightly cheaper than normal, so you invest a bit more than your base amount.

Step 6: Make Your Investment

Buy shares of your chosen index fund using your adjusted investment amount.

Example: Buy 383 shares of BMO S&P/TSX Capped Composite Index ETF (ZCN) for $10,743.15 ($28.05 per share).

Step 7: Consider Switching Systems (Optional)

You can switch to a different investment system at any time if your goals change. If you do, treat your already invested money as if it had been invested using the new system all along.

Step 8: Selling Your Investments

When it's time to sell your investments, pay attention to whether the overall stock market is expensive or cheap. Just like you want to buy when stocks are cheap, you ideally want to sell when stocks are expensive!

Remember, System Two is all about being a smart shopper in the stock market. By investing more when stocks are "on sale" and less when they're "overpriced," you can potentially earn better returns over time.

KEY TAKEAWAYS (SYSTEM TWO)

Let's review what we've learned about our second investment system! Here are the most important points to remember:

1. Be a Smart Stock Market Shopper

The easiest way to beat the average stock market returns while investing over time is to invest in an index fund, but with a twist: invest more money when stocks are cheaper and less money when stocks are more expensive. This is like being a smart shopper who buys more ice cream when it's on sale and less when the price is high!

2. Use the P/E Ratio as Your Price Tag

To figure out whether stocks are cheap or expensive, you need to look at something called the P/E ratio (Price-to-Earnings ratio) of a stock index that represents the overall market (like the S&P 500 in the USA.

Compare the current P/E ratio to the average P/E ratio of the same index over the past 15 years:

- If the current P/E is lower than the 15-year average, stocks are relatively cheap (buy more!)

- If the current P/E is higher than the 15-year average, stocks are relatively expensive (buy less!)

3. Use U.S. Data as a Guide for Global Investing

If you're investing in countries other than the United States, you can still use the S&P 500 index P/E ratio data to help determine whether stocks are cheap or expensive. This works because stock markets around the world tend to move in similar patterns, especially in developed countries.

Remember, System Two still uses index funds (just like System One), but by adjusting how much you invest based on whether stocks are cheap or expensive, you can potentially earn better returns over time. Our experiment showed that this approach could increase your returns by about 20% compared to investing the same amount each year!

STOCK INVESTMENT SYSTEM THREE

Complexity of the System: low to moderate
Profitability (approximate; on average): 12% annualized return (200% in 10 years*)

*Compounded profits

Systems One and Two were about investing in the entire stock market through index funds. System Three takes a different approach. Instead of buying the whole market, we'll learn how to select individual stocks using simple formulas.

Think of it like this: Systems One and Two are like buying a variety pack of candy that includes all flavors. System Three is like picking out just your favorite flavors!

Can We Really Beat the Market?

Most professional fund managers (people who invest money for others as their job) don't beat the stock market average. In fact:

- After 5 years, 84% of them perform worse than the market
- After 10 years, 90% perform worse than the market
- After 20 years, 95% perform worse than the market

In 2021 alone, 79% of professional fund managers couldn't beat simple market indexes like the S&P 500 and Dow.

So beating the market is actually a big achievement! But if professional investors with fancy degrees can't do it, how can we? The answer might surprise you: by using simple formula investing that anyone can understand.

Why Do So Many Investors Fail to Beat the Market?

Reason #1: Aiming Too High

Many investors try strategies that are too complicated for them. It's like trying to run a marathon when you've never jogged before!

A good investment strategy should match your abilities and resources. Simple strategies might make less money, but they're easier to learn and follow. Complex strategies might make more
money, but they're harder to understand and require more time and effort.

You don't need to be a genius to be a good investor. In fact, sometimes being too smart can be a problem! Really smart people often make investing too complicated and miss the simple things that actually matter.

Reason #2: Using Strategies That Don't Work

Many investors use strategies that sound good but don't actually work in real life. They haven't been properly tested over long periods.

For example, many new investors get excited about "technical indicators" - special charts and patterns that supposedly predict stock movements. These are available on most trading platforms and come with instructions on how to use them to make money.

A beginner might get lucky at first, but most of these strategies stop working pretty quickly. Very few traders succeed with technical indicators alone over the long term.

Why do brokers (companies that help you buy and sell stocks) provide all these technical indicators? It's because they want to encourage more trading, and brokers make money every time you trade—whether you win or lose! In the same way, many investing websites offer fancy tools like complicated ratios and formulas, analyst opinions, and price targets to keep you engaged.

While some of this information can be useful, it's often confusing and overwhelming.

The Power of Simplicity

Simple financial measurements work best. It's often better to look at several simple financial ratios than one complicated formula that tries to combine everything.

Think of it like baking cookies. Instead of using a pre-mixed cookie dough where you can't tell what's in it, it's better to see the individual ingredients (flour, sugar, butter) so you know exactly what you're getting.

Complex formulas might seem impressive and authoritative, but they often hide important details that smart investors need to see.

Reason #3: Emotional Instability

Many investors fail because they let their emotions control their decisions. This affects short-term traders the most, but it impacts long-term investors too.

When investors don't fully understand their strategy or aren't confident in it, they make erratic decisions - buying when they should be selling, or selling when they should be holding.

To succeed, you need to:

1. Understand your strategy deeply

2. Have confidence in your strategy based on evidence

3. Stick to your strategy even when your emotions tell you otherwise

In the next sections, we'll learn a simple formula-based approach to picking individual stocks that has been proven to work over time. This strategy is straightforward enough for anyone to understand, yet powerful enough to potentially beat the market by a significant margin.

THINKING LIKE A BUSINESS BUYER

Let's try a fun exercise that will help you understand how to evaluate investments!

The Restaurant Exercise

Imagine you've inherited a few million dollars (wow!). You love cooking and your dream has always been to run your own restaurant. Instead of starting from scratch, you'd prefer to buy an existing restaurant that's already up and running.

