Book Remarks

Books

- The Interpretation of financial statements
- Security Analysis (STANDARDS OF SAFETY)

Websites (Stock Screener)

- www.quicken.com/investments/stocks/search/full.

Bonds:

- look at number of times that total interest charges have been covered by available earnings for years in the past.

When Buying Bonds:

make sure that the Earnings to debt for the company you are loaning money is at Minimum:

Type	Before Income Taxes: Average Past 7 years	Before Income Taxes: Measured by Poorest Year	After Income Taxes: Average of Past 7 years	After Income Taxes: by Poorest year
utilities	5 times	3 times	2.65 times	2.10 times
RailRoad	4	4	3.20	2.65
Industrial	7	5	4.30	3.20
Retailing	5	4	3.20	2.65

also Consider:

- Size of Enterprise → the larger, the safer
- Stock Price / Equity Ratio → the larger the safer
  i.e. could sell more shares because price is high & finance debt
- Property Value: Value of tangible assets hold by the company. the greater the safer.

THOSE ISSUES that strictly stick to the standards of safety have been able to face difficult future conditions better than those promising better results at a riskier cost.

if a company has been able to survive a depression or multiple depressions & is still sound, that indicates an economic advantage over other sectors or industries

Common Stocks:

1 General Prospects (forecasting):

in general, no ONE can Predict the future. the forecast of WALL STREET are usually as bad or even worse than yours avoid these opinions at all costs.

2 Management:

wall street puts a lot of attention to management, this tends to drive prices to over valuation states. it is always better to look at the figures first & if the managent is good that is always a +, not the other way around.

3 Cash, debt & leverage:

upon two equal companies it is always better to own one with as few amount of issued bonds or preferred stock.

a company with surplus of cash & no debt can survive easier to tough times than another one that is already highly leveraged.

basically look at how much leverage a company needs to incur into to generate their earnings, could indicate highly competitive market.

4 dividend Records:

a company that is able to pay continuous dividends over the last 20 years or more, presents a clear indication of economic strength. & quality.

5 Current Dividend Rate:

a continuous dividend rate over

the last 20 years or so, Proves that a company has the stockholders interests at hearth, if a company does not pay dividends examine carefully that the surplus cash is used efficiently NOT TOWARDS BONUSES, COMPENSATIONS ETC.

Growth Stocks Conservative Valuations:

P/E with no Growth

Value = Current (Normal) Earnings × (8.5 plus twice the Expected annual growth Rate)

the growth is that expected over the next 7 to 10 years

REMEMBER: with growth stocks you are looking into the future, There is absolutely NO way to know future performance, not based on past performance neither on expert expectations, Nevertheless an ample margin of safety can be used to safeguard yourself, or an Conservative Valuation can be used to maximize the odds of future gains.

also Remember that under rational Circumstances, the maximum expected rate of growth for a company should be no more than 8% annually.

If the above formula is to be used the current as well as expected interest rates have to be introduced for a more comprehensive valuation

Stocks By Industry Analysis:

thorough qualitative analysis can be both misleading as well as fruitfull. However under most cases, the market price tends to reflect these Valuations early, leaving no room for the lay investor.

two Part Appraisal Process.

① Past Performance Value:
What will the stock be worth, if the past performance continues in the future

Carry out using:
Profitability, stability, growth & current financial conditions measures

② Current conditions & future expectations:
modify the past performance Value by the current & future expectations

for this case you can use the conservative mechanic Valuation formula as well as a qualitative analysis of the Enterprise:

Value = Current (Normal) Earnings x (8.5 plus twice the expected annual growth rate)

These Valuation methods are more Accurate for sectors whose profits are not dependent on unforeseeable factors such as: interest rates or raw materials prices

e.g. gaming, cosmetics, alcoholic beverages, nursing homes, waste management.

Extended Graham Growth Value Intrinsic formula.

