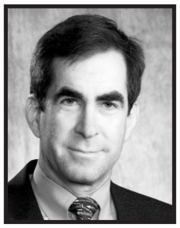
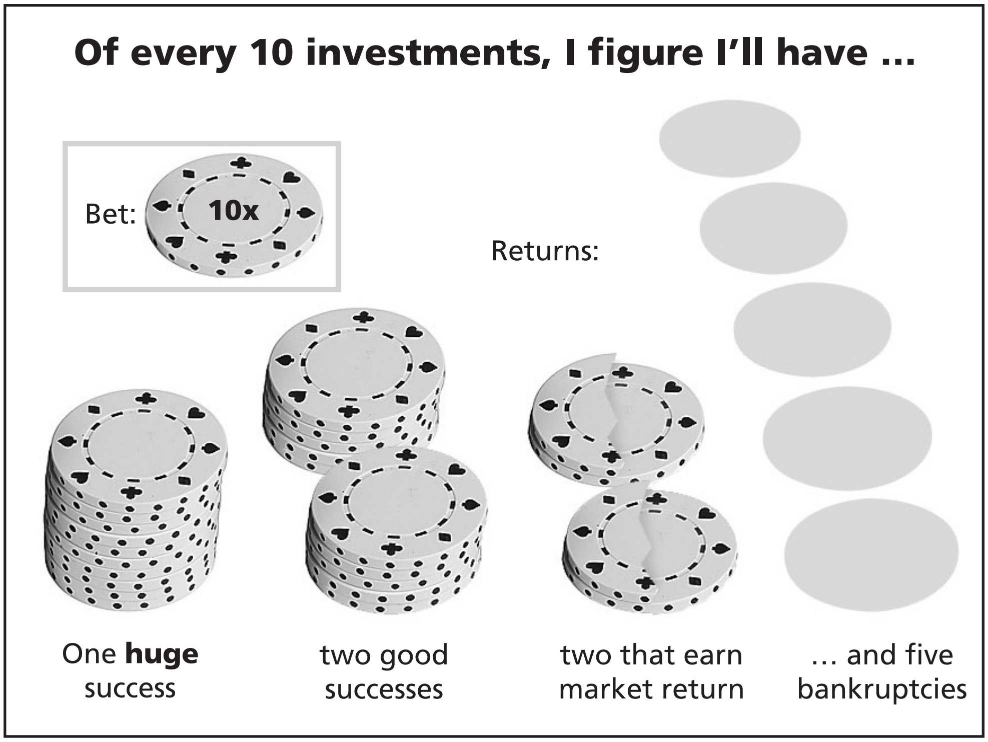
The Colorado Springs
BUSINESS JOURNAL

August 4, 2006

Fun with investing — Let your inner gambler out



ALLAN ROTH



Anyone who knows me personally, or reads my column, has a pretty good idea about my investing philosophy — low cost, diversified, tax-efficient investing is mathematically guaranteed to trounce most investors, blah, blah, blah.

My logical brain understands this, but there are times my emotional brain nods off out of boredom. It whispers in my ear "Come on, Allan, let's have a little fun. You know you want to."

And I do want to, because beneath this dull exterior beats the heart of The Gambler. Even yours truly gets the occasional urge to buy that risky stock and get a 1,000 percent return, and sometimes I just can't resist acting on that thrill-seeking urge.

That's why I carve out a small piece of my portfolio for, perhaps, the only fun I have in investing. I call it my gambling portfolio.

Now everybody should have their own system to outsmart the market. Mine is buying stocks that have fallen from grace that I think have about a 50-50 chance of going bankrupt.

Let me digress for a moment. It turns out that great companies usually make lousy investments, and bad companies make good investments. This happens because of a phenomenon known as "reversion to the mean."

In other words, the great companies touted by Wall Street end up not being as great as they were touted, and the stock price doesn't keep up. Conversely, companies shunned by Wall Street often end up not as bad as expected, and the stock price rises when the low expectations are exceeded.

So if bad companies make good investments, then my hypothesis is that awful companies near bankruptcy will make unbelievable investments. Not a commonly held hypothesis, I'll admit, but I think it's better than being part of the herd following the gurus on TV.

For example, buying a company like Qwest at a buck a share was incredibly risky. It easily could have gone into bankruptcy and taken my entire investment with it. Nonetheless, at a buck a share, many institutions simply can't own stocks priced that low. What money manager wants to explain to their board why they kept the stock as it went into bankruptcy? When institutions have to dump a stock, it might just cause the stock to be undervalued.

Qwest stock went up and, I confess, even a passive investor like me watched it daily. Well, it wasn't dull me, it was The Gambler who was neuron-surfing that dopamine wave of excitement as the stock went up. It was thrill city!

Of course, as I reveled in my brilliance, I conveniently blocked out my purchases of United Airlines, Delta Airlines, Ford, and others that didn't make it or are looking rather bleak. It was much more fun to think of my 1,000 percent successes in the past such as IBM and Bank of America.

Know when to hold and when to fold

The most important rule for my gambling portfolio is that it's a finite size, and I will not draw upon the main part of my boring portfolio under any conditions.

Of every 10 investments, I figure I'll have five bankruptcies, one huge success, two regular successes and a couple that just earn a market return. The exhibit on the previous page shows what I would hope to return over a few years.

Even those stocks that go belly-up offer the tax benefit of providing a tax loss, and I can defer the gain on those that make it indefinitely. In this way, Uncle Sam actually subsidizes some of my gambling.

How has it worked?

In my emotional mind, The Gambler convinces me that I have kicked market booty with the return I've received. I don't really care what my logical mind says. I could easily go back and evaluate my return versus the market, but why do that? I prefer to keep my parade unrained on.

Continued

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What does this mean to the gambler in you?

In his book, "The Lazy Person's Guide to Investing," Paul Farrell notes the brain loves thrills and chills. He writes, "If you have two brains – you may need two portfolios."

As for my two brains, I use my logical one for the vast majority of my portfolio that I count on to meet my financial goals. This portfolio is in the boring, low cost, diversified and tax-efficient portfolio that I know will win by harnessing the powers of compounding and inertia.

My emotional brain is in the driver's seat for my gambling portfolio. This is invested in a strategy that I feel will win by picking ultra-risky individual stocks that Wall Street doesn't want.

I call my total portfolio a "core and casino" approach. The core part is in the logical, dull, own the whole market approach. The casino part is in the risky business stocks I pick from the emotional side of my brain, or The Gambler approach.

Viva Las Vegas.

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Rules for My Gambling Portfolio

1. Gambling is gambling, whether it's investing or Black Jack, I only bet what I can afford to lose.
2. When I'm looking for that risky stock to buy, I go so far off the beaten path that I need a machete. Look for me on the wrong side of the Wall Street tracks.
3. Buy-signals that catch my gambler eye include:
   a) Large price declines.
   b) Stocks priced below $5, which forces many institutional investors to dump.
   c) Media noting money managers being fired for holding a particular stock.
   d) Accounting scandals.
   e) Insider trading allegations.
   f) TV gurus saying the company is dead.
4. Make lemonade out of those stock lemons that went belly-up by harvesting the tax losses.
5. Keep perspective on my wins and losses and the territory they go with. My own version of "What happens in Vegas, stays in Vegas" (or ought to).
6. Never confuse luck with brilliance.
7. Always remember rule No. 1.