You find a charming restaurant in a great location that's for sale. Before deciding whether to buy it, what information would you need?

Take a moment to grab a pencil and paper. Write down 3-5 key pieces of information you'd want to

know about this restaurant before buying it. Then you could even rank them in order of importance if you feel up to it. Do this now before reading further.

What Did You Come Up With?

Let's see if your list matches what most experienced investors would ask:

1. The Price of the Business

This is probably the most obvious question! How much does the restaurant cost? But the price alone doesn't tell you if it's a good deal - it only tells you if you can afford it.

2. How Profitable Is the Business?

This is where things get interesting! You'd want to know:

- What percentage return would you earn on your investment?
- How many years would it take to earn back your initial investment?

- How many years would it take to earn back your investment while keeping the restaurant in good condition?

This last question is super important! Restaurants need maintenance - equipment wears out, buildings need repairs, and eventually, things need to be replaced.

For example, if the building costs $500,000 and will last about 50 years, you need to set aside $10,000 each year (2% of the building's value) so you'll have enough money to replace it when needed. This is called "depreciation" - it's like saving up for future repairs and replacements.
You also need to consider taxes and any loan payments if you borrow money to buy the restaurant.

We have already come across something called the Price-to-Earnings ratio (P/E) to measure this. It tells us how many years it would take to earn back our investment if profits stay the same:

P/E ratio = Price of the business ÷ profits in the last 12 months

For example, if the restaurant costs $1,000,000 and made $100,000 in profit in the last 12 months, the P/E ratio would be 10. This means it would take about 10 years to earn back your investment through profits.

3. What Are the Assets Worth?

You'd want to know the value of everything the business owns - the building, land, equipment, furniture, etc. This helps you understand if you're paying a fair price.

If the restaurant went out of business tomorrow, what would all its stuff be worth if you sold it?

In investing, we use the **Price-to-Book ratio** to measure this:

Price-to-Book ratio = Price of the business ÷ Value of assets (minus any debts)

For example, if the restaurant costs $1,000,000, but all its assets (building, land, equipment) are worth $500,000, the Price-to-Book ratio would be 2. This means you're paying twice the value of the assets.

If the business has debts, those get subtracted from the asset value. For example, if the restaurant has $100,000 in loans, the actual book value would be $500,000 - $100,000 = $400,000.

There's also something called the **Price-to-Tangible-Book ratio**, which only counts physical things you can touch (like buildings and equipment) and ignores things like the restaurant's reputation, recipes, or customer loyalty.

Why This Exercise Matters

This exercise shows you how to think like a business owner or investor. When you buy a stock, you're actually buying a small piece of a business - just like buying a restaurant, but on a smaller scale!

The same questions that matter when buying a restaurant also matter when buying stocks:

1. What's the price?

2. How profitable is it?

3. What are the assets worth?

In the next section, we'll learn how to use these same principles to pick individual stocks that might perform better than the overall market.

THE SCIENCE BEHIND SYSTEM THREE

Have you ever wondered why some people are really good at picking stocks? One of the best stock pickers ever was a man named Benjamin Graham (1894 1976). He was like the Yoda of investing - a wise teacher who trained many successful investors, including Warren Buffett, who is one of the richest people in the world today!

Benjamin Graham taught at Columbia University and wrote books called "The Intelligent Investor" and "Security Analysis." Warren Buffett says these are among the best books ever written about investing. In fact, he calls "The Intelligent Investor" the absolute best!

Think Like a Business Owner

Graham taught a simple but powerful idea: when you buy a stock, think of it as buying a small piece of a real business (which it actually is!). Don't just think of stocks as numbers that go up and down on a screen.

Remember our restaurant example? Graham would say buying a stock is just like buying a tiny piece of a restaurant or any other business. And just like with the restaurant, he liked to look at things like:

1. How much profit the business makes compared to its price (P/E ratio)

2. How much the business's assets are worth compared to its price (Price-to-Book ratio)

The Scientific Evidence

Scientists and professors have done experiments to see if Graham's ideas really work. Let's look at what they found!

Experiment #1 Price-to-Earnings Ratio Study

Professor Roger Ibbotson from Yale University did an experiment where he:

1. Took all stocks on the New York Stock Exchange

2. Divided them into 10 equal groups (called deciles) based on their P/E ratios

3. Tracked their performance for 18 years (from December 31, 1966 to December 31, 1984)

Here's what he found:

Group	**Annual Return**	**$1 Invested Grew To**
1 (Lowest P/E ratio)	14.08%	$12.22
2	13.81%	$11.67
3	10.95%	$7.21
4	10.29%	$6.43
5	9.20%	$5.32
6	6.43%	$3.27
7	7.00%	$3.62
8	5.57%	$2.80
9	5.50%	$2.77
10 (Highest P/E	5.58%	$2.81

ratio)		

Wow! The stocks with the lowest P/E ratios (cheapest compared to their earnings) performed much better than those with high P/E ratios. If you had invested $1 in the lowest P/E stocks, you would have ended up with $12.22 after 18 years. But if you had invested in the highest P/E stocks, you would have only $2.81!

Experiment #2: Another P/E Ratio Study

Professors Josef Lakonishok, Robert W. Vishny, and Andrei Shleifer did a similar experiment from 1968 to 1990. They found that over a 5-year period:

- The lowest P/E ratio stocks returned about 139%
- The highest P/E ratio stocks returned only about 72%

Again, the cheaper stocks (low P/E) did much better!

Experiment #3: Price-to-Book Ratio Study

Professor Ibbotson also studied how the Price-to-Book ratio affects returns over the same 18
year period:

Group	Annual Return	$1 Invested

		Grew To
1 (Lowest Price/Book value)	14.36%	$12.80
2	14.40%	$12.88
3	14.39%	$12.87
4	12.43%	$9.26
5	8.82%	$4.98
6	8.36%	$4.60
7	7.69%	$4.09
8	5.63%	$2.83
9	5.26%	$2.65
10 (Highest Price/Book)	6.06%	$3.06

Once again, the stocks with the lowest Price-to-Book ratios (cheapest compared to their assets) performed much better!