Intrinsic Value:

$$V^* = \frac{EPS \times (8.5 + 2g) \times Y_1}{Y_2}$$

where

V = Intrinsic Value   EPS = the Company's last 12 month's EPS

8.5 = P/E ratio of a no growth company

g = the company's long term (five years) earnings growth estimate

Y_1 = the average yield of high grade corporate bonds (3.94) 2012

Y_2 = the current yield on 20 yr AAA corporate bonds (3.45) 2012

Conclusions: forecasting future prices is a risky business. however if you feel inclined to follow this path, Graham Suggests. ↓

Putting a price on the future:

Guidelines:

A - Company's general long-term prospects
B - quality of management
C - financial strength & capital structure.
D - dividend records
E - Current dividend rates.

A. general long Term Prospects:

- 5 year looks of the Company's annual Reports

answer two Questions:

1. what makes this company grow?
2. where do its profits come from?

Problems to watch for

1. Company is a serial acquirer, more than 2 or more.
   indicates they rather spend on another company rather than their own.
2. Company obtains bad deals in their acquisitions
3. Company is an OPM addict (other people's money Addict)
   watch for:
   - Compulsive sell of Stock (diluting)
   - Borrowing debt.

     these are: cashflow statement
     ↳ Cash from financing activities 10K

     these can make a sick company look like growing.

4 Company is a Johnny One Note: relying on a single customer or a handfol of them for it's daily Busines.

Weak Economics

Good Signs for a Company

① Company has a wide MOAT or COMPETITIVE ADVANTAGE

- Strong brand Identity (Harley Davidson)
- monopoly or near monopoly on the market. (Microsoft)
- Economies of Scale (Intel)
- low cost producer, distributor of goods (WAL-Mart)
  CHEAP
- Unique intangible asset (CocaCola)
- resistance to substitution, Inelastic demand (Utilities)

② Company is a Marathoner, not a sprinter

the fastest growing companies tend to overheat & flame out

Safecheck:

- if earnings are growing at 10% Pretax this growth can be sustainable 6-7% after tax
- growth of ~15% or expectation of growth at this rate for a long time are irrational

look for companies with steady growth year after year.

③ the company sows & reaps

A company that spends to much in R&D is as vulnerable as one that spends to little, look for the perfect amount by Industry & returns.

B. Quality & Conduct of Management.

① Managers should say what they will do & do what they said.

- Look at past annual reports & compare the promises with the actual results
- Managers should always admit their failures & take responsability for them. rather than blaming others:

e.g. blaming

- the economy
- Uncertainty
- weak demand
- Is their speech tone & substant constant with their business or is it full of speculation & hopes.

② How much do they pay their managers?

be very carefull with high wages paid to the managers of your firm.

➤ if a company pays unreasonable high wages to its managers that means it is run by the managers for the managers.

➤ if a company reprices its stock options for insiders Stay Away. this is bad management of a company's assets & is cheating stockholders.

always add the potential new stocks from options into your calculations for intrinsic value.

③ Are they Real Managers or Media Promoters.

managers should manage their company in private, more focused towards long term planning than short term speculation

- Avoid earnings guidances & guesstimates of quarterly profits

④ Avoid Accounting Fads

Are the company's financial results transparent - or opaque

hints: (bad management & accounting fads)

- if non-recurring charges keep recurring
- Extraordinary charges keep comming up but avoid being put into ordinary
- Company puts priority on EBITDA over net income
- pro forma earnings are used to hide actual loses

c. Financial Strength & capital structure

Simple: a good Business is one that generates more Cash than it consumes.

good managers further find ways to put these Cash to productive use, either by reinvestments or dividends favorable to stockholders.

• analysis: Statement of Cash flows (10K report)

Check That:

- cash from operations: has been steadily rising for the past 10 years.
- Owner Earnings: *

"if you owned 100% of this business, how much Cash would you have in your pocket at the end of the year"

general

OE = NetIncome + (Amortization & Depreciation) - normal Capital Expenditures

If applicable also Subtract:

- Costs of granting Stock options (dilution of value)
- "unusual", nonrecurring" or "extraordinary" charges
- Income from the company's pension fund.

