JIM CRAMER'S

GET RICH CAREFULLY

JAMES J. CRAMER

ALSO BY JAMES J. CRAMER

Jim Cramer's Getting Back to Even
Jim Cramer's Stay Mad for Life: Get Rich, Stay Rich (Make Your Kids Even Richer)
Jim Cramer's Mad Money: Watch TV, Get Rich
Jim Cramer's Real Money: Sane Investing in an Insane World
Confessions of a Street Addict
You Got Screwed: Why Wall Street Tanked and How You Can Prosper

Jim Cramer's GET RICH Carefully

JAMES J. CRAMER

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To Lisa Detwiler,
who is everything that’s good in this world

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Author’s Note

As I put this book to bed, I know we are in for still another year during which Washington wi provide no rest for the weary. This book is about getting rich carefully; Washington is writing a serial novel about bankrupting us slowly.

We would have loved to think that after the bitter conclusion of the October 2013 debt ceiling fracas we could at last invest without endless daily intrusions from politicians, many of whom don’t know the difference between a stock and a bond. But let’s be realistic. Politics has sewn its way into the very fabric of our daily lives, in large part because our nation has spent beyond its means (and ye seems to have so little to show for it). The fabric’s going to choke us several times a year now if we aren’t mindful of how harmful politicians of both parties have become to our portfolios.

As you will see in this book, I don’t think it’s for me to opine on what Washington should or shouldn’t do about debt ceilings, tax rates or budget appropriations. I don’t care if you are a Tea Part member or a tax-and-spend liberal. I care about making you money. I am focused on the savings side of your ledger. Given that Washington’s going to be wrangling about matters that directly impact you portfolio for years to come, let me share some tips gleaned from what has worked each time these hideous interchanges have occurred so that you can survive—and possibly even thrive—through the partisan pulverizing that Washington is now guaranteed to do to your savings.

Within the last three years, our stock market has had four separate run-ins with politics that caused you to lose a lot of money: the 2011 federal budget bust, which led to a ratings agency debt downgrade; the 2012 fiscal cliff debacle, with its concomitant tax increases; the spring 2013 failure t avoid the federal sequester; and, finally, the pointless fall 2013 government shutdown and debt ceilin clash. All four battles curtailed business, eroded confidence, and hurt your pocketbook. Even if this litany of pain can’t be broken, is there any way to profit from it?

The short answer is yes. Each Washington tussle has the same familiar pattern. All four bitter budget contests were basically scheduled events, meaning that you could tell that they were about to occur because they were provoked by deadlines that were clearly visible to all. In each case, approximately one month before each deadline, you began to hear chatter, typically from political commentators (not businesspeople), that Republicans and Democrats might be at loggerheads over some sort of budget issue or tax resolution that had to be agreed upon or the government would cease to function. Soon after, you got pleas from various money managers, who assured you there was no need to worry about the upcoming turmoil; all you needed to do was “stay the course,” because it’s just politics and every time we get one of these political dramas, the action may become twisted and tortured but all will work out in the end.

While, ultimately, these “cooler heads” are right that we haven’t defaulted yet and most likely won’t, their “stay the course” admonition only makes sense if you are willing to experience heavy ~~losses—realized or unrealized—and then hope to recoup those losses once the issues are resolved.~~ That is not now nor has it ever been my style. I say if you can dodge big declines and get back into th market at lower levels, you should do so, at least with some of your money, and not just sit there and take an undeserved beating.

But here’s the trick. You must take aggressive action and do some selling the moment you hear these false reassurances and not one second later. You cannot afford to wait. Here’s why: In all four o these go-rounds, the stock market lost on average about 8 percent from the moment a potential skirmish began to be talked about—usually one month before the drop-dead deadline that’s supposed to trigger a default or a downgrade—to when the war was finally concluded. Given this consistent peak-to-trough decline, you would be nuts *not* to do some selling the instant you hear the words “looming” and “Washington” in the same sentence. You have to overcome the complacency bred by smug money managers who blithely assure you with Shakespearean wisdom that All’s Well that End Well. That’s because when you hear their soothing entreaties, you are at the exquisite moment at which you can still take action to preserve some of your hard-earned dollars before that coming 8 percent plunge.

Then and there, you need to trim whatever stock portion of your portfolio you can trade, be it an IRA, 401k, discretionary, or whatever; it doesn’t matter. Try to sell at least 10 percent of your holdings before the alarm bells go off, because that’s probably the last moment at which you will get prices that are high enough and worthwhile enough to exit whole. You can take that newfound cash and put it safely on the sidelines, readying it for the inevitable and brutal denouement that all of thes phony reassurers didn’t see coming during the downgrade debacle, the fiscal cliff, the sequester and the debt ceiling rows. Similarly, if you are about to make your regular contribution to one of those retirement accounts, try to hold off and wait for the ensuing stock decline. Having that money taken “off the table” so as to be ready for the inevitable buy point is akin to saving up for a sale at the mall You need to have cash at the ready to take advantage of the bargains Washington’s about to give you

Then I want you to be prepared to buy several of the stocks that I recommend here, which I believ will hold up under any politically engendered onslaught; they have catalysts that will not be stopped by the shenanigans in the Capitol. You have to pull the trigger at the point of maximum fear, because these are the kinds of stocks that rarely get clocked except in a sell-off that’s extraneous to the performance of their underlying companies.

Now, how will you know when to begin to reinsert your money into the market? Easy: A few weeks after the exquisite sell moment, as the market has begun to plummet, you are going to hear FROM THE VERY SAME PEOPLE WHO TOLD YOU NOT TO WORRY that, oops, the divisions in Washington are far more serious than they’d thought, maybe even worse than the last dispute. They will suggest that perhaps it is time to start selling some stocks in preparation for the “coming” declin even though the market’s already been rolling over for days now. Sadly, for those who don’t understand the rhythm of these events, it will then already be too late to take defensive action. In fact when the “stay-the-coursers” change their tune and tell you that it is prudent to raise some cash, that’ precisely when you must begin to reapply your sidelined money into the best-of-breed names that are described in this book.

As we get closer and closer to each fated deadline, it pays to get more aggressive with that sidelined cash. However, do not wait until the last day to do your buying because history shows that some traders will get wind of a settlement ahead of others. You snooze until that last hour, you lose; the best opportunity will have come and gone.