Experiment #4: Another Price-to-Book Study

The same three professors also studied Price-to-Book ratios from 1968 to 1990 and found that over a 5-year period:

- The lowest Price/Book ratio stocks returned about 146%
- The highest Price/Book ratio stocks returned only about 56%

What Does This All Mean?

Based on these scientific experiments, we can draw two important conclusions:

1. **It's profitable to invest in companies with low Price-to-Book ratios.** This is because most businesses eventually find ways to make good use of their assets to generate profits. It's like buying a restaurant with great equipment and a prime location at a bargain price -sooner or later, someone will figure out how to make it successful!

2. **It's profitable to invest in companies with low Price-to-Earnings ratios.** After all, the main reason we invest is to make money, and the P/E ratio directly tells us how much we're paying for each dollar of profit. Companies with low P/E ratios are often overlooked because they're not famous or popular. They might be like that little restaurant in your neighborhood that doesn't advertise much but serves amazing food at great prices!

These "neglected" companies often have very low trading volume (not many people buying and selling their stocks), which can be another way to spot them. Investing in these overlooked gems is a proven strategy that has been documented in famous research papers about stock investing.

In the next section, we'll learn how to use these scientific findings to create our own formula for picking stocks that might beat the market!

STOCK INVESTMENT SYSTEM THREE THE TRUTH ABOUT INVESTMENT STRATEGIES

You might be thinking, "Now I understand! System Three must be about buying stocks with low P/E ratios and low Price-to-Book ratios, just like Benjamin Graham taught and those scientific studies showed."

If that's what you're thinking... you've just fallen into a trap that catches many investors!

The Surprising Truth

Here's something that might shock you: the investment principles we just learned about from Benjamin Graham are mostly outdated and don't work well anymore!

Wait, what? But we just saw all those scientific studies showing they worked!

Yes, those studies were real. But they used data from many decades ago (1966-1990). The world has changed dramatically since then. Today's economy is very different from the economy of the 1960s-1980s.

This is one of the most important lessons in investing: **What worked in the past might not work in the future.**

The Modern Reality

Recent analysis conducted for this book using fresh, modern data found some surprising results:

1. **There is almost no connection between Price-to-Book ratios and stock returns today.** The only exception is for extremely cheap stocks with Price-to-Book ratios below 0.5 (meaning the stock price is less than half the value of the company's assets). These might still be good investments, but they're very rare and require additional research.

2. **Even more surprisingly, stocks with HIGHER P/E ratios often perform BETTER than those with low P/E ratios!** This is the opposite of what Benjamin Graham taught and what those old studies showed.

3. **Even a company's growth rate is a poor predictor of future performance.** We'll discuss this more in System Four.

Why Would Warren Buffett Disagree with His Teacher?

Warren Buffett, who was Benjamin Graham's student, once said in a 1988 Fortune magazine interview: "If I had listened only to Ben, I would be a lot poorer."

Both Buffett and his business partner Charlie Munger believe that following Graham's methods strictly is outdated. That's why Buffett's investment strategy has evolved throughout his career.

Important Lessons to Remember

1. **Everything changes.** The world changes, businesses change, economies change, and investment strategies must change too if they're going to remain profitable.

2. **Just because something sounds logical doesn't mean it works.** Many investment ideas sound perfectly reasonable but fail in the real world.

3. **A good investment strategy must be both logical AND proven through testing with recent data.**

The Power of This Lesson

If this lesson is the only thing you remember from this entire book, you'll still be ahead of most investors! Many people, even professional fund managers, keep using outdated strategies because "that's how it's always been done" or because some famous investor used that strategy decades ago.

Think of it like this: If someone gave you a map from 1950 to navigate a modern city, you'd get lost because new roads have been built, old ones have changed, and entire neighborhoods have been transformed. Investment strategies are the same way - they need to be updated as the world changes.

So what is System Three actually about? Don't worry - in the next section, we'll reveal a modern formula that has been tested with recent data and actually works in today's markets!

KEY PRINCIPLES OF STOCK INVESTMENT SYSTEM THREE

Now that we understand how investment strategies need to evolve with the changing world, let's explore what System Three actually recommends for today's market.

Finding the Right Balance with P/E Ratios

Finding companies with very low price-to-earnings (P/E) ratios used to be a great strategy, but it rarely works today. Why? Because companies with extremely low P/E ratios are usually in trouble or declining. They might be like an old restaurant in a neighborhood where nobody wants to eat anymore - cheap, but cheap for a reason!

Think about it this way: If you saw a bicycle for sale at 80% off the normal price, you'd probably wonder what's wrong with it. The same goes for stocks that seem "too cheap" compared to their earnings.

Many investors who own these super-cheap stocks are what we call "trapped investors." They don't want to sell because they would lose money, so they keep holding and hoping things will get better. It's like refusing to admit your lemonade stand in a rainy location was a bad idea, even though nobody is buying your lemonade.

On the other hand, you also want to avoid stocks with extremely high P/E ratios, even if the company is growing quickly. Companies with sky-high P/E ratios are like restaurants charging $50 for a hamburger because they think they'll be famous someday. Eventually, reality catches up, and the price comes crashing down when people realize the burger isn't worth $50.

The Golden Rule of System Three

The hard rule of Stock Investment System Three is to invest only in companies whose P/E ratio is between two-thirds and double the median average P/E ratio for all stocks in that country.

For example, if the median P/E ratio for all U.S. stocks is 15

- The lower limit would be 10 (two-thirds of 15)
- The upper limit would be 30 (double 15)

You would only invest in companies with P/E ratios between 10 and 30.

Note: There are some special situations where companies with very high P/E ratios might still be good investments, but identifying these companies requires more advanced analysis that we'll cover in System Six.

