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INVESTING IN STOCK MARKET

10 LESSONS FROM PETER LYNCH

PETER Lynch is a highly successful investor who is renowned for his expertise in the stock market.

He is best known for his tenure as the manager of the Fidelity Magellan Fund from 1977 to 1990, during which he achieved exceptional annual return of 29.2 per cent for his investors.

Lynch's investment methodology can be summarised in several key principles that guided his investment decisions.

❑ **Invest in what you know:** Lynch strongly believed in investing in companies and industries that he understood well. He emphasised the importance of thorough research and analysis of companies before making investment decisions. He encouraged individual investors to leverage their knowledge gained from everyday experiences and invest in companies they understood.

This is a two-step approach — know your company well and know the industry in which it operates.

❑ **Long-term perspective:** Lynch was a proponent of long-term investing and believed that successful investors should be patient. He often compared investing to owning a business and recommended holding stocks for the long haul. He cautioned against trying to time the market or chasing short-term gains, emphasising that the best returns were often achieved over a period of years.

This is an affirmation that in the short term, prices fluctuate based on market emotions, while nothing has changed at the company level or industry level. Only when the basis or rationale for your investment changes should one consider divestment.

❑ **Be wary of market timing:** Lynch advised against trying to predict short-term market movements and discouraged market timing strategies. He believed that it was nearly impossible to consistently time the market correctly and that investors were better off focusing on the fundamentals of individual companies rather than trying to outsmart the market.

There are two main types of investing — technical analysis and fundamental investing. The former is about timing, and the latter is about fundamentals.

They both have a role to play in a healthy and robust stock market. As a fundamentalist, Lynch preferred not to time the market.

❑ **Invest in simple businesses:** Lynch preferred to invest in businesses with straightforward operations and understandable business models. He believed that complexity could lead to increased risks and that simplicity often translated to better long-term performance. He advocated for avoiding companies with convoluted financial statements or businesses that were difficult to comprehend.

We should value simple things because they do all the things we need easily and none of the things we don't. Simplicity is harmonious.

Even Leonardo Da Vinci said: "Simplicity is the ultimate sophistication". It plays on the idea that being simple isn't banal, it's elegant.

❑ **Conduct fundamental analysis:** Lynch emphasised the importance of conducting thorough fundamental analysis of companies before investing. He looked for companies with strong financials, competitive advantages, and solid management teams.

He examined key financial ratios, such as price-earnings (PE) ratios, earnings growth rates, and return on equity to assess a company's valuation and performance.

The beginner or intermediate investor may prefer to use Lynch's approach as a guide. Though it worked for Lynch, there is no guarantee it will work for all. Fundamentals are static, emotions are dynamic, in that emotions may change when fundamentals do not.

❑ **Consider the "PEG" Ratio:** Lynch popularised the use of the PE-to-growth (PEG) ratio as a valuation tool.

The PEG ratio compares a company's PE ratio to its expected earnings growth rate. A lower PEG ratio implies a better value, as it indicates that the market is not fully pricing in the company's growth prospects.

❑ **Look for growth opportunities:** Lynch was a growth investor who sought out companies with strong growth potential. He believed that investing in companies with the potential for significant earnings growth over time could lead to substantial returns.

He looked for companies with innovative products, expanding markets, or competitive advantages that could drive sustained growth.

Growth companies typically have higher than average PE ratios as their current higher PE ratios may be based on anticipation of future growth. Also, it pays to remember that growth companies tend to reward investors through share price accretion over time rather than immediate dividends — they need the cash for their growth.

❑ **Diversification:** Lynch advocated for diversification but warned against excessive diversification. He believed that investors should hold a diversified portfolio of stocks to reduce risk but cautioned against owning too many stocks as it could dilute potential gains. He recommended focusing on a limited number of carefully chosen stocks.

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❑ **Be patient and emotionally disciplined:** Lynch stressed the importance of emotional discipline and urged investors to remain patient during market fluctuations. He believed that successful investing required staying focused on the long term and not being swayed by short-term market volatility or noise.

There is a plethora of emotions out there in the market, with fear and greed being the dominant emotions. All may be able to analyse a stock and apply a methodology but it is the emotions that give the investor the edge.

Lynch once said: "In the stock market, the most important organ is the stomach. It's not the brain." If you can't tolerate a market downturn, you shouldn't own stocks.

❑ **Learn from mistakes:** Lynch acknowledged that not all investments would be successful and encouraged investors to learn from their mistakes.

He believed that analysing and understanding the reasons behind investment failures could lead to improved decision-making in the future.

No one likes failure or delve into reasons for their failure. According to Henry Ford, the only real mistake is the one from which we learn nothing.

The writer is chief executive officer of Minority Shareholders Watch Group.