Now I know that this is an intense way to approach these moments. You can argue that you don't need ~~to avail yourself of these sell-offs, but as you will soon see, if you want to get rich, carefully~~, it' precisely these kinds of declines that can make a big difference in doing so over the long-term. You are about to read about plenty of other, easier ways to make money, but you now know what's worke before and what I believe can work the next time a divided, dysfunctional government raids your nes egg.

October 20

Introduction

We've been beat up. We've been struggling to come back. We're finally breaking out to levels that were thought to be unthinkable given how poorly stocks have performed in th past decade and a half. We need to stop getting knocked around and settling for incremental strides. It's time to use the stock market to build wealth again. It's time to get rich, but t do so carefully this go-round, not recklessly and not with blind disregard to this new world of investing. We accept that this market has overpowered most small investors. The big funds too seem to have lost their ability to beat the averages, perhaps permanently, because of their size and because of their collective bunker mentality that has them simply trying to mimic the Standard & Poor's 500. am confident you can beat the averages if you work with me to triumph over the obfuscating, infuriating and often broken process of trying to profit from short- and long-term stock price movements.

What does it take to Get Rich Carefully? In the past eight years, watching the markets for *Mad Money* and then *Squawk on the Street*, as well as investing in them for my charitable trust, I have had to rethink entirely how you can use stocks to generate the wealth you need to put children through school, buy a house, afford your leisure time and ultimately fund your retirement needs. During my frequent trips to colleges for *Mad Money*, I have seen that a whole new generation has discovered the wonders and dangers of the stock market, but they do not have the tools to profit from its gifts or protect themselves from its pitfalls.

Most of all I have come to realize that the basics continue to elude people, that most people feel left out, that they "never took the course," so to speak, about how the markets really work. Consequently, they feel ignorant and disenfranchised. They know a small number of people are making money again. They yearn to be a part of that select group, but they know that the losses in the past few years have been staggering and that bonds and cash are the only choices for those who don't know how money creation works.

Unfortunately, the thirty-year bull market in bonds—where prices went up and interest rates wen down—has now ended. The easy, safe, if not guaranteed money has turned into the risky money that' anything but guaranteed and has been generating humongous losses over short periods of time. That' not what these bondholders expected when they stashed trillions of their hard-earned dollars in these funds. They didn't know they could lose money. But switching that giant hoard to stocks without the tools, without the knowledge base? That's just foolhardy, isn't it?

No, not if you read this book. *Get Rich Carefully* is designed for investors who thought they were being careful playing it safe, storing cash in bond funds and keeping it in low-interest certificates of deposit. It's tailored for those who are befuddled about and distrustful of stocks but seek better return than they've gotten from somnambulant managers and underperforming mutual funds. It's meant for ~~those who think they can profit from stock price gyrations but don't know how and why stocks~~ really go up or down. They are mystified by the process though eager to learn how to gain wealth from stocks in a prudent but opportunistic way.

What will you find here to help you make the transition from amateur investor to someone who can go toe-to-toe with professionals—although they have hardly distinguished themselves in the past fifteen years—and become the more informed client who produces the best results? How about a novel, fast-paced how-to book that gives you insights into how stocks really work and how you can profit from this market's machinations and mysteries rather than be turned off or freaked out by them?

First I let you in on secrets that you don't know unless you've worked within every part of the process of how the stock market works, a process I've been exposed to throughout my financial caree Then I explain what propels stocks, why they really advance or decline. No matter what I have done and how hard I have tried in my media career, I still run into thousands—yes, thousands—of people who do not understand the anatomy of a one-point gain. How can a stock move up a dollar? Why doe a stock shed three points in a heartbeat? How does it actually work? After all the chicanery that's bee visited upon this stock market, many people think it's all alchemy. Others think it is just plain crooked. They don't trust the explanations they hear daily about why their stocks moved up or down and why the market rallied or swooned.

They're right to be suspicious and skeptical. After you read *Get Rich Carefully* you'll be wise to what really happened on a given day's trading and, therefore, ready to make money in the next day's session or the next week's, month's or even years' worth of sessions ahead of us. No, I am not able to give you tomorrow's cyber paper today, but I can try to do the next closest thing, showing you how to predict moves with a degree of certainty that will make you more comfortable and better at creating your own wealth.

Next, I show you how to take advantage of the confusion and obfuscation that surrounds the movements of equities to pick the right stocks at the *right* prices. Why not get your portfolio in tip-to shape to profit from what looks to be the chaos of daily trading?

People always ask me what I read, how I get my input, how I have such an edge when it comes to so many stocks and so many sectors. How come it seems to come so easily for me? Believe me, I wis it did. Sure, I have resources that you can't have, but they are way overvalued compared to the information I glean from public information about stocks that is readily available to you on dozens o sites around the web. You just haven't been taught how to parse the releases, how to understand the research and, most important, how you can use conference calls to make sense of things. Yes, these sources can be arcane and difficult to divine, but they are a unique part of the stock market firmamen that you must tame so you can try to profit from every earnings report. They are among the most important sources for understanding why individual stocks advance over longer periods of time, sources I am confident you will understand after reading *Get Rich Carefully*. Once you have learned how to do the homework, I bet you will become as good a student of the market as I am, maybe bette because you will focus only on what matters, not on the millions of extraneous details that I have, at last, learned to cull and discard.

Everything I do, almost every stock I pick, emanates from major themes that are playing out underneath the market. What are those themes? I refer to them on television, and I try to flesh them out as carefully as I can. However, I have never done them justice. If you are going to Get Rich Carefully, you are going to have to get rich over time—no shortcuts. So you need longer-term investment ideas, rooted in concepts that can withstand the vicissitudes of a sometimes broken, often confounding market over the next five to ten years. I’ve got seven of them, seven themes all built to last no matter what the world’s economies throw at you. Don’t worry, I don’t just detail the themes. This book is practical: I give you the best stocks to profit from them, stocks to buy now and hold as the themes unfold over many years’ time.

I want you to benefit from some of the insights I have gained, specifically from hosting *Mad Money* and running ActionAlertsPlus.com, the fancy name for my $3 million charitable trust. For example, I have seen chief executive officers take their poorly performing ugly duckling stocks and turn them into extremely profitable swans through acquisitions and breakups. I show you who might be next to create that wealth for shareholders. That means no matter how sick or tortured the market might be at any given moment, there’s still a huge amount of money to be made. No one else is talking about this new and amazing money-making process, yet I think it is the most lucrative path to great wealth currently playing out today.