Using Random Selection

Here's something that might surprise you: Systems Three, Four, and Five all use randomness to pick stocks!

Why? Because after you've filtered out the bad companies using the rules of each system, you'll still have many good companies to choose from. Most investors make the mistake of trying to pick "the best" from this group, but this is where many people mess up.

For example, let's say you've found 300 companies that meet all your criteria. You want to invest in just 3 of them. Instead of agonizing over which 3 are "the best," System Three says to use a random number generator (you can find these online by searching "random number generator").

Generate random numbers between 1 and 300 until you have 3 different numbers. These numbers correspond to the companies you'll invest in. Some investors add one more rule: don't invest in the same industry twice. If a randomly selected company is in an industry you've already invested in, just generate another random number.

This might sound crazy, but it works! Most investors aren't skilled enough to pick the absolute best stocks, and trying to do so often leads to worse results than random selection from a pre-filtered group of good companies.

Using a simpler system isn't a sign of failure. Someone who finds advanced investment math challenging might be extremely talented in other areas like art, music, sports, or science!

Why We Use Median Instead of Mean Average

You might be wondering why we use the median P/E ratio instead of the regular (mean) average.

The median is the middle value when all numbers are arranged in order. For example, if five stocks have P/E ratios of 5, 10, 15, 20, and 1000, the median is 15 (the middle value).

The mean (regular average) would be (5 + 10 + 15 + 20 1000) ÷ 5 = 210, which is much higher than most of the values!

Median averages work much better in investing because they don't get distorted by extremely high or low values. Sometimes a company might temporarily have almost no earnings, which could make its P/E ratio shoot up to 15,000 or even higher! Including such extreme values in a regular average would give you a very misleading number.

The median, however, simply identifies the middle value, so these extreme outliers don't affect it much, especially when you're looking at hundreds or thousands of stocks.

In the next section, we'll put all these principles together and show you exactly how to implement System Three step by step!

INVESTING IN DIFFERENT INDUSTRIES

Have you ever noticed how there are many different types of businesses in the world? Some companies make computers, others make medicine, and some build houses or operate banks. All these different types of businesses are grouped into categories called "industries" and "sectors."

What Are Industries and Sectors?

An **industry** is a group of companies that do similar types of business. For example, companies that make medicines are part of the "Pharmaceutical" industry.

A **sector** is a broader category that includes several related industries. For example, the "Health Care" sector includes both the "Pharmaceutical" industry and the "Health Care Technology" industry.

Think of it like a music streaming service: industries are like specific music genres (rock, hip-hop, country), while sectors are like the broader playlists (workout music, party music, study music) that contain multiple genres. Just as you might find both rock and pop songs in your "Workout" playlist, you'll find pharmaceutical companies and medical device manufacturers within the "Health Care" sector.

Why Invest in Different Sectors?

Different sectors perform differently depending on what's happening in the economy. It's like how some types of businesses do better in summer (like ice cream shops) while others do better in winter (like hot chocolate stands).

When you invest in many different sectors, it's called **diversification**. This helps make your investment portfolio safer because if one sector is doing poorly, others might still be doing well.

The Major Market Sectors

Here are the eleven main sectors of the U.S. stock market as of March 2023, along with how much of the total market each one represents:

SECTOR	MARKET WEIGHT	EXAMPLE FOR 30 STOCK PORTFOLIO
Information Technology	26%	8 stocks
Health Care	14%	4 stocks
Financials	13%	4 stocks
Consumer Discretionary	10%	3 stocks
Industrials	9%	3 stocks
Communication Services	8%	2 stocks
Consumer Staples	7%	2 stocks
Energy	4%	1 stock
Utilities	3%	1 stock
Materials	3%	1 stock
Real Estate	3%	1 stock

Note: Different countries might have slightly different sector weights, but developed countries (like the United States, Canada, Australia, and European countries) tend to be fairly similar.

How to Use This Information

When building your investment portfolio, it's often a good idea to invest in various sectors while considering their size in the overall market. This helps you create a balanced portfolio.

For example, if you're planning to invest in 30 stocks using System Three, you might consider investing in 8 technology companies, 4 health care companies, 4 financial companies, and so on, as shown in the table.

However, you don't need to match these numbers exactly. Think of them as helpful guidelines rather than strict rules.

Balancing Diversification and Profit

There's always a trade-off between making your portfolio very safe through diversification and focusing on the most profitable investments.

- If you're using a simpler system like System Three, it makes sense to focus more on diversification by investing across many sectors.

- If you're using a more advanced system like System Six (which we'll learn about later), you might focus more on finding the most profitable investments, while still trying to diversify when possible.

Interestingly, even if you don't specifically try to diversify with System Three, you'll probably end up with a well-diversified portfolio anyway. This is because you'll be investing in at least 30 randomly selected companies that passed the System Three screening.

On the other hand, with System Six, you might end up with a less diversified portfolio because you'll be investing in as few as 10 companies. But that's okay because the advanced analysis in System Six helps compensate for the reduced diversification. Remember: Diversification is not a hard rule in any of our systems, but it's something to consider, especially if you have enough time and can handle the extra bit of complexity.

EXPERIMENTS WITH P/E RATIOS

Have you ever wondered if we could test whether our investment ideas actually work? Scientists do experiments all the time to test their theories, and we can do the same with investment strategies!

Testing the P/E Ratio Strategy

Let's look at a real experiment that tested whether the P/E ratio rules in System Three actually work.

For this experiment, the first 50 U.S. stocks (in alphabetical order) listed on Stockrow.com with financial years ending on December 31st, 2017 were selected. These stocks were then divided into three groups based on their P/E ratios:

1. **Low P/E Group**: Stocks with P/E ratios below two-thirds of the median average

2. **Medium P/E Group**: Stocks with P/E ratios between two-thirds and double the median average

3. **High P/E Group**: Stocks with P/E ratios more than double the median average

The median P/E ratio for all profitable U.S. stocks on December 31, 2017 was 19.21.