Safeguard:

If owner earnings per share have grown at a steady 6-7% over the past 10 years, generation of cash is stable & prospects are good.

- Analysis: Balance Sheet
  - debt: how much debt (including preferred stock) does the company has?
    Safeguard: long term debt should be under 50% of total capital
    "Be wary of variable interests on debt, firm could suffer severely if interest raise"

- ratio of earnings to fixed charges: a healthy Company should at all times earn more than it ows otherwise you are relying on exceptional future performance to cover charges + interest rates!

- dividends: If a firm decides to retain earnings & not pay dividends, the firm should show that it has consistently outperformed the competition via the use of the extra cash. otherwise the managers are missmanaging the investors money & they should pay dividends

- splits: multiple splits on the stock of a firm denote bad management, avoid investing in these firms

- Stocks Buybacks: companies should buyback their shares when they are cheap not when they are overpriced. otherwise they are using the company's cash to wasteful use. in most cases they are selling their own shares to reap fortunes at the stockholders expenses.

admire those managers that are conservative for the future, focus in the long term & spend their time doing their job. AVOID those others that promise miracles for the future & spend their time making up excuses & blaming others

per share earnings considerations:

two advices:

(1) Do not take a single year's earnings seriously
- Carefull with short term earnings they might have false per-share figures

Example: ALCOA

EPS.	1970	1969
	$5.20	$5.58

at the time ALCOA P/E was ~10 with an average P/E ratio for this sector at ~16, undervalued?

NO, a lower P/E is just the first test of value, looking at the 10-K footnotes you can see four earnings figures!

10-K	1970	1969
Primary Earnings	$ 5.20	$ 5.58
Net income (after special charge)	$ 4.32	$ 5.58
Fully diluted, before special changes	$ 5.01	$ 5.35
fully diluted, after special changes	$ 4.19	$ 5.35

4Q		
Primary Earnings	$ 1.58	$ 1.56
Net Income	$ 0.70	$ 1.56

the correct conservative approach will be to look at the fully diluted, after special changes earnings which give us a more clear picture of the company's current standing.

Notes on EPS dilution

- The dilution in the earnings per share arose because part of the convertible bonds were converted to stock.

In Calculating EPS Correctly it is very important to consider the convertible issues & warrants as if they are part of the current number of Stock Shares. otherwise the stock may appear better than it really is.

Notes on Special charges:
Questions to answer:

for ALCOA for 1970 special charges were 88 cents/share or $18,800,000.

1. Why did a lot of companies write special charges for the close of the 1970 year?

2. How did the ALCOA charges arose, do they belong to the Non-operating special section?

Explanations:

1. It is a common though unfair accounting/management practice to write off chargess before they actually occur & blame them on the bad economic situation on that year. Since these are future charges they can be lawfully considered to be special, this allows companies to keep them apart from net Income or earnings per share in the current year & to deduct them from future years raising their earnings & making the company look twice as profitable than it really is; this is so since those losses were already accounted for. Therefore the investors are mislead into thinking the company EPS increased substantially when in reality they haven't.

2. ALCOA charges arose from:

   1. Managements estimate of the antipated cost of clossing the manufactured products division
   2. " " " " " " " " closing ALCOA's Casting Co's plants.
   3. " " " " " " " " losses in phasing out ALCOA Credit Co
   4. " " " " " " "

$ 5.3 million associated with completion of a Contract to a curtain wall

Since all of the charges are for future operation they clearly dont belong to this years operating expenses, so where do they belong & considering the business of ALCOA can they really be considered Non-Operating?

They should be considered on the year they are taken & as normal operating expenses.

also, what about the taxes incurred, if they are estimated as special charges for future years that means future years will be very profitable at the expense of this year's "justified" poor performance

In Summary when looking at EPS be wary of:

- The use of special charges (which are not reflected in EPS)
- The reduction in the normal income-tax deduction by reason of past losses
- The dilution of shares due to the existence of convertible issues & warrants (always consider into # of shares)

also less widely use but also important.

