



Spinning Straw Into Gold

This is not a fairy tale, but a true story about a stock that has made many of us a lot of money by going down rather than up. Watching recent buys like Conoco Phillips (NYSE:COP), Potash Corporation (NYSE:POT) and any number of other stocks fall on what seems a daily basis can be discouraging, but not for me and I suspect not for many of the loyal grizzled clients who have been with me for at least one market cycle. They have learned through experience that far more often than not, buying bargain stocks with bullet-proof balance sheets usually leads to a very profitable outcome. One just never knows how long it will take.

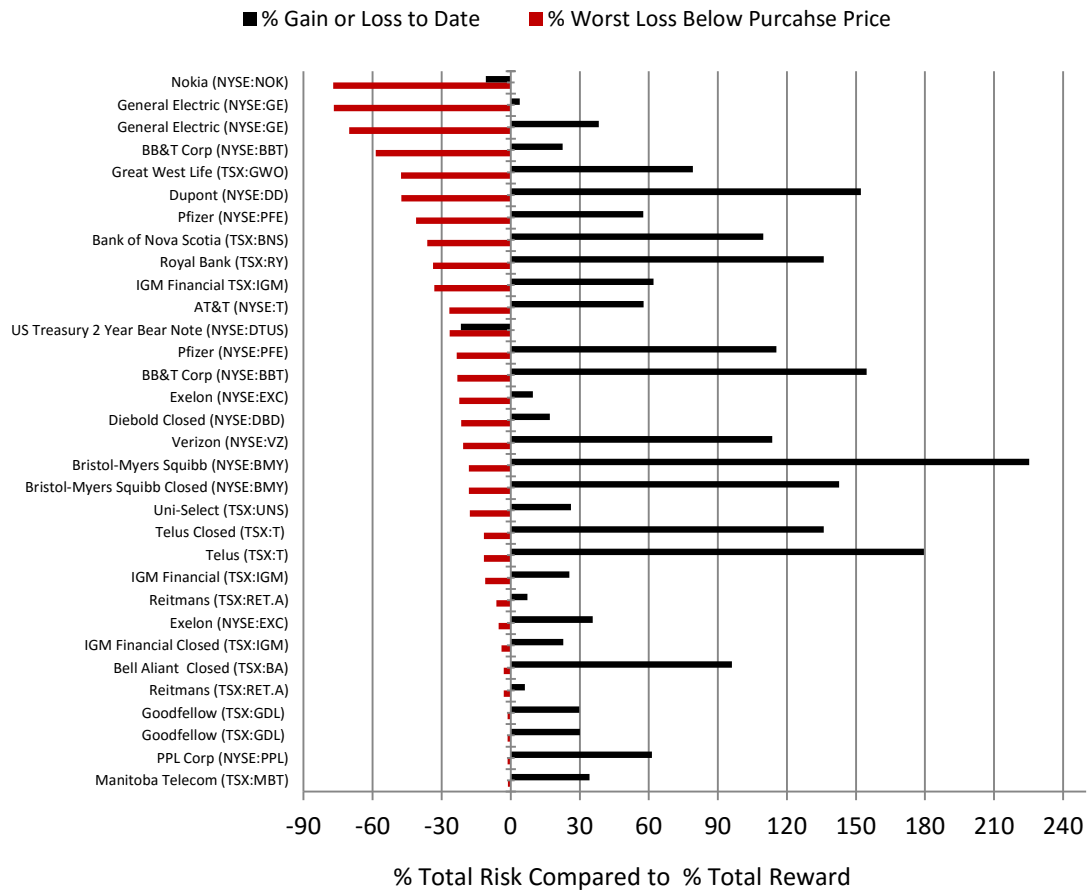
Remember the chart on the next page that was included in the annual November performance review of individual stock purchases as Figure 5 on page 10? ¹ It compared the returns against the risk of every stock purchase that I have made and alerted clients about since December 2005. It showed that the total return of profits (black bar) for each stock dwarfed the losses (red bar) incurred to obtain those profits. So much so that the average return per stock was 2.7 times greater than the average unrealized loss from the purchase price. ²

But what I want to highlight was the average percentage loss from the purchase price to obtain that result. It was a whopping 25.1%. In other words, on average, purchasing a stock at \$100.00 would mean having to first watch it fall to \$74.90 before it eventually reached \$167.40. As I write this, the extreme intra-day low for Conoco Phillips has been 29.7% below its purchase price and Potash Corp's was 18.2%. That is an average of 24.0%, so they may still have some work to do on the downside to keep up the 25.1% average ;)

¹ "2014 Annual Review of Bond Substitutes, Special Situations, Risk / Return, & Rebalancing," *Capital Ideas*, November 23, 2014, p.10.