- The lower limit was 12.81 (two-thirds of 19.21)

- The upper limit was 38.42 (double 19.21)

The Results

After tracking these stocks for four years, here's what the results showed:

P/E GROUP	NUMBER OF STOCKS	AVERAGE RETURN IN 4 YEARS	COMPARED TO OVERALL AVERAGE

All stocks	50	35.48%	1.00 x
Low P/E (<12.81)	17	8.14%	0.23 x
Medium P/E (18.21-38.42)	22	46.36%	1.31 x
High P/E (>38.42)	11	55.99%	1.58 x

What Do These Results Tell Us?

1. **Medium P/E stocks** (the ones System Three recommends) performed 31% better than the average of all stocks. This confirms that our System Three rule works well!
2. **Low P/E stocks** performed terribly - only 23% of the average return. This is surprising if you believe the old investment wisdom that "cheaper is better." In reality, these super-cheap stocks were cheap for a reason - they were often troubled companies.
3. **High P/E stocks** actually performed the best, with returns 58% higher than average. This is the most surprising result!

If High P/E Stocks Did Best, Why Not Invest in Them?

This is a great question! If the experiment showed that high P/E stocks performed best, why doesn't System Three recommend them?

The answer comes from Benjamin Graham, who said: "In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

What does this mean? In the short term, stocks can be popular based on excitement and hope rather than actual business results. It's like a popularity contest or a vote. But over the long term, what really matters is the actual value the business creates -how much it "weighs" in terms of real profits and assets.

High P/E stocks are often priced based on extremely optimistic expectations about future growth. For a while, these stocks can keep rising as more people get excited about them. But eventually, if the company doesn't live up to these sky-high expectations, the stock price can crash dramatically.

Think of it like a balloon that keeps getting bigger and bigger. The bigger it gets, the more impressive it looks - until it pops! When high P/E stocks fall, they often fall very hard and very fast.

Remember, a good investment strategy needs to be both:

1. **Logical** - it needs to make sense

2. **Back-tested** - it needs to be proven with real data

The high P/E group passes the back-testing part (at least for our 4-year period), but it fails the logic test for long-term investing.

System Three chooses the middle path - stocks with reasonable P/E ratios that have shown good performance in testing and also make logical sense for long-term investing.

MORE EXPERIMENTS WITH P/E RATIOS

Let's look at another experiment that tests our P/E ratio strategy, but with a different group of stocks.

Testing with S&P 500 Companies

For this experiment, the first 50 U.S. stocks from the S&P 500 index (in reverse alphabetical order, from Z to A) with financial years ending on December 31st were selected.

- The median P/E ratio for profitable S&P 500 companies on January 1, 2018 was 24.97.
- The lower limit was 16.65 (two-thirds of 24.97)
- The upper limit was 49.94 (double 24.97)

Just like before, these stocks were then divided into three groups based on their P/E ratios:

The Results

P/E GROUP	NUMBER OF STOCKS	AVERAGE RETURN IN 4 YEARS	COMPARED TO OVERALL AVERAGE
All stocks	50	82.94%	1.00 x
16.65>	13	31.78%	0.38 x
16.65-49.94	27	104.91%	1.26 x
49.94<	10	90.13%	1.09 x

What's Similar and What's Different?

The pattern is similar to our first experiment:

- Medium P/E stocks performed the best compared to the average (1.26× better)
- Low P/E stocks performed the worst (only 0.38× of the average)

But there's something interesting: the overall returns for these S&P 500 stocks (82.94%) were much higher than the returns for the random stocks in our first experiment (35.48%)!

Why Did S&P 500 Stocks Perform Better?

This wasn't just luck. When you take a sample of 50 or more stocks, you usually get results similar to the whole group they came from. The entire S&P 500 index returned 91.60% during this period, so our sample's 82.94% return makes sense.

But why did large companies (S&P 500) perform so much better than the broader market? This seems strange because historically, smaller companies have grown faster and provided higher returns (about 20% more per year on average).

The S&P 500 Bubble

There's an interesting explanation for this:

1. **Index Fund Effect**: Many index funds automatically buy all the stocks in the S&P 500. As more people invest in these funds, they create constant buying pressure on these 500 companies.

2. **Momentum Investors**: Some investors buy S&P 500 companies simply because they expect them to rise due to index fund buying, which pushes prices even higher.

This is what economists call a "Castle in the Air" strategy - buying something not because of its actual value, but because you expect others will pay more for it later. The famous economist John Maynard Keynes described this approach in 1936, saying: "In this kind of world, there is a sucker born every minute - and he exists to buy your investments at a higher price than you paid for them."

This is different from Warren Buffett's approach, which focuses on buying companies based on their actual business (intrinsic) value.