You want proprietary ways to wealth? I have now conducted hundreds of interviews with chief executive officers and spent thousands upon thousands of hours prepping for, sitting with and learnin from the best of the best executive talent that America has to offer. Here, for the first time ever, I reveal my Bankable 21, my salute to the twenty-one best leaders who have come on *Mad Money*, and why you should invest with them and ride their coattails to tremendous gains. The list will surprise you, might even amaze you, because most are anything but household names. I want you to pick your favorites of my favorites, invest in their stocks and stay with them through thick and thin. That’s wha my Bankable 21 CEO list is all about.

As Bob Dylan noted years ago, the times, they are a-changing, and I have had to change with ther For years I have described myself as a fundamentalist, someone who looks strictly at the companies underlying the stocks and tries to discern where, when combined with the news of the day, they are heading. I have shunned technical trading and charting because I thought those methods were lazy an less rigorous than my routine of homework and selection of individual stocks. However, through the regular and wildly popular “Off the Charts” segment of *Mad Money* I have validated the success that can come from interpreting the arcane and seemingly inscrutable stock pictographs that the segment explores. Now, at last, I teach you how to harness the “technical” and divine the charts in a digestible way that makes you better at picking winning stocks and what prices to pay for them. Through my “Charting for Fundamentalists” chapter I hope to augment the timing of your buys and sells and even short sales using better, more precise entry and exit points.

I also want you to glean from my lessons learned after a decade of picking stocks with an open hand through the brutal gauntlet that is ActionAlertsPlus.com. I critique my own moves after examining the contemporaneous bulletins, looking for misjudgments, pitfalls and bogus rationalizations that you must never make if you are going to Get Rich Carefully. I give you the raw, often embarrassing insights and the do’s and don’ts these insights spawn. Twenty-twenty hindsight can actually be a brilliant teacher when you learn from my mistakes. Be my student; let me show you how to learn from what I have done right and, perhaps more important, what I have done wrong. Be wary of a creeping lack of diversification, reckless stock picking masked as prudent portfolio management and dozens of other sand traps that you must avoid if you’re going to use stocks to get rich.

Finally, you know how important I believe discipline is to managing your own money. When I sa Get Rich Carefully, I mean get rich with disciplines that I have pioneered and, hopefully, by now hav almost perfected. I say “almost perfected” because I have sometimes let emotions get through the door instead of leaving them outside so I could become a better trader and investor. I give you the co ~~checks to your anxieties and fears and, yes, greedy tendencies. So sit back and enjoy my keys to~~ "What Matters? What Doesn't? What We Should Care About," "When and How to Sell in the New, More Difficult World of Investing," and how to "Check Your Emotions at the Door" so you know ho to discipline yourself. Believe me, after reading those chapters you will be cracking your own whip and will be your own best critic and disciplinarian.

I know, lots of tall, ambitious orders here. And certainly lots of new orders, not anything warmed over or seen in any other investment book, including my own. Because this is a different market. It's better one than we have had in decades, even though it seems ever more treacherous and unfair. The rallies are happening at a period of tremendous and deserved disenfranchisement for the everyday investor. How in heck are you going to make big money in that case? Personal income levels are stagnant; they have been for years. Bond funds have gone from cautious friends to reckless, wily enemies. Real estate seems played out, gold stymied, commodities kaput. But stocks? Let's go figure them out. Let's go harness them together. Let's go get rich with them, carefully this time, so you don give it back. Let's go forward and make some hay, because at last the sun is shining, and we have the tools to harvest the money that's within our grasp after years of toiling in the most barren of vineyards.

CHAPTER 1

What Moves a Stock

If we are going to invest successfully in this new, more treacherous environment, we are going to have to recognize that bizarre stock movements have become a staple, if not the hallmark, of this era. Before we even get to the buying and selling of individual stocks in order to create wealth, w have to understand how stocks are impacted by both understandable events and what seem to be random gyrations that baffle and frighten us. We need to fathom these moves because when we become scared and confused investors we become emotional and reckless investors. Ignorance is the opposite of bliss in the stock market.

Let’s take the most glaring example of a pernicious quarter-hour event that turned off more peop to the stock market than just about anything since the Great Recession: the Flash Crash of May 6, 2010. I happened to be on television when this horrific 1,000-point decline occurred, and I have to tel you that it was one of the most mystifying moments in my career. Virtually nothing of any real impo was happening; we were all chatting about riots in Greece at the moment the crash was triggered, explaining why riots aren’t a reason to sell off investments. But the market proceeded to decline so precipitously that a giant stock like Procter & Gamble traded at $60 one minute and then at $50 and then sliced right through $40, all within the confines of a commercial break. Fortunately, I was in a position to say there was nothing fundamentally wrong with P&G or a host of other stocks that were also plummeting, but I was at a loss to explain how it could happen.

It was only after the event and the subsequent run right back up that we realized it was just an example of the power of the S&P 500 stock futures running roughshod over all stocks, as the market couldn’t absorb a couple of huge sell orders that came into the futures pits in Chicago all at once. Th pummeling in the stock futures cascaded over to individual stocks, and the avalanche took down almost everything in its path as stocks broke down, triggering various sell strategies. Buyers were fleeing the market in fear that something larger and more terrible was occurring that no one knew about. When we found out there was nothing fundamentally wrong, nothing that spooked the markets just a series of overzealous traders selling all at once, it turned out to be a terrific buying opportunity However, the fact that there was no precipitating event for the 1,000-point decline, no real rhyme or reason for it, only served to scare people even more about the stock market. The whole asset class wa tarnished more in fourteen minutes of trading than when banks and brokers crashed in 2008 and high flying dotbombs went off in 2000. The exit from the building has pretty much continued unbridled since the Flash Crash, aided by several other similar but smaller crashettes, as we call them, includin perhaps the most bizarre of all: a total shutdown of the NASDAQ for three hours, the Flash Freeze.

Unfortunately, these terrifying mechanistic obstacles have occurred during an incredibly good ~~performance for the stock market. But can anyone blame those who flee? I understand the reasoning.~~ Who would risk their hard-earned dollars on the stocks of even the strongest companies with the biggest dividends, the best earnings track records and most bountiful balance sheets, when their market capitalizations can be cut in half, or even more, during the time it takes to brush your teeth, shower and get dressed in the morning?