- How the company treats depreciation (accel, straigth line...etc)
- when is R&D charged, now or amortized over several years.
- How does the Company Value Inventories (FiFo or LiFo)

first in firs out   last in first out

Earnings Valuation Techniques

The use of average earnings:

Average earnings over a long period of time, usually from 7-10 years, are usefull for taking out the fluctuations due to the business cycle & to get a better idea of the companies earning power. The special/extraordinary changes should be included

after this figures are considered, ratings for growth & stability of earnings should be applied thus getting the real picture of the Company's past performance.

Calculation of the past growth rate:

Earnings can be given in terms of both the average & the latest figure.

growth Rate: Compare the average of the last 3 years with corresponding figures 10 years earlier.
(be sure to include special changes)

questions to answer with these figures:

- Is the past growth rate greater than the sector's index growth rate?

Return on book value (Earnings on Capital funds):

$$RBV: \frac{\text{net Income}}{\text{tangible net Assets}}$$

This is a measure of profitability & only considers current results, however it can be used to explain high P/E's

Accounting Missmanagement.

Case Scenarios:

AS IF8

Pro Forma Earnings: Statements normally used to provide a truer picture & growth of long term earnings by adjusting for short term non-recurrent events, was corrupted by accounting to show how well they would have done if it wasn't for their operating losses

Hungry For Recognition:
it is a well known fad for companies to start to recognize revenues for products they haven't been yet payed for. aggressive revenue recognition is often a sign of dangers that run deep & loom large!

CAPITAL OFFENSES:
Companies can also hide their operating expenses as capital expenses thus increasing the company's assets when in reality, these expenses should be considered as the cost of selling goods.

e.g. The cost of building a bridge is not an asset as it doesn't have any market value, the asset is only recognized as the bridge is completed & a fair valuation can be made. otherwise you are inflating assets with operating losses.

AN INVENTORY STORY

Very often companies end up with lots of excess supply overpriced inventory which in order to sell needs to be written down at a loss, these charges are usually accounted as special charges even though they are executed subsequently quarter after quarter

THESE RECURRING LOSSES ARE OPERATING EXPENSES NOT SPECIAL CHARGES!

THE PENSION DIMENSION

Companies pension plans generate returns which the company uses to preserve the real value & pay retirees at the end of their careers. However companies sometimes include returns from these pension plans into their net income relying on the good current performance & raising the estimates on their returns. however the returns on these investments usually result over stated & later on have to be recognized as a loss.

Keep in mind these dangerous considerations

- Is the net pension benefit > 5% of the company's net Income?

  will you be comfortable with the other earning if the company were to loose its pension gains

- Is the assumed long-term rate of return on plan assets reasonable?

  anything above 6.5% (2003) is implausible while a rising rate is fuso delusional /

Considerations to follow when Reading Financial Statements:

Read Backwards: Start from the last page to the front since all bad results are most likely there

Read the Notes: Never buy a stock without reading the footnotes to the financial statements in the annual report.

Look for: ①

- recognition of revenue
- recording of inventory
- treats sales
- treats cost, special charges

②

- debt
- stock options
- loans to customers
- reserves against losses

A Comparison of four Listed Companies *

Companies:	Price
- Eltra Corp	27
- Emerson Electric Co.	66
- Emery Air Freight	57 3/4
- Emhart Corp	32 3/4

Main Analysis (Items To gather.)

A. Capitalization Category

- Price (Current)
- Number of Shares of Common (including Convertible Issues)
- Market Value of Common (Price x Number of Shares)
- Bonds & preferred Stock
- Total Capitalization (Market Value of Common + Bonds & Preferred Stock)

B. Income Items

- Sales (current year)
- Net Income (current year)
- EPS (current year)
- EPS (Average, past three years)
- EPS (7th year Average, three years)
- EPS (10th year Average, three years)
- current dividend

C. Balance Sheet Items (Current year)

- Current Assets
- Current Liabilities
- Net Assets for Common Stock.

- Book Value per Share.