The Price of Popularity

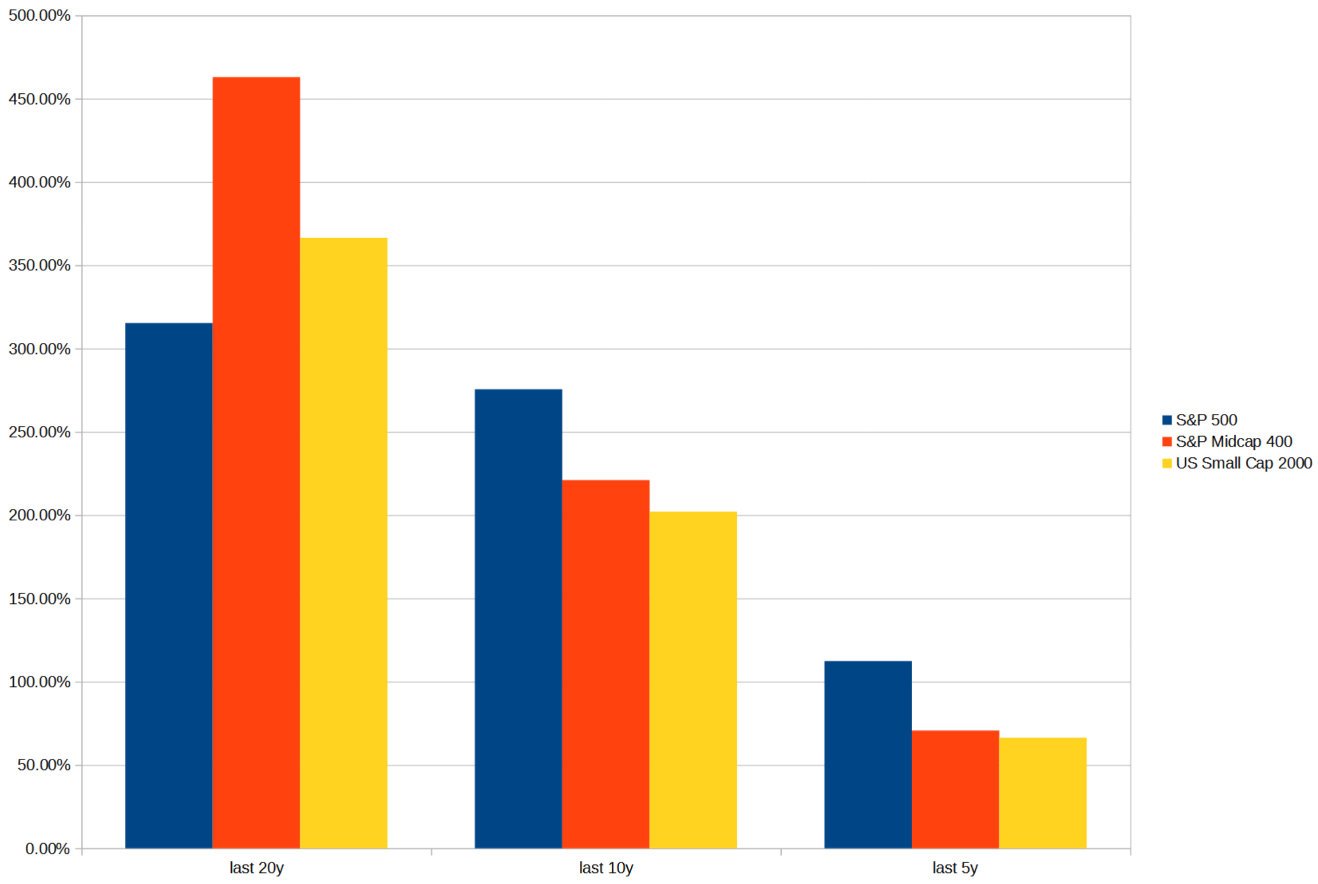
By January 2022, the median P/E ratio of profitable S&P 500 companies was more than 50% higher than the median for all U.S. profitable companies. This means if you bought large companies, you were paying over 50% more for the same amount of profits compared to medium or small companies!

Let's look at the long-term performance of different sized companies:

INDEX	20-YEAR PERFORMANCE*	20-YEAR PERFORMANCE*	20-YEAR PERFORMANC
S&P 500 (large companies)	+315.39%	+275.59%	+112.44%
S&P Midcap 400 (medium companies)	+462.88%	+221.10%	+70.73%
US Small	+366.46%	+202.10%	+66.43%

Cap 2000 (small companies)			

*as of January 3, 2022



Over 20 years, medium-sized companies actually performed much better than large ones! But in the last 5 and 10 years, large companies have outperformed smaller ones - possibly due to the index fund effect we discussed earlier.

If the S&P 500's strong performance proves unsustainable and reverses in the future, our System Three approach (which works for companies of all sizes) could become even more valuable.

SPECULATION: THE RISKY SIDE OF STOCK MARKETS

When we talked about the "Castle-in-the-Air" theory, we mentioned something called speculation. Speculators are people who try to make money from quick changes in stock prices rather than from the long-term growth of businesses. They often use risky methods like buying stocks with borrowed money or something called "short selling." Let's learn about these practices and why they can be dangerous.

Why Do People Speculate?

There are five main reasons why someone might choose to speculate instead of invest:

1. **The dream of fast profits** - Some people want to make money in a single day rather than waiting years

2. **Higher profit potential** - The possibility (though not the likelihood) of making much more money than through regular investing

3. **Simplicity** - Some forms of speculation seem simpler than researching companies

4. **Lack of knowledge** - Not understanding the risks or not knowing better ways to invest

5. **Enjoyment of gambling** - Some people find the excitement of risk-taking addictive

While a few speculators have made enormous amounts of money, most end up losing everything. Even the most successful speculators live in constant fear of losing it all—and many eventually do. They can lose their money, jobs, reputation, and careers practically overnight. Is that excitement really worth the risk?

Buying Stocks with Borrowed Money (Leverage)

Using borrowed money to buy stocks is called "buying on leverage" or "using margin." This is much easier to do than you might think. You don't need to go to a bank and apply for a loan. Many brokers (the companies that help you buy and sell stocks) offer this option right from their trading platforms.

Here's how it works:

Imagine you have $1,000 to invest. With "triple leverage," you could buy $3,000 worth of stocks - $1,000 of your own money plus $2,000 borrowed from the broker.

This might sound great, but it's extremely risky. If the stocks you buy go up by 10%, you'd make $300 (10% of $3,000) instead of just $100 (10% of $1,000). But if the stocks drop by 1/3, you would lose your money because the loss would be tripled by the triple leverage.

Plus, you have to pay interest on the borrowed money, which reduces your profits.

Think of it like using a magnifying glass. With leverage, both your gains and losses are magnified. If you make a good investment, the magnifying glass helps you see (earn) more. But if you make a bad investment, that same magnifying glass makes your losses look much bigger too. And unlike a regular magnifying glass that you can put down anytime, with leverage, you're stuck looking through it until you close your investment position.

