

>: The #1 Investing Secret - Revealed!

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Editor's Note:As soon as Dylan originally published this article in The Tycoon Report on January 30th of this year, it became an instant classic. It is an excerpt from his [Fallen Angel Stocks investing service](#) (Volume 4, Issue 1) and is back by wildly popular demand.

The #1 Investing Secret - Revealed!

What makes a great a stock recommendation?

That is a question that has puzzled millions of investors ever since the beginning of capital markets. Over time, though, the greatest number of the richest investors in history have proven that the answer is *a great business purchased at a great price.*

Ask the people who started Google.

Since they were the founders, they got millions of shares in the business at a great price, in exchange for 60 hours per week in labor ... and are now billionaires. A hundred years ago, the same would have been said about good old John D. Rockefeller: he also got a ton of shares of the company he started without paying a single dollar for them. It was all earned through sweat equity as well.

Forbes 400 investors like Warren Buffett, John Templeton, Carl Icahn or Ron Perlman didn't have to start the next Standard Oil or Google to become filthy rich: they just had to learn how to identify the truly great businesses and then purchase them at a reasonable price using cash, not labor.

Naturally, of course, you might be wondering what makes a great business.

As I've explained here more times than I can remember, the simple answer is that it's the business that gets the highest return-on-invested-capital for the longest period of time.

For example, it would stand to reason that for every \$1,000 in capital (people, cash) a company spends each year, a \$1,500 total return would obviously be better than a \$1,200 return.

Wouldn't you rather make \$500 in net profits for every \$1,000 you had at the bank, instead of \$200? Of course you would.

Therefore, any business that gets more bang for its buck would naturally be better than any business that doesn't. Once again, the companies that get the most bang for their buck over the longest period of time are great businesses.

That's why Coca-Cola, Microsoft, Proctor & Gamble and Comcast are among the most valuable companies on Earth: their returns-on-invested capital are far above 12%, which the average American corporation gets, and they've been doing it for a long time.

This is such an important concept in successful stock investing that I feel I wouldn't be doing you justice if I didn't explain it, in its entirety.

(Understanding this key point literally unlocks the door to success in both business and investing.)

Guns, Germs & Steel (and Capital?)

High returns-on-capital are synonymous with productivity. And increased productivity means that you get more in return for the same resources.

To illustrate my point, let's say that Company A has a staff of 10 people working for it (the labor portion of invested capital). The combined revenue for the entire company is \$1 million per year. That means that revenue for each employee is roughly \$100,000. If you were able to increase sales to \$1.5 million a year with the same 10 employees, you've increased productivity per person by 50%.

In other words, you've increased the "return" the company gets by 50% without increasing your invested capital (labor) to get it: you're still using the same 10 people.

Throughout human history, the societies that have focused on increasing total output per worker (productivity) have always become the wealthier and most dominant societies on Earth. That's why the Federal Reserve Board monitors our nation's increases in productivity so closely. The higher the return (money) we get using the same population (capital), the richer we become as a society.

Let me take another moment to show you just how important increased productivity/return-on-invested-capital is to both a country on a macro-

economic level and to an individual company on a micro-economic level.

(For those of you who have a hard time understanding these concepts, please hang in there for a minute longer. It was tough for me at first many years ago also, but there is a huge pot of gold at the end of this knowledge rainbow, and I want to make sure you have access to it. In addition, the only way I can maintain our reputation as what some people call the "smartest" investment newsletter service in America is to take time to explain this in greater depth so that you, and other members of our FAS family, stay more informed than any other investment newsletter family out there!)

In his seminal Pulitzer Prize winning book, *Guns, Germs & Steel*,

author and scientist Jared Diamond offers invaluable insight into why some societies have become wealthier than other societies (and now that they've made a great PBS special, you don't have to read the entire book; you can actually watch it).

Peeling back the layers of history, the author begins the book seeking to answer a simple question asked to him by a native of New Guinea. I'm paraphrasing here, but the question essentially was, "Why do you (white people) always have more cargo (money/food, etc.) than us native New Guineans?"

In the book, Mr. Diamond offers a theory that the main explanation for why Europeans, Middle Easterners and Asians grew so powerful relative to other ancient civilizations (Africa, Mayans, Incas, etc.) was due to one reason and one reason only: Location, location, location. They hit the geographic location jackpot.