² Average Profit per Stock: 67.4%, Average Unrealized Loss Per Stock From Purchase Price: 25.1%.

Figure 5
(as referenced in November 2014 Performance Review)
Risk / Reward
All Stocks in this Review
Worst % Loss Below Purchase Price Compared to Total % Return November 7, 2014
(including dividends)



It is one thing to read about this and it is quite another to experience it, especially the downside. That is why I thought it would be a good time to review what it has been like to hold a stock that was purchased back in 2007 and many of you who were with me back then hopefully still own because it has become extremely profitable, so much so that in my case, it has grown to become my largest non-ETF holding. And even more surprisingly because it sports a price chart in Figure 1 on the next page that shows no growth in price over the holding period.

Apart from a brief move up to \$45.00 within a year of buying it in the fall of 2007 at \$36.83, the volatility was all downhill until March 2009 when it bottomed just under \$13.00 and since then has fought its way back up to about the same purchase price.

Figure 1
BB&T Monthly Price Chart
October 18, 2007 to August 31, 2015



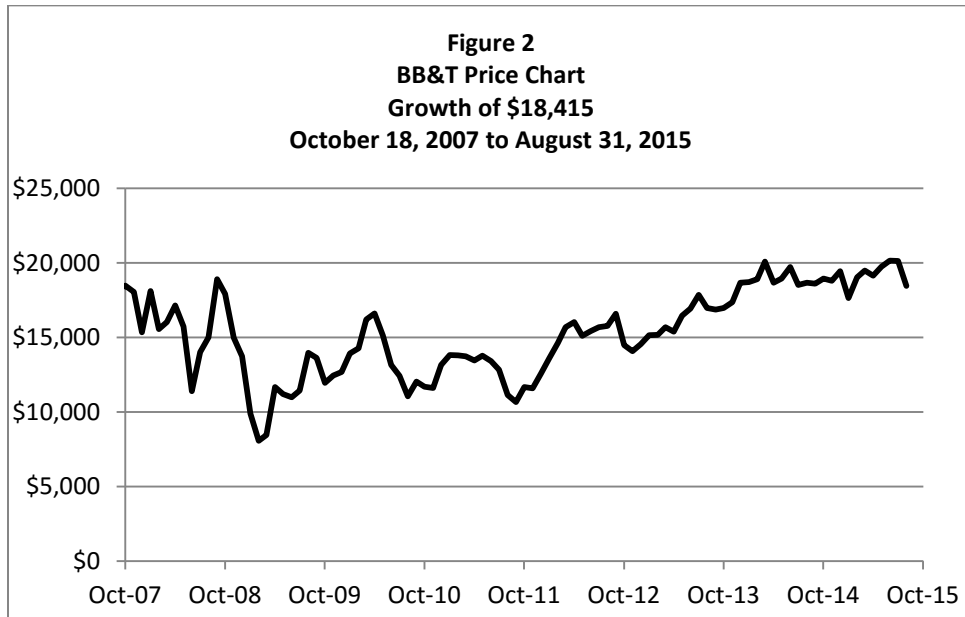
Source: [BigCharts](http://BigCharts.com) from MarketWatch

So how could an unremarkable price chart like that ever produce a wildly profitable return after eight years? It is a heck of a story with many twists and turns and always keep in mind that this all happened in real time with real money.

Background

If you have been with me for any length of time, you know that I am going to use [BB&T](http://NYSE:BBT) (NYSE:BBT) as the example because it became a favourite of ours with its relative obscurity, unusual name and many branches scattered in the southern US states. On visiting the states in which the bank is located, the many good sports among you sent me pictures of their head office, branches, and even one of their ATM machines. But I digress. BB&T has now not only become longer-term holding, but when I bought it on October 18, 2007 at \$36.83, it encapsulated everything that I look for in a “bond substitute”.