Short Selling: Betting That Prices Will Fall

Short selling is a way to make money when stock prices go down instead of up. It works like this:

1. You borrow shares of a stock from someone else (your broker handles this)

2. You sell those borrowed shares at the current price

3. If the price drops, you buy the shares back at the lower price

4. You return the shares to the lender

5. You keep the difference between what you sold them for and what you bought them back for

For example, if you think Company XYZ's stock price is going to fall:

- You borrow 10 shares when they're worth $100 each
- You sell those 10 shares for $1,000
- The price drops to $70 per share
- You buy 10 shares back for $700
- You return the 10 shares to the lender
- You keep the $300 difference as profit

This might sound complicated, but on most trading platforms, you just click "sell" on a stock you don't own, and the computer handles all the borrowing behind the scenes.

Short selling is even riskier than buying stocks with borrowed money because:

1. Stock prices generally go up over time, so you're betting against the historical trend

2. If you own a stock and its price falls to zero, the most you can lose is 100% of your investment. But with short selling, there's no limit to how high a stock price can go, so your potential losses are unlimited if you keep adding money to your trading account assuming the price will reverse soon.

3. You also have to pay any dividends the stock issues while you're borrowing it

Imagine borrowing your friend's bike to sell it, hoping to buy a cheaper one later to give back to them. If bike prices suddenly double instead of falling, you're in big trouble!

Why This Book Doesn't Recommend Speculation

This book focuses on investing, not speculation. When you invest, you become a partial owner of real businesses and benefit from their growth and profits over time. When you speculate, you're essentially gambling on price movements.

While speculation might seem exciting and offer the possibility of quick riches, it's much more likely to lead to quick losses. The methods in this book are designed to help you build wealth steadily and safely over time, not to make you rich overnight (or broke tomorrow).

INVESTMENT METHODOLOGY (SYSTEM THREE)

Key Principles

System Three involves investing in a portfolio of randomly selected stocks that have price-to-earnings ratios within a specific range - between two-thirds and double the median average for profitable stocks in your target country. You'll invest more when the overall stock market is cheaper and less when it's more expensive. The goal is to build a portfolio of at least 30 stocks of similar investment size.

Think of this system like building a collection of trading cards. Instead of trying to get just the rarest cards (which might be overpriced), you look for good-quality cards that are reasonably priced. And you buy more cards when there's a sale at the store!

Step 1: Choose Where You Want to Invest

Decide which country's stock market you want to invest in.

Example: Australia

Step 2: Check if the Market is Cheap or Expensive

Before investing, find out if the stock market in your chosen country is currently cheaper or more expensive than its historical average.

To do this, calculate the average P/E ratio of a stock index for that country over the last 15 years. If you can't find this data (which is common for many countries), you can use the S&P 500 index data from the United States, since stock markets around the world tend to move similarly.

Example: Since historical P/E ratio data for Australian stock indexes isn't easily available, we'll use S&P 500 data instead.

You can find current and historical P/E ratios for the S&P 500 at: www.multpl.com/s-p-500-pe-ra tio/table/by-year

Let's say the average P/E of the S&P 500 over the last 15 years is 21.41, and the current value is 24.64. Since the current value is higher than the average, this suggests stocks are currently more expensive than usual.

Step 3: Plan Your Investment

Decide:

- How long you'll invest for

- How often you'll invest
- How much money you'll invest in total
- How many stocks you want to buy

Remember, System Three requires you to eventually own at least 30 stocks of similar investment size (this is a hard rule).

If you're investing regularly over time, you should plan for at least 10 years, investing at least once per year.

If you want to invest all your money at once, you should only do this when stocks are undervalued or at least neutral compared to their historical average (based on P/E ratio). If stocks seem expensive right now, start investing as if you were spreading it out over 10 years, and save the rest for when stocks become cheaper.

Example: Let's say you inherited $250,000 and want to invest it all in the stock market as quickly as possible. You plan to eventually own 60 stocks of similar investment size and will invest twice per year if you can't invest it all at once.

Since the stock market currently appears overvalued (current P/E is higher than the 15-year average), you'll start investing as if you were spreading it over 10 years, and invest the rest when the market becomes cheaper.

Step 4: Calculate Your Base Investment Amount

Figure out how much you'll invest each time if the market was neither cheap nor expensive.

Example:

- Total investment: $250,000
- Investment period: 10 years
- Frequency: twice per year
- Number of investments: 10 years × 2 = 20 investments
- Base investment amount: $250,000 ÷ 20 = $12,500 per investment
- Money for each stock: $250,000 ÷ 60 stocks = about $4,167 per stock

Step 5: Adjust Your Investment Amount Based on Market Value

Adjust your investment amount based on whether the market is cheap or expensive:

Adjusted amount = (15-year average P/E ÷ Current P/E) × Base amount

Example:
Adjusted amount = (21.41÷ 24.64) × $12,500 = 0.869 x $12,500 = $10,861.40

Since the market is expensive right now, you'll invest less than your base amount.

Step 6: Decide How Many Stocks to Buy Now

Based on your adjusted investment amount, decide how many stocks to buy in this round.

Example: Since your adjusted amount is $10,861.40, and each stock costs about $4,167, you should buy approximately 3 stocks. To calculate this, divide $10,861.40 by $4,167, which equals 2.6. Since you can't buy a fraction of a stock, you would round this up to 3 stocks.

Step 7: Choose a Stock Screener

A stock screener is a tool that helps you filter stocks based on criteria you set. Free versions on websites like Investing.com, Yahoo Finance, or Stockrow.com (for U.S. stocks) work well for System Three.

Step 8: Find the Median P/E Ratio

Use your chosen screener to find the median P/E ratio of all profitable stocks in your target country.