Simply stated, civilizations which existed in the relatively moderate climate areas at the same latitude and longitude as Europe to China were less affected by harsh elements of nature than those civilizations which were built either north or south of them. The further north, the colder the conditions were for farming; the further south, the warmer the conditions were for farming.

People who lived along this "lucky" geographic belt had several distinct advantages over people who didn't. The first stunning piece of luck was that they laid claim to fertile land, which enabled them to grow crops such as wheat and rice that could be stored for future use.

Archaeologists today are now discovering facilities in the Middle East dated to 5,000 years ago which enabled the storage of crops they grew for future use. The fact that the crops could be stored at room temperature and preserved led people to be able to farm in excess of their immediate needs. This insured that they had enough food all year around, eliminating the need to hunt and gather each and every single day.

In contrast, people in other lands (such as New Guinea) only had crops available to them for limited usage, as they would go bad in a short period of time, usually lasting no more than several days.

The difference is startling: cultures that developed in lands without the ability to farm crops with a longer shelf-life were forced to spend virtually every day of the year hunting and gathering more food. This stunted their ability to devote time to other tasks.

Equally as remarkable is the effect that geography had on animal adaptation. Of the 300 or so mammals in the world that weigh over 100 pounds, only 14 have ever been domesticated. Incredibly, 13 of the 14 were found along the same geographic belt.

Not only did this supply ample livestock, but all year round it provided something equally as important: the ability to increase productivity.

What Farming 5,000 Years Ago Teaches Us About Investing & Economics in 2007

What does this history lesson have to do with the both the global economy and investing in the stock market in 2007? Everything!

Let me explain using a simple but revealing example: Imagine you lived in a village in the Middle East 5,000 years ago that had a population of 100 people. Since you are geographically "lucky," you are able to grow and store crops that can last for many months. Equally as important, you are able to use domesticated mammals such as horses to help you in your farming.

Had you lived in a tribe in New Guinea that also had 100 people, each person would have had to spend time each and every day hunting and gathering food. That means that all the tribe resources would have to be dedicated to that one task each day.

In contrast, your tribe in the Middle East is able to use domesticated animals to improve farming abilities and enjoy increased food productivity. One horse alone is equal to the efforts of three people. Thus, by using 10 horses (hence the true origin of the phrase "horsepower") to help your tribe's crops each year, 30 people are freed up to pursue other interests such as becoming blacksmiths, clothing makers, thinkers or scientists.

The net result: Not only is your tribe able to produce the same amount of food as before (output), but now, you're able to free up 30 people to produce additional goods and services!

The blacksmiths can make horseshoes, the leather-makers can help create saddles, harnesses and other horse gear, and the "thinkers" can help come up with new and better tools to integrate into the entire process and further increase productivity.

By using the "technology" of the day (horses, plows), the tribe is better able to increase its return (total output) on its invested capital (people in the

tribe).

History has proven beyond a reasonable doubt that no society can ever become a wealthy society unless it continuously invests in technologies that help increase its productivity. It was this search to increase productivity that foreshadowed the rise of machines during the industrial revolution, which in turn led to the rise of computers in today's technological revolution.

Whether it be a horse, assembly line or computer, the net result today is exactly the same as it was 5,000 years ago: fewer people are needed to make the same or a greater quantity of goods.

The same can be said of companies.

How I Find Great Investments for You, Part I

"Productivity" is the term most often used to describe the output of a country in relation to resources when studying the macro-economics of a given country.

When studying the micro-economics of individual companies, however, the phrase "return-on-invested-capital," which means the same thing, is most often used.

In business, as in societies, the goal is to increase the amount of output (revenue and profits) per employee (invested capital). Since the average American company gets a 12% return on its invested capital, my number one priority is to find companies that get more return for their investment.

It's this quest (and this quest alone) that frames every single investment recommendation I make. After I answer this question (by finding companies that are the most productive/have the highest returns-on-capital), my objective changes.

It's at this point that I pare that list down to those companies which are then selling at a reasonable price per share.

Next time I will delve further into that part of the equation (lucky you) and uncover the true secrets of the temple. This will be truly beneficial for those of you who work/ run businesses or want to become better investors.

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