BB&T is a large regional US bank headquartered in Winston-Salem North Carolina that had fundamentals comparable to any large Canadian bank. In 2007 it had at least a decade of prior uninterrupted yearly growth in earnings and dividends per share. Its dividend yield of 5.0% on my purchase price was in the upper end of its historic range. There was a lot to like about this bank. So let’s follow what happened using charts but first converting the price chart above to one based on a portfolio value in Figure 2 on the next page. It should look identical except that it is based on monthly closing values without the intra-month highs and lows.

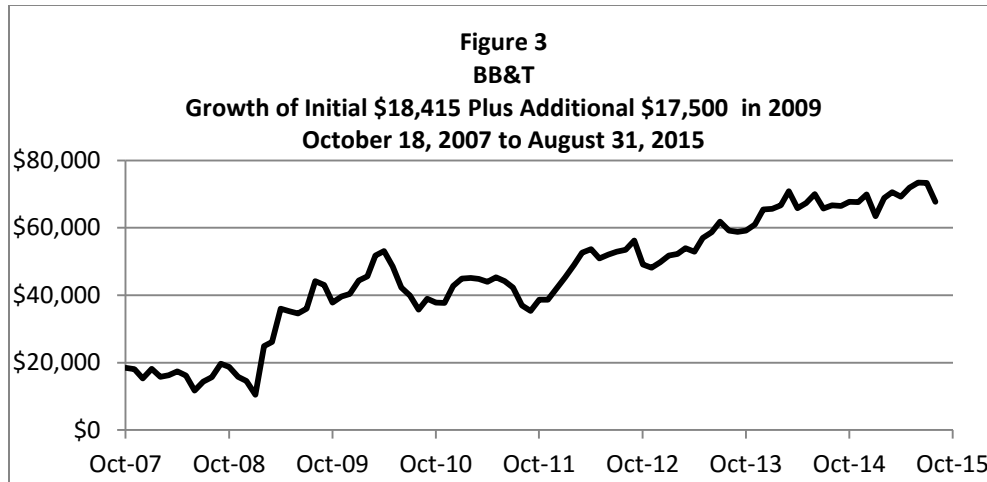


The chart follows the monthly value of 500 shares of BBT bought at \$36.83 giving a beginning portfolio value of \$18,415 on October 18, 2007. Eight years later the closing portfolio balance is just \$18,460. So how does an investment like that with such poor price performance become highly profitable? There are three major reasons:

- Not Taking Profits Too Quickly.
- Re-Investment of Dividends.
- Being Greedy When Others Are Fearful. ³

Here's how these three factors contributed to turning a mediocre holding into the following on the next page.

³ Quotation attributed to Warren Buffet.



That's right; the original \$18,415 has become \$67,698 and while it wasn't magic, there was the usual healthy dose of luck. Here is the story and it is not a fairy tale or so Grim(m) after all. ⁴

Not Taking Modest Profits Too Quickly

Whenever I buy anything, I'm looking for a major move. Under normal conditions that would mean at least a 100% price gain so that I can sell half and then keep the remainder as effectively "free stock".

Now let's say I was a genius and had sold the stock at its highest intraday price over the eight years to date. Figure 1 on page 3 shows that would have been in September 2008 at \$45.31 giving an \$8.48 profit on an original investment of \$36.83. Then add another \$1.39 for dividends giving a total dollar return of \$9.87 or 26.8% on the initial investment.