D. Key Ratios

- P/E (Current Year) → Compare with sector for better picture on Valuation
- P/E (Average Earnings past 3 years) → Compare w/ Sector
- Price/Book Value
- Net Earnings/Sales
- Net EPS/book Value
- dividend Yield
- Current Assets/Current Liabilities
- Working Capital/ Debt
- EPS growth
  - (Current Past 3 years Avg Vs 7th Past 3 years AVG)
  - (Current Past 3 years Avg VS. 10th past 3 years)

E. Price Record.

- Historic
  - Low
  - High
- Current year
  - Low
  - High

Key steps

P/E Ratio

Compare Current P/E with that of the sector/index. This is a raw measure that will tell you whether the issue is undervalued.

Chief Elements of Performance:

(1) Profitability: check that companies show satisfactory earnings on their book Value. Specifically look at:

EPS

- Satisfactory Current EPS as compared to 7th & 10th year averages

Return on Invested Capital

- Satisfactory Net Income / (tangible Book Value) as compared to 7th & 10th year averages. this is also a measure whether the company requires lots of capital, or not to operate

e.g. GM C capital intensive RIC ↓ ×

CocaCola non Capital Intensive RIC ↑ ✓

Profit Margin (Comparative Strength or weaknesses)

- Satisfactory margin a compared to the 7th & 10th year margins

$$PM = \frac{\text{net Income}}{\text{Revenue}} \times 100$$

② Stability

Look at the maximum decline in EPS in any of the past 10 years as compared to the Average of the past 3 years

no decline indicates 100% Stability ✓

- a moderate decline approximate to that of the Sector or index is acceptable if it comes with a handsome price discount or low P/E Ratio

③ Growth.

Keep in mind that the market reacts first to overprice rapid growing companies, Stay away from these. Look instead for underpriced issues at a reasonable EPS growth Rate.

(4) Financial Position (debt)

Assets/Liabilities ...

Current Assets/Current Liabilities, is a measure of a Company's financial strenght & should always be more than 2 to 1.

Long term debt

Low lon term debt is a must. Should be lower than other Companies in the same industry

Debt / Equity

this is a meausure of a companys leverage Should always be less than 0.5 or 50%

Dilution

the usual way to treat convertible Issues, and warrants is to treat them as if converted into common.

5. Dividends

what really counts here is history of continuance without interruption. if a company does not pay dividends & retains earnings, and other companies in this sector pay dividends. The company that does not pay dividends should reflect better EPS than the others consistent with the retained earnings!

6. Price History

Look at the ratio from all time high to all times low, a ratio that is to big by common standards, or when compared to other companies in the same sector might indicate that the issue is overprice & the rise have been overdone.

High Valuations entail high risks!

General Observations of our Companies

- Emerson Electric has the greatest market value, a considerable rapid growth & a considerable high P/E ratio though lower from to 89 P/E valuation
- Emery Air Freight has to have the higher growth expectations as seen in the current overvaluation of 40 P/E ratio, it is often easier to grow fast when a company is small & competitors are few. at the current price this stock has to be taken with caution & might not be the best option for conservative investors

- Emhart & Eltra, both have done better than the DJIA index continuously over the past 14 years, neither companies are in the consumer minds because of their moderate earnings growth, however they pass all the statistical tests of value.

- While many financial investors, analists & speculators favor the first two companies based on past performance & guesstimates, we have no reason to expect that past exceptional performance will continue in the future, & at the current high P/E ratio these companies do not provide a margin of safety nor do they fit our value standards.

- Eltra & Emhart however are valued at or below book value, here the investor is basically entitled to a tangible part of the business equal to the money invested. The rate of earnings on invested capital is satisfactory, stability, profits & growth are above average as well. In conclusion these 2 companies will meet our value standards & are fit for our defensive investor.

The standards to follow for the defensive investors are:

1. Adequate size Mid to large caps
2. A sufficiently strong financial condition
3. Continued dividends for at least the past 20 years.
4. No earnings deficit in the past 10 years

5. Ten-year growth of at least 1/3 in EPS
6. Price of Stock no more than 1 1/2 times net asset Value
7. Price no more than 15 times average earnings of the past 3 years

Stock's selection for the Defensive Investor.