It’s not just events like the Flash Crash, though, that confound people about this asset class and drive them to either more tangible investments like real estate or less rewarding ones like corporate and treasury bonds. There’s the day-to-day interchange between stocks and bonds themselves, where the bond market seems to call the tune regularly over the stock market, even though it seems many companies should be immune to such movements. There’s the “macro” tug of events, the impact of important economic influences, like jobless claims or pronouncements by the Federal Reserve or aggregate retail and home sales numbers, and how they can impact many of your stocks that you might believe shouldn’t be buffeted by such extraneous issues. Even more disturbing is the role of a Cyprus bank failure, a Spanish employment report, a riot in Brazil or a slowing Chinese industrial production number on your purely domestic holdings, many of which might have nothing whatsoever to do with those overseas events.

And it’s not just these big news items that can impact stocks in mysterious ways. These days ther is an intense sector pull on stocks that almost at all times overwhelms the individual characteristics o individual companies. People ask me, “What kind of insanity allows good companies and bad companies to trade in lockstep?” How can you be careful and prudent in picking stocks when the wor stocks in a group can pull down the best ones? What an obstacle to the homework that’s now become what a roadblock to serious investing. How can the performance of an individual company not matter if it’s put in an index of companies that it’s beating the pants off and they all go down at once?

Then there’s the impact of the “micro,” the individual news coming out of individual companies that you might be investing in. You’ve navigated the flash crashes, accepted the bizarre role that bonds and big-government data may have on your stocks; you know the Fed’s pronouncements can impact stocks in strange ways that you can’t figure out and that the bad stocks can take down your good ones. But how can a stock you own not go up on good earnings news? How can it not rally whe its quarterly sales are stellar and it raises its dividend and reloads its buyback? What the heck is that all about? That’s not the way it used to be. How can you protect yourself from this seeming lunacy, l alone profit from it?

These are all the new mitigating factors that we must now calculate before we can decide whethe we should even own stocks, let alone select individual equities for our portfolios. That’s why I want t break down, one by one, each of these hard-to-fathom distortions to all stocks before we get into the weeds and learn how to select, buy and own individual stocks for the long haul. We can’t possibly be in shape to own stocks until we can live with the roller coaster of volatility caused by all of these mysterious and often profoundly negative events that have taken root since the time my previous boo was published.

So let’s get started examining the other-worldly forces that can impact your stocks in a way that can often trump the businesses that these pieces of paper are supposed to track. Let me give you the mechanics of how and why stocks can move without anything happening at the underlying companie themselves.

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SOMETIMES I JUST have to own the fact that the whole time I've been picking stocks and espousing the virtues, I have skipped over perhaps the most basic part of the stock market's anatomy: the actual pressure put on stocks from buyers and sellers. While every single one of the extraneous forces that I just mentioned plays a role in a stock's movement, it all still comes down to the fact that a stock goe up when there are more buyers than sellers, and a stock goes down when more people want out than want in at any given moment.

As someone who's been analyzing stocks for most of his life, I have often taken for granted this tug-of-war between buyers and sellers. But I know from interactions with so many of you that I had better explain the underlying process of a stock's movement right here, right now, before I suggest which stocks will move and why they will do so. So many times people ask me or tweet me, "Jim, which book of yours can help me, a beginning stock market investor?" While many of my books and articles delve into what can move a stock, none of them has explained why a given stock moves the way it does, something that often eludes not just the beginners but those with years of experience trying, and failing, to pick good stocks. Without that initial understanding, the whole thing feels a bit like alchemy at best, or a rigged contest at worst. Surely, we think, given the prevalence of insider information, lots of stocks go higher because someone has the skinny and we don't. While the now rampant federal prosecutions are needed because plenty of people do know information and trade on that information illegally, that's profoundly not why the vast majority of stocks move up or down in given session.

What moves stocks, what makes them gain or lose pennies, dimes or dollars, is a process that mystifies many and puts them at a huge disadvantage if they don't know how these jumps and dives actually occur. They get confused, angry even. Why bother to try investing carefully if you have no idea what moves the stocks you own? If you get frustrated because stock movements seem so illogica —a pretty universal complaint these days—then you've come to the right place. I am certain you can improve your financial health if you become attuned to the way stocks really do work.

First, let me tell you a story about how hard it is to even figure out what moves a stock, and why you aren't alone in being confused by it. It's a story about when I was starting out, when I, too, didn' understand what could cause a stock to move up or down a dollar.

Before I got to Goldman Sachs in 1983 as an intern, I was fascinated to learn what was behind a stock's given move, despite nothing new or of import happening at the company the stock was supposed to stand for. Sure, a big earnings surprise could impact a stock's price. But those reports come out only four days a year. How about the 361 other days when nothing material occurs? I know that investor meetings, high-level resignations and appointments, product introductions and changes in analysts' opinions can occur. Nevertheless, those too can be considered to have only an ephemeral impact. When I first walked into Goldman Sachs I considered myself a legitimate student of the stoc market, but deep down I was always befuddled when a stock jumped a quarter or a half or a point seemingly based on nothing. (We used fractions back then, not pennies.) Was it stock news I didn't know about but would know if I toiled at an in-the-know place like Goldman Sachs? Was it a cascade of buyers who just couldn't wait for something that I didn't even know about? Did one person know something no one else did, and he left enough tracks that others followed him? Was it insider trading ahead of a good earnings report that a chump like me just didn't know yet? What caused these seemingly random moves that defined the range of that day's trading?

In one of my countless interviews with Goldman Sachs (about a dozen over a year just to get a summer internship), one of the executives said I could ask him anything I wanted about the market. The interviewing process had been tedious if not futile by then, and I figured if I hadn't gotten the jol by now I was never going to get it anyway, so I blurted out what was actually on my mind. I believe the ~~same question is on the mind of the vast majority of you reading this or watching my show:~~ What makes a stock move—I mean, really move? What gets it going? What takes it from $9 to $10 in a single session, when nothing's happening, nothing at all, at the enterprise that's being traded?