Think of the median as the middle value when all P/E ratios are lined up from smallest to largest. If there are 100 stocks, the median would be the average of the P/E ratios of the 50th and 51st stocks (since there's an even number of stocks, and the median falls between these two middle values). If there were an odd number of stocks, the median would simply be the P/E ratio of the stock in the exact middle.

Example: Using Investing.com's screener for Australian stocks, you find 636 profitable companies (out of 2,437 total stocks). When arranged by P/E ratio, the median value is 14.61.

Step 9: Find Stocks Within Your P/E Range

Now, find all stocks with P/E ratios between two-thirds and double the median:

- Lower limit: (14.61 ÷ 3) × 2 = 9.74
- Upper limit: 14.61 x 2 = 29.22

Example: Using these limits, you find 251 Australian companies with P/E ratios between 9.74 and 29.22. These are all suitable for investment under System Three.

Step 10: Randomly Select Your Stocks

If you have too many suitable stocks (which you usually will), use a random selection method to choose which ones to buy.

This might sound strange, but it's actually one of the key parts of System Three! Most investors make the mistake of trying to pick "the best" stocks, but this often leads to worse results. Using random selection from pre-filtered good companies works better for most people.

You can use a random number generator online (just search "random number generator") to select from your list of suitable stocks.

Step 11: Make Your Investments

Buy your selected stocks through a trusted broker. Make sure you're buying real shares, not derivatives or other financial products.

Step 12: Consider Switching Systems (Optional)

You can switch to a different investment system at any time if your goals change.

Step 13: Selling Your Investments

When it's time to sell, follow these guidelines:

- If selling gradually, sell the same proportion of each stock (hard rule)
- Be aware of whether the overall market is cheap or expensive when selling
- Avoid the common mistake of selling winners while keeping losers

The "Four Years Rule"

It's recommended to wait at least four years after creating your portfolio before considering selling. This applies to System Three and higher systems.

Don't worry about how your stocks are performing in the first two years, regardless of your investment strategy. The stock market needs time to work its magic!

KEY TAKEAWAYS (SYSTEM THREE)

Let's review the most important points about System Three! This system helps you pick individual stocks that have a good chance of outperforming the market.

The Core Principle

The main rule of System Three is to invest in stocks with P/E ratios between two-thirds and double the median average of all profitable stocks in your chosen country. This helps you avoid both extremely cheap stocks (which might be troubled companies) and extremely expensive stocks (which might be overvalued).

Think of it like shopping for sneakers - you avoid the suspiciously cheap ones that might fall apart and the ridiculously expensive designer ones that aren't worth the price. You focus on good-quality sneakers at reasonable prices!

The Hard Rules of System Three

1. **Build a diverse portfolio** - Own at least 30 stocks of similar investment size (this means you invest roughly the same amount in each stock)

2. **Adjust for market conditions** - Invest more when the overall stock market is cheaper and less when it's more expensive

3. **Invest regularly** - Invest once per year or more frequently

4. **Be smart about lump-sum investing** - If you want to invest all your money at once:

   - Go ahead if the market is undervalued or neutral

   - If the market is overvalued, start investing as if you were spreading it over 10 years, and save the rest for when the market becomes cheaper

5. **Use random selection** - If you have more suitable stocks than you need (which you usually will), use a random selection method to choose which ones to buy

6. **Be consistent when selling** - If selling gradually, sell the same proportion of each stock to maintain your portfolio's structure

7. **Consider market value when selling** - Be aware of whether the market is cheap or expensive when selling, especially for large amounts

Optional Practices

- **Account for inflation** - You can increase your investment amounts over time to account for inflation, but this is optional

- **Invest for the long term** - Plan for at least 10 years if investing gradually over time

- **The Four-Year Rule** - It's recommended to wait at least four years after creating your portfolio before considering selling. Don't worry about performance in the first two years -the stock market needs time to work!

- **Consider diversification across sectors** - While not a hard rule, it's often good to invest across different industries

Remember, System Three is designed to be simple enough for anyone to follow while still having the potential to outperform the market. By focusing on stocks with reasonable P/E ratios and using random selection from pre-filtered good companies, you avoid many of the emotional mistakes that cause investors to underperform.

STOCK INVESTMENT SYSTEM FOUR

Complexity of the System: moderate
Profitability (approximate; on average): 15% annualized return (300% in 10 years*)

*Compounded profits

Welcome to System Four! If System Three was like learning to ride a bicycle, System Four is like upgrading to a mountain bike with gears. It's more complex, but it gives you more power and control.

System Four could be called "advanced formula investing." We're going to look at more information about companies to make even better investment decisions.

Investing is About Probabilities

Imagine you're trying to guess how many jelly beans are in a jar. If you can only see one side of the jar, your guess probably won't be very accurate. If you can see all sides, your guess will be better. But even if you can see the whole jar, you still might not get the exact number right.

Investing works the same way. Nobody—not even the CEO of a company—knows everything about a business. But the more good information you have, the better your chances of making a good investment decision.

However, there are two problems that can happen:

1. **Analysis paralysis** - Having so much information that you feel overwhelmed and can't make a decision

2. **Not knowing what's important** - Having lots of information but not knowing which pieces matter most

Different types of information have different levels of importance, but these levels can change depending on the company. It's like how weather is very important for an ice cream shop but less important for a video game company.

Safety in Numbers

No matter how good your analysis is, it's still important to invest in multiple stocks (at least 20 for System Four). This spreads out your risk, just like not putting all your eggs in one basket.

The Two Phases of System Four

System Four has two main phases:

1. **First Screening**: Finding "Stable Bargain Companies" - These are good-quality companies at reasonable prices

2. **Second Screening**: Finding "Stable Growable Bargain Companies" - These are stable bargain companies that also have great growth potential

End of Book Sample

Thank you for reading this free preview.
Continue your journey to financial freedom — get the complete book now from your preferred Amazon store:

- Amazon USA
- Amazon UK
- Amazon Canada
- Amazon Australia

Start applying these proven stock investment systems today — your future self will thank you!