Previous Suggestions:

- only High-grade bonds
- Diversified List of Comon Stocks at reasonable price multiplies

Diversified List Of Common Stocks choices:

① DJIA Type portfolio

② Quantitatively tested portfolio

— o —

① The investor can buy a cross-section sample of the leading issues, currently the investor can achieve his goal by buying a low cost index fund.

② The investor can apply standards of value to guarantee that he obtains

- A minimun of quality in past peformance & financial condition of the Company
- A minimun of quantity in terms of earnings and assets per dollar of price

THE DEFENSIVE INVESTOR SHOUID ADHERE TO THE FOLLOWING VALUE STANDARDS:

① Adequate size of the enterprise:

The idea is to exclude volatile small companies, no less than 100 M[1] of annual sales for an industrial & no less than 50 M[1] of total assets for a public utility

- only Mid & Large Caps (today's)

② Sufficiently Strong Financial Condition

for industrial:

- assets should be at least twice liabilities
- long term debt should not exceed net current assets (or working capital)

for utilities

- debt should not exceed twice the stock equity

③ Earnings stability

Some earnings for the common stock in each of the past ten years

notes

1. total market value should be >2 billion

④ Dividend Record

Uninterrupted payments for at least 20 years

⑤ Earnings Growth

a minimum increase of at least 1/3 in EPS in the past 10 years using three year averages at the beginning & end

⑥ Moderate Price/Earnings ratio

current price should never be > 15 times average earnings of the past 3 years

⑦ Moderate Ratio of Price to Assets

Current price should be no more than 1½ times last reported book value.

In general the product of the P/E ratio × $\frac{P}{B.\text{Value}}$ should never exceed 22.5

IMPORTANT REMARKS (from Previous Chapter)

* How to calculate recommended Maximum PE ratio

recommended Maximum = $\frac{100}{Y} \times 0.80$ → 20% margin of safety

where Y = 10 year AA-rated corporate bonds

E.g.

for 2012 in current conditions

Y = 3.41 %

∴

Max P/E ratio = $\frac{100}{3.41} \times 0.80 \doteq 23$ $\frac{P}{E}$ actual

REMEMBER HOWEVER TO STICK WITH THE MAXIMUM P/E RATIO BY GRAHAM OF 15

* How to Calculate Stability Index

measured by the maximum decline in EPS in any of the past 10 years Vs the average of the 3 past years EPS

no decline = 100 % Stability Index

SI = max Decline EPS (Past Ten Years)

$$SI = \frac{\text{max Decline EPS (Past Ten Years)}}{\text{Past 3 years EPS average}}$$

* Graham Growth (EPS growth)

growth from:

- Past 3 years EPS AVG vs. 7th year 3 years AVG.
- Past 3 years EPS AVG vs. 10th year 3 years AVG

As Recomended the Previous Remarks apply to Industrial & Public utilities.

Investing In Stocks of Financial Enterprises

The main thing to look at is financial Soundness
other than that: these stocks need to adhere to the Same Value Standards mentioned before.

Railroad Issues (today's airline Issues)

Have Suffered from extreme competition, have underperformed the market & have been highly unprofitable with their history plagued with Booms & busts. There is no reason for the investor to buy these Issues, Except when he is certain he is getting so much Value for his money that it would be unreasonable to look somewhere else.

Selectivity for the defensive Investor:

an Investor has two choices when looking at the future:

- Projection: forecasting results (Qualitative analysis)
- Protection: Using Margins of Safety by buying at discounted prices to provide protection against unforeseen events. (Quantitative/Statistical Approach)

GRAHAM RECOMMENDS A QUANTITATIVE APPROACH & A HIGHLY DIVERSIFIED PORTFOLIO.

RECOMMENDATTIONS FOR THE DEFENSIVE INVESTOR

- Buy every Index Stock.
index fund that tracks total US Stock Market
- that can be done by buying a total stock market Index fund.