The market was open for trading, so the exec said, "You really want to know? Okay, watch this: I will make a move happen. Keep your eyes on the symbol SRR." That was the stock symbol for Stride Rite, a shoe company known for its Keds label, which at the time was trading at $9. I was sitting in front of a quote machine called a Quotron, a priceless relic of a different era. Only a limited number of machines had the prices you now see routinely on every PC or cell phone, making you a far more powerful and intelligent trader than I was in the old days, despite the fact that the market has become far more difficult to fathom on a daily basis. The Quotron showed that the SRR stock's last sale was $9. That was the quote line. Next to that were two numbers, 9 and $9^{1}/_{8}$, and two more numbers with a *x* between them: 100 x 100. That meant that someone was willing to buy 100 shares at $9 and someone else was willing to sell 100 shares at $$9^{1}/_{8}$. Who knows who they were and what they had in mind beyond that, but you could "hit the bid" for 100 shares, selling them at $9, or you could "take the offer" and purchase 100 shares for $$9^{1}/_{8}$. Markets don't trade like this anymore; now stocks trade in penny increments, and many stocks are so "deep" or filled with so many buyers and sellers that you can sell thousands of shares or even 10,000 shares at the exact same price and not move the stock at all. But the gist of the example remains relevant, as huge buyers can and do overwhelm large sellers every moment in the market. Given that I am trying to show you how I could be so obtuse and almost afraid to learn because it could reveal my ignorance, let's let the example suffice.

I was totally glued to these flashing green numbers, thinking, What's going to happen next? There's no reason for the stock to move. Nothing's new. It's just another random day at the company that makes Top-Siders and Keds Champion Oxfords.

The exec knew he had me on the hook. He said, "Ready?" I nodded. He then picked up the phone and called one of Goldman Sachs' in-house traders. "Eddie, take 50,000 Stride Rite, with a 9.25 top." In English that means Eddie was just ordered to buy 50,000 shares of Stride Rite, with a limit of $9.25 and not a penny more, to "get in," or purchase, all 50,000 shares. The trader could do what he wanted to buy the 50,000 shares, as long as he did not exceed the top of $9^{1}/_{4}$, or pay more than $9.25. Next thing I know, the green line on the Quotron is going nuts and the stock is jumping straight up to $9.25. Just like that. Yep, in no more than thirty seconds, maybe less, Stride Rite has gone from $9 a share to $9.25. Twenty-five cents gained if you owned Stride Rite because Jim Cramer wanted to see how a stock moves.

Eddie calls back after the green stops flickering at $9^{1}/_{4}$ and says, loud enough so I can hear it, "You've got 6,500 shares in at slightly more than nine and an eighth," and he's now "working the order," trying to get the rest of the stock, 43,500 shares, purchased at $9^{1}/_{4}$ or less.

Eddie goes on to explain that he had no choice but to move the stock to $9.25 in order to get that meager amount in. He adds, "Look, there's nothing offered in size right now up anywhere near here," meaning that there are no real sellers offering to part with shares at that moment anywhere in sight at the $9^{1}/_{4}$ level or even above that limit. Eddie then suggests that he might have to take the stock of Stride Rite all the way to $10 per share to get all 50,000 shares in if "your guy" is in a hurry. Hmm, I think to myself, I'm the "guy"! The exec says, "Stay there for a few minutes," code for Eddie to bid up to $9.25 "out loud," meaning "Show my bid on the green screen to see if that will draw out sellers."

Suddenly, I see on the screen “9.25 9.375, 1000 x 100,” with Goldman’s trader trying to execute my order, ~~bidding for 1,000 shares and some nameless soul offering just 100 shares an eighth above~~ whe we are willing to pay. It stays that way for about a full minute with nothing happening at all. The last sale is $9.25 and there’s nothing doing. Bored, point proven, the exec tells Eddie to “walk away,” to hold up the order for now, “and let’s see if someone shows up as a seller.” A few minutes go by and n one surfaces as a seller, so the exec gets Eddie on the horn again and cancels the remaining buy ticke

The exec turns to me and says, “You want to see that stock move up a dollar, you take the top off meaning if he doesn’t limit his buy order of 50,000 to $9.25 he will have to pay perhaps as much as $10, in Eddie’s judgment, to bring out enough sellers to get the job done and complete the order. There, right in front of me, was my anatomy of a one-point gain. The $1 move up in Stride Rite woul occur not because of a terrific earnings report, not because of a takeover, not because of an analyst upgrade and not because of a new model Ked, but because this Goldman exec placed a very large ord relative to the market capitalization of the entire company, at that time $500 million, and demanded that it be filled quickly with no limit.

When you’ve wondered why a stock went up on no news, you might have heard reasons like “mo demand than supply” or “more buyers than sellers.” You probably wanted to shoot the person who gave you that kind of glib answer. You wanted to know what the buyer knew, what insight he had tha you didn’t, what the “real” reason was. You thought the response was totally lacking in candor. I too always hated that kind of “explanation”—until I saw Stride Rite jump from $9 to $9.25 in less time than it takes to run from one end of a football field to another and back again. And I know it could have gone to $10 if that exec simply pressed the issue to demonstrate how a stock can rally a dollar o nothing, indeed nothing at all.

I could only imagine what the good people sitting in Stride Rite’s headquarters, then in Cambridge, Massachusetts, would be thinking if SRR suddenly rose to $10. Takeover? Some news th even the CEO didn’t know about? The absurdity of it all was palpable, but in the end, there was simp more demand than supply and a larger buyer was overwhelming all sellers at that moment. The supercilious answer was the correct one. And the scales were lifted from my eyes. I had been part of vast conspiracy to move Stride Rite higher—at least that’s how it would have appeared to the outside world if we had continued to press it—and all that had really happened was a larger order had been placed than the volume of the Stride Rite market could handle at that minute. I am sure that had we reversed course and tried to dump 50,000 shares all at once, we could have just as easily smashed through the $9 level and taken the stock to the $8s if we were in a hurry. And yet all that would have happened at Stride Rite that day was a bunch of shoes would have been made and still another bunch would have been sold. Just like any other day.

Of course, not all stocks are like Stride Rite was, a thin or lightly traded stock with a relatively small market capitalization. But you get the picture. Stocks move when supply overwhelms demand over a very short period of time. That’s what propels or pushes down stocks when nothing’s happening. That was the real answer to my question.