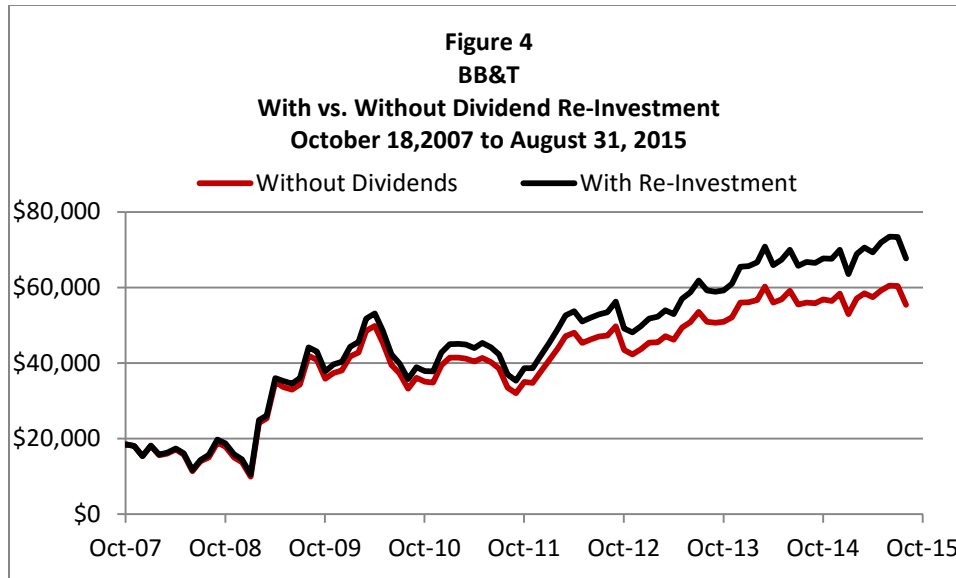
On the original \$18,415 that is equivalent to a profit of \$4,935. Not bad, but is nothing compared to the \$31,783 profit ⁵ in this example that it has made after holding it for eight years.

Re-Investment of Dividends

The second contributing factor to the position's profitability was the automatic re-investment of each quarter's dividends. As you can see in Figure 4, that added over \$12,000 of additional return over the return just based just on price.

⁴ I couldn't resist, as you know the title *Spinning Straw into Gold* is from the fairy tale [Rumpelstiltskin](#) by the Brothers Grimm.

⁵ Value on August 31, 2015 \$67,698 less first purchase cost on October 18, 2007 of \$18,415 less second purchase cost on February 23, 2009 of \$17,500 equals a profit of \$31,783.



Being Greedy When Others Are Fearful

This was the single largest contributing factor to the profitability of this position. And it shouldn't surprise anyone that it is psychological and tied to controlling the emotional aspects of investing.

Remember that on page 2, I mentioned that BB&T fell to an extreme low of under \$13.00 after I initially bought it? That is only part of it. On its way to that level during the financial crisis of 2008-2009 I decided to double our dollar position when it hit \$17.50, after all my reasoning was that if it was a bargain when I first bought it at \$36.83, it had to be that much more of one at less than half the price. Right? Double the original 500 shares is an additional 1000 shares that were bought at \$17.50,⁶ bringing the total number of shares to 1,500. But we were not through yet with market foolishness as the price continued to fall to an extreme low of \$12.90 and at the same time, just for good measure; BB&T (like so many other companies in the financial sector) cut their quarterly dividend from \$0.47 to \$0.15.

So let's pause for a moment and reflect on this. At the worst moment, the stock price had fallen 65% from my original purchase price and from the second purchase price by 26%. Plus the dividend had been cut by two thirds. It does not get much worse than that for a "going concern", unless it is going to zero. Obviously the market and I were having at a minimum a temporary disagreement over appropriate valuations.

Why didn't I panic and sell with all of this bad news? It is because I had analyzed the stock before buying it and I knew it would survive. Like everything I buy, first and foremost it

⁶ My actual net purchase price was \$16.80 not \$17.50 because I bought the shares through a short put option on the stock and collected a \$0.70 premium.

had strong balance sheet. Less tangible, but no less important was its senior management. This company was conservatively run and was not even close to a gun slinging Bear Sterns or Lehman Brothers. It even had loan ratios more in line with conservative Canadian banks than its US counterparts. So this was just another example of the market and its participants panicking and throwing the baby out with the bath water. It made no sense.

Oh and just one more thing as [Columbo](#) would say. The overall portfolio was hedged for most of the 2008-2009 decline so that gave added confidence to holding the position because most of its losses were offset by gains on the hedged broad market short position.

Does all of this sound familiar? If Conoco Phillips, Potash Corporation or any other company stock that falls 50% below what I paid for it, you can be sure that instead of selling, I'll be doubling up on it because these companies will survive and be around for the next bull market. There could not be a better example than BB&T.

Remember, I could have been a genius and sold on the high at \$45 after just under a year after buying it, but by simply having patience and a longer term perspective a profit of \$4,935 has been spun into \$31,783. And the spinning continues.

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