- Make the Index fund the foundation of your portfolio by Investing ~90% of your capital on it & practice stock selection with the remaining 10%

A patient investor can always find treasures through the breakages of a bear market.

Remarks on Earnings Growth:

Graham specification of a 1/3 Growth per decade, or 3% annual growth is the lower bound limit of earnings growth.

The recomendations are

- 1/2 over decade or 5% annually

with strong candidates at

- 1 over decade with 7% annually

REMEMBER THIS IS ONLY ONE MEASURE OF VALUE HOWEVER

Remark on P/E Ratio.

Remember that Graham P/E ratio is current price over past 3 years earnings average, Graham recomends a maximun P/E ratio of 15

Strong Value Initial Screener ($P/E \times P/_{BV} \leq 22.5$)

Graham recomendation of choosing stocks whose $P/E \times P/_{BV}$ is less or equal to 22.5 is still an strong filter for today's markets. & should be used to filter out overpriced stocks

Final Remarks:

① DO YOUR HOMEWORK: www.SEC.GOV → Edgar database

Read at least 5 years worth of:

- Annual Reports / Quarterly reports to zoom in if needed.
- Proxy statement disclosing Manager's:
  - compensation
  - Ownership
  - Conflicts of Interest

② CHECK OUT THE NEIGHBORHOOD:

Look at percentage of ownership in:

- http://quicktake.morningstar.com
- http://finance.yahoo.com
- www.quicken.com

If 60% or more of a company is owned by an Institution you run the risk of massive selling by that single owner & a devaluation of the price. If instead the owners are money management firms with a similar style to yours that's a good indication.

IF YOU. ARE NOT WILLING TO GO TO THE MINIMAL EFFORT OF READING THE ANNUAL REPORTS, THE PROXY STATEMENT & ASSESING MINIMAL HEALTH THEN YOU ARE TO DEFENSIVE TO BE PICKING YOUR OWN STOCKS & SHOULD PUT YOUR MONEY IN AN INDEX FUND

Stock Selection for the Enterprising Investor

Word of Recommendation: Though everyone might think that overperforming the defensive investor is easy as it seems. Numerous firms & funds & Investors with the highest qualifications have failed at doing So.

Refer to mutual funds performance over history

The intelligent investor Can be in a position to profit if & only if:
HE FOLLOWS THOSE SPECIFIC METHOD THAT ARE NOT GENERALLY ACCEPTED ON WALL STREET, Since those that are so accepted do not seem to produce satisfactory results.

A SHORT SUMMARY OF GRAHAM-NEWMAN METHODS (GRAHAM'S FUND)

Graham Newman dealt with the following activities:

- **Arbitrages:** The purchase of a security and the simultaneous Sale of one or more other securities into which it was to be exchanged under a plan of reorganization, merger or the like

  e.g. a Simple example is the purchase of an agricultural commodity undervalued by Some Market reasons & selling it in another Market where the price is higher

- **Liquidations:** Purchase of shares which were to receive one or more cash payments in liquidations of a company's assets.

  e.g. Buying shares of a company at a price below that received when the Company was liquidated.

  Two Requirements for this:

  a. a Calculated annual return of 20% or more, AND

  b. our judgement that the chance of Succesful outcome was 4/5

- **Related Hedges:** The purchase of convertible bonds or

Convertible preferred shares, and the simultaneous sale of the common stock into which they were exchangeable.

i.e. Buying Senior Issues as close to the stock price as possible ∴ if the stock price were to rise a small loss was incurred but if the price did fall a substantial gain was taken

▶ Net-Current-Asset (or "Bargain") Issues: *

G&N aimed to acquire as many issues as possible at a cost of less than their book value in (net current assets alone) i.e. working capital

PURCHASES WERE MADE TYPICALLY AT 2/3 or LESS OF WORKING CAPITAL

G&N Discontinued 2 investment operations due to poor results. (not dependable, not headache proof)

- The purchase of apparently attractive issues (based on our general analysis) that were not obtainable at less than their working capital value alone.
- Short-selling practices

The enterprising investor will do well to apply various tests of quality & price-reasonableness along the lines we have proposed for the defensive investor

they should however be more flexible to counter some bad measures with some other exceptionally good ones. NEVER FORGETTING TO ALWAYS ASK FOR THE PRICE.