This exercise isn’t an idle one but one that could have serious consequences for you if you don’t enter your order right, with a limit and not “at the market.” Let’s go back to the original purchase order. Think of the options the buyer had. Instead of putting a limit on his buy, he could have said, “Buy me 50,000 shares at the market.” Given that 6,500 shares took the stock to $9.25, it is entirely possible that a market order, meaning “Buy everything in sight until you got to 50,000,” might take i to $10 or even beyond, because a market order without proper guidance is just an order to pay whatever you can, even if it moves a stock. Now, most of you won’t be buying stocks in that quantity

However, it is entirely possible that in the time between when that market order is placed and when it is ~~fully executed, you might be putting in an order to buy 100 shares of Stride Rite at the market~~—no limit. You have no idea what’s happening with the stock. But I bet you thought you could buy it around the price you saw it trading at, $9 a share. Next thing you know, because of someone’s aggressive market order, you just paid $10 for a stock you thought you could purchase for no more than $9.25 at worst. You’ve just made a horrible trade. You have a miserable basis, and you feel totally betrayed by the process. Then, of course, now that the buyer is done, next thing you know, SRR’s back at $9 as sellers at last see nothing’s going on at the company and decide to take advantag of the temporary rise and get out at better prices than they deserve. That’s why, beyond solving the mystery of why a stock can jump on no news, you need to protect yourself from this insanity by using limit orders. That’s also why I always admonish you to stick by a price and not deviate: precisely because you now know what—or who—can move a stock.

Of course, if there actually is some news, some positive surprise to earnings, we accept this hazard. We’re in there buying with everyone else on the news, and we accept the consequences. It’s just that, as I said earlier, that kind of instantaneous earnings reappraisal happens only four times a year. The rest of the time it’s pretty much as I have just traced out. That’s why the wise customer put the top, or limit, on the order.

Let me tell you the much larger takeaway of this story in the new world we find ourselves in now The whole Stride Rite exercise is actually a mini-version of what happened that day in the Flash Crash, except the orders that day caused the whole stock market to plummet, not increase. For reason I am about to show you, the stock futures are very powerful, and with a surprisingly small amount of money relative to the actual size of the stock market, a seller can overwhelm all buyers very quickly, especially in a skittish market where some extraneous event might be occurring that you don’t know about that’s now linked electronically to our market at the speed of light.

Just as there were no sellers lined up in time to meet my 50,000-share Stride Rite buy order until took the stock up to $10, there weren’t enough buyers lined up that fateful afternoon to match the selling that stemmed from stock index futures selling. If the orders had been smaller—there were multiple sellers at that level, not just one “guy”—and the sellers were willing to take their time rathe than burst in with market orders that had to be executed immediately, the disaster would not have occurred. But the sellers at that moment had much more stock “to go” than the buyers had to buy, all the way down in price, so that stocks could get cut in half in a few minutes. That’s, again, why I say, *Please, people, use limit orders!* Can you imagine if you went in to sell 200 shares of Procter & Gamble when it was at $60, using a market order, and you ended up getting a report that you sold it a $40? Yet that’s exactly what happened to thousands of people on that Flash Crash day. That’s why a limit order is prudent and a market order is reckless, and always will be until the government figures out how to stop trading in the whole market when these events occur. And it sure isn’t doing that now

The Distortion of Common Stocks by Index Futures

The whole thing seemed ridiculous to me. I was sitting in my Corporate Finance class at Harvard Law School in 1982, reading the *Wall Street Journal* as always, just trying not to disturb the zombies around me with my page-turning. I liked to hide in the back during class; that way it was much less likely that I would be called on, because I either hadn’t read the material or didn’t understand it. Plus who could concentrate on the stock tables and take notes on a meaningless class at the same time? ~~Better to have your priorities straight in order to get your money’s worth for the $25,000 a year~~ you’l owe in student loans at the completion of the exercise.

Anyway, there was an article in the paper that day about some stock index that was going to start on the Kansas City Board of Trade, an exchange I thought just traded those agricultural products you didn’t care about unless you were in the food business—you know, grains, winter wheat, whatever. Yet there it was. Some wise guy was putting together not a basket of grains or pork bellies but a bask of stocks, specifically a basket of the stocks in the Value Line Index, which represented the same stocks as the Value Line Investment Survey, at one time the bible of all stock research for the home gamer and the professional alike. Those were the quaint days, when individual stocks were studied an owned, not the quant, or quantitative, world of today, when whole groups of stocks are charted and traded via machines that are supposed to tell you the optimum purchase price and let you exercise th trade within the blink of an eye.

This newfangled package of stocks was meant to trade as a futures contract, meaning you would bet on the future direction of all the stocks combined in the index, except, unlike a grain index, at the future’s conclusion you wouldn’t have to deliver the stocks themselves. The prices would settle in cash, and you would be able to take your gains from where you first made your bet. And it *was* a bet, not an investment, because you weren’t actually buying the individual stocks in the package. Just lik a future, you could sell short the basket too, if you thought it was going to go down.

So if you thought the collective value of all the stocks in the Value Line Index was going higher, you bought a future that gave you the right to the gains at a specific point in time. If you thought they were going lower, you could short the index and then buy it back and pocket the difference, if indeed went lower, as you hoped and wagered. Of course, if you bought, thinking the index was going highe and it went down, you had a loss of the portion of the money equal to the decline, just as you would with an individual stock.

After I read about this new index futures market, I asked one of my securities professors, “How can this be legal?” Stocks, I said, don’t trade in lockstep. There’s nothing in a group of stocks that is comparable to winter wheat, which is uniform and not meant to have any differentiating statistics or characteristics. Stocks trade on their own mettle. They have so little in common there could be no point in homogenizing them in an index. The repercussions could be huge. Stocks might cease being representative of the enterprises behind them and take on the characteristics of an entire market, eve as that market had little to do with the profits or sales of the individual companies. I said it was absu and I couldn’t believe the Securities and Exchange Commission would allow such an irresponsible grouping of stocks to trade together.

I questioned whether this Kansas City Board of Trade idea would pass muster given how it might play havoc with how we value individual stocks. Surely the SEC would see the detriment and distortion a Value Line Index could cause down the road if it caught on. My professor, clearly oblivious to who the heck I was, as he would never have seen my face behind the front page of the *Journal* I read each day in class, informed me that there was nothing insane at all about this basket o stocks. This new index would be a risk tool for portfolio managers, just as the farmers needed risk tools for their crops. If someone owned a portfolio of stocks and wanted protection from events and feared the downside, he could sell a Value Line future against his portfolio, hedging that risk, just lik a farmer or a grain buyer who might fear a drought or a frost. In fact, a stock future could work even better for a portfolio manager than it might for a winter wheat farmer. If the portfolio manager truly feared some sort of catastrophic event, he wouldn’t have to blow out each individual stock, incurring all sorts of imperfections, commissions and time pressures. Instead, with one order, he could put a ~~hedge on that would insure against the downside during a very specific period and then have that~~ hedge taken off when the event concluded or was safely behind him.

If someone wanted to accumulate exposure to stocks, meaning he just wanted to bet that all stock were going to go higher, my professor explained, he didn't have to do all of the work on the individu stocks or tediously buy each one; he could just buy a future and get all the exposure to the stock market he needed in one immediate, seamless transaction. No hedging in this example, just an outrig instant accumulation. The professor reminded me that many portfolio managers simply viewed stock as part of a broader allocation of stocks, bonds, real estate and gold, and that this future simply gave the portfolio manager the chunk of stocks he needed to get the proper exposure to this one portion of the investment supermarket. It was a beautiful expedient, in his opinion.

I bridled. How could it not matter what the companies in the index do? What about all of the wor people put in to discover or purchase an individual stock? What about the research process, the process of finding the best stocks, not just stocks themselves as one unit? Why would anyone want to own the bad stocks with the good? Who would want to check his stock-picking abilities at the door? The haughty professor lectured that perhaps I didn't understand what was about to happen to stocks, that portfolio managers were moving away from the futility of individual stock picking and into a "can't beat them, join them" strategy. They were just trying to equal a benchmark or try to slightly exceed it, rather than trump it. They simply wanted to put, say, 40 percent of their entire portfolio in stocks and, say, 50 percent in bonds, because they preferred bonds over stocks in general, and not specific stocks. That way they couldn't fall to0 far behind the stock market with their allocation and would be "truer" to that allocation than they would be otherwise. The stock future *was* the future, and he saw it coming.

But wouldn't the index influence the action of the stocks in the index itself? I persisted. The professor, who knew exactly what the SEC was doing (he was a corporate finance professor tied in to Washington), told me that the SEC was unconcerned because the government believed—and to a degree still does, by the way—that stocks themselves were much bigger than the index and the index was a tail that could never wag the whole dog. The idea that an index could ever control a stock's particular movement was antithetical to the purpose of the hedge or the accumulation. No single portfolio manager or even a group of portfolio managers would ever be big enough to influence an index to the point that it would impact the stocks in the index themselves.

The certainty of that statement annoyed me, but I didn't make the rules. I realized that at one poi in life I would have to live by them, as I already had my heart set not on practicing law but being a real-life stock-picking portfolio manager.

Thus, with one obscure index on one obscure exchange, the index future was born.

Two months later the much, much larger Chicago Mercantile Exchange began trading futures on the Standard & Poor's 500, a sainted group of stocks, considered the best representation of the stock market since 1923, when it was first created. (Older, more desultory investors still seize on the Dow Jones Industrial Average as the benchmark, and I start each *Mad Money* show with how it fared that day, but portfolio managers compare their performance to the much more broad index that is the S&I 500, the benchmark that one must beat regularly to be considered a successful, or outperforming, manager.)

Pension funds, huge portfolio managers and mutual funds almost immediately took to the S&P 500 index futures as a cheap, low-commission way to get exposure to the market and yet not have to deliver stocks, as they would wheat or pork bellies, because the settlement, what happens when the future comes due, like the Value Line future, was in cash. One of these big institutions could put, say $20 ~~million to work in some S&P futures contracts that allowed it to get a gain six months out.~~ If the S&P 500 rallied 10 percent in that period, the account stood to make $2 million at the time of settlement.

Not only were futures convenient, but the managers didn’t have to put up the entire amount that they sought to buy or sell. In fact, they could borrow money and put up only a fraction of that $20 million in real money. Of course, the logic extends to large numbers: $20 million could get you $200 million in exposure in seconds. The rules for futures are very different from those for stocks. With futures you can use leverage and put up much less cash than with stocks and get much more bang for the buck—still another advantage for those who want to use these commodity-like instruments. Simple as that.

Too simple.

Almost overnight these contracts became a sensation as the big funds fell in love with them. They got to be so popular, at the same time that funds were growing ever larger as money flowed into the stock market, that within a few years the impossible had come true: they began to have a more powerful impact on stocks than anyone had dreamed, including the people who run the companies in the indices. I always felt they were too powerful, and I railed against them in the 1980s in the few press outlets available to me. I suggested that they would one day cause a stock market crash because the futures could easily overwhelm the actual stock market, as the little amount of capital needed to control a stock future could turn millions of futures dollars into billions of stock dollars.

Sure enough, by 1987 they were so sought after that a bunch of financial consultants decided that they could use the futures to hedge out all risk to stocks, no matter the size of the fund. They created product called “portfolio insurance,” and they peddled it to big institutions that owned a lot of stock. The consultants said that for a fee they could protect any fund from the downside because, as the market went down, the consultants could dynamically hedge out any losses using these S&P 500 futures.

The product initially worked terrifically well as the market drove ever higher through most of that year. Then, when the stock market started to crumble in August 1987, culminating in the crash of ’87 portfolio insurance began to fail. It directly contributed to that record-smashing one-day 508-point decline as the consultants threw the equivalent of acetylene on that raging fire of selling by trying to short the futures ahead of the plummeting stocks. The Chicago-based futures had overwhelmed the New York–based stocks. The stock that came in for sale because of the S&P 500 futures sellers arrived too fast and in too large amounts, so that buyers couldn’t be found. As a result, the stock market lost almost a quarter of its value in a day. The dynamic hedges, the insurance, failed to protect the portfolios properly, so the clients lost huge amounts and the consultants went under.

After that fateful day, it dawned on many market participants that the S&P 500 futures were now bigger than the stocks, and big sellers of futures can knock down stocks with impunity, even if they didn’t deserve to be knocked down.

A Treasury Department investigation of the crash identified the interaction between the futures and the stocks themselves as a proximate cause of the precipitous decline simply because the leveraged selling of futures could impact stocks faster than buyers could be found to offset them. Just think back to that Stride Rite example to understand how speed can overwhelm volume; multiply that speed by ten, the approximate ratio of futures selling to stock buying on that fateful session. Rules were put in place after the crash to slow the futures-to-stock linkage on big price declines, but the whole portfolio-basket approach was already ingrained, and, being just a few years old, it was never even called into question as a possibly manipulative and pernicious entity.

~~Stocks eventually climbed back up after the crash, when it became clear that the whole episode~~ was caused by a problem with the mechanics of stocks versus futures, and not with the underlying economy and its impact on stocks. The futures had simply caused the stocks to go haywire, but the economy never skipped a beat. Never again, though, did any of us have any illusions about how futures had changed the stock market. From then on, for many of the biggest funds, stocks might as well have been soybeans or corn or wheat. For many managers, it never again mattered what companies did. They decided to just trade the whole index as an asset class, regardless of the individual stocks that made it up.

From the birth of that now obscure Value Line Index until the present day, we know that perhaps the biggest influence on a stock beyond its sector and its own business is whether it's in the S&P 500 index. And at times of real crisis, the S&P futures are a far more powerful influence than the fundamentals of any individual company. If the futures roar higher or plummet, your stocks will rise or fall if they are in the index. They react as if there is one giant buyer or seller of everything, from the tiny Stride Rites to the Exxons and Apples. The futures are so powerful in their influence over individual stocks that a stock you own might get a real beat-down as part of an S&P futures sell-off, even on the day of a good earnings report or positive analyst chatter. It's just the way it is. I got used to it, even though I hate it, just as I hated the Flash Crash, which was very similar to the Great Crash of '87 in its speed and almost in its size.

You too have to get used to this reality, and you have to recognize that, as in the individual stock example I gave you, nothing a company does can stop the tide. The movement in the stock price simply has decoupled from the underlying stock because of this financial innovation. The genie jumped out of the bottle three decades ago, and we have not been able to stuff it back in, no matter what the companies in the index try to do about it, including aggressive buybacks and even bountiful dividends.

Sector ETFs Overpower Individual Stocks

Traditionally, a stock's sector plays a tremendous role in performance. Sector gravity has been considered responsible for close to 50 percent of a stock's move. These days, however, during very b stretches in time, and certainly on any given session, it can be as much as 75 to 80 percent of the mov in short-term bursts. So sectors are worth exploring and fleshing out when we talk about what causes your stocks to move intraday on no news. Sector groupings, like broader index funds, are still one more obstacle that mocks the notion that homework and knowledge of individual stocks can play an important role in the money-making process. You must learn to respect the power of sector exchange traded funds (ETFs), because you must understand how they can impede, mystify and distort what should be a totally rational process. Yet, like stock futures, the ETF-led sector propulsion gets in the way of the fundamentals on a very regular basis.

Why does the sector pull matter so much? Because stocks are hostage to them, even if individual companies don't deserve to be. That's because of the immense popularity that sector indices and the ETFs that mimic them have gained among huge institutional money managers. To put it bluntly, they would rather play with big, liquid ETFs than mess with trying to get in and out of individual stocks. These baskets, designed by firms to, once again, give big-portfolio managers large and quick exposu to a group of stocks instead of one stock, fulfill the same role the S&P 500 futures play for the entire ~~market. You like the banks? There’s an ETF that mimics the banks. You hate the gold miners? There~~ an ETF that you can use to short them at the drop of a hat. You can even own or go long on an ETF that represents gold and short the miners that pull the precious metal out of the ground to come up with a perfect hedge, as the miners have performed poorly even when gold is stellar, and when gold cools the miners totally tank.

The federal government has blessed these individual ETFs, and in many cases has even allowed particular ETFs to be traded in a leveraged fashion. In other words, you can get two or three times th buying or shorting power over a sector with a leveraged ETF. Once again, the government, oblivious to the impact of the tail that can wag the dog, has approved these machine-gun instruments in a field formerly dominated by the individual rifle-toting stocks. In a matter of minutes all members of these ETFs can be blown to bits or elevated to outrageously high prices with small amounts of selling or purchasing power. In the past few years this financial engineering has become gospel, and those who don’t take into account the individual stock fallout from these ETFs are doomed to make a lot less money than those who do. They defy prudent investing.

How do they impact stocks on a day-to-day basis? Let’s take the oil service group, one of the sectors most keenly dominated—I would go so far as to say it has been wrecked—by ETF trading. Over the past thirty years, we have seen tremendous differentiation and a superiority-inferiority dichotomy emerge among the players in this industry. For example, Schlumberger, the largest oil service company, has been considered vastly better run than the other well-known players, particularl Baker Hughes and Halliburton. Schlumberger is more global in reach and is less levered to the fickle nature of North American drilling. It is more lucrative than most of the other players and is the open envy of the industry. While there are brief periods when Halliburton and Baker Hughes execute well, the consistency of the company the Street calls SLOB for its SLB symbol is a marvel to behold. Even when its longtime CEO, and a personal favorite of mine, Andrew Gould, stepped down in 2011, the performance of the company didn’t skip a beat.

Same with the actual drilling concerns. Most of the time Transocean, Ensco and Weatherford trad in lockstep on a day-to-day basis, but their true colors do surface at certain times, typically during earnings reports, when the fundamentals exert themselves in a most definite and material fashion. Ensco is the best of these three because of its technologically superior and younger rigs. Transocean second best, but it became deeply scarred by the Macondo fiasco, as it was contracted to do the actua Gulf drilling for BP. Weatherford is third best, dogged by unfathomable accounting issues and a confused and out-of-touch management. Yet for most of the year, none of these seemingly germane characteristics matters at all because of sector domination over individual securities. They might as well be the Transocean-Ensco-Weatherford Company.

It is obvious and logical that when the West Texas and Brent oil futures, the principal pricing structures of crude oil, rally, all of these stocks should and will trade higher, as they all stand to make more money when oil is moving higher than when it is going down. What’s mystifying for most of you, though, is that even though the gradations of management and performance are severe, they are not differentiated when the underlying oil futures do their tugging.

While there has always been a similar relationship to the group’s oil gearing, the nature of the sector pull has gotten increasingly pronounced in the past few years—pronounced, frankly, to the point of absurdity, with the stocks of the worst companies often increasing in price almost exactly as much as the stocks of the best. That’s because of the underlying pull of the extremely popular OIH, the Market Vectors Oil Services Sector index, which includes all of these stocks. Consider the OIH to