SECONDARY COMPANIES OPPORTUNITIES

those companies that are making a good showing, have a satisfactory past record, but appear very unpopular to the public. e.g. ELTRA & EMHART previous sections

HOW TO FIND THESE COMPANIES:

- ▶ Standar & Poor's Stock Guide.
- ▶ Multiple web stock screeners.

The main filter for these companies is the net asset value or book value per share.

WINNOWING OF THE STOCK GUIDE (ENTERPRISING STOCK SELECTION)

First Valuation Measures

1. P/E Ratio: (FILTER)

$P/E \leq 10$

Look for those stocks valued at 10 or less per earnings

2. FINANCIAL CONDITION:

(a) $\frac{\text{Current Assets}}{\text{Current Liabilities}} >= 1.5$

&

(b) debt not more than 110 % of working capital

3. Earnings Stability:

No deficit in the last 5 years

4. Dividend Record:

Some current Dividend.

5. Earnings Growth:

Last year's Earnings > than 5 years - 6 years ago.

6. Price

Less than 120% net tangible assets

$\frac{P}{\text{net tangible Assets}} \leq 1.20$

7. S & P rankings & other ranking agencies.

only Issues ranked as average or better $\geq B^+$ ranking

PAST HISTORY RESULTS

The two consistent methods that have been found to give good results are:

(a) Purchase of low-multiplier stocks of Important Companies
≥ MidCaps

(b) The choice of a diversified group of stocks selling under their net current asset value.

$$\text{GRAHAM Net Working-Capital} = \frac{\text{Current Assets} - \text{Total Liabilities}}{\#\text{ of shares.}}$$

* Be GREEDY during Bear markets, because it is at those times that tangible undervalued Issues come about, if there are goodwill items adding extra value that is always a big plus.

* Be FEARFUL during Bull Markets, because it is at that time that prices are highest and quality is the lowest.

Patience:

The buyer of bargain Issues has to be an extremely PATIENT INVESTOR as the Market can take years to advance to fair valuations.

SPECIAL SITUATIONS OR WORKOUTS / ARBITRAGES

three illustrative examples on this field:

Case (1): acquisition of Kayser-Roth by Borden's.

Borden. Inc announced the acquisition of Kayser Roth by giving 1⅓ of its shares in exchange for one share of Roth. at 26 for Borden & 28 for K.Roth an investor could have made a profit by buying Roth & selling Borden.

Case ②: National Biscuit Co. offered to buy Control of Aurora plastics. at 11/share. Aurara plastics was Selling at ~9. the risks were non consumation & time.

Case ③: Universal-Marion Co., which had ceased its business operations had a liquidation book Value of 28½ & was selling for 21½, indicating a potential profit.

Some of this cases were to turn losses & other wins However the field of arbitrage reguires its own carefull studies in a professional manner

Advice. 7

PRACTICE MAKES THE MASTER

It is best fitted for most investors to restrain from picking their own stocks & rely instead on Index Funds. However, If you would like to pick your own stock practice first using the following portfolio trackers from:

- morningstar.com
- finance.yahoo.com
- money.cnn.com/services/portfolio/

By practicing you can develop discipline & avoid:

- frequent trading
- Compare your approach with leading money managers
- Refine your Valuation skills
- Learn that some of your picks are winners & some are losers

After a year measure your results & decide for yourself

- for a defensive investor remember to keep only 10% for stock picking. everything else in index fund.

Places to look at:
- Stock Screeners
- new 52-week lows Wall Street journal
- " " " Market week Barrons

A better measure for Earnings

After you have a good Valuation of a company.
Check a company Truly Earnings by ROIC

Return on Invested Capital (ROIC)

ROIC = Owner Earnings ÷ Invested Capital

where owner Earnings * (warren Buffet's measure of real Earnings)

OE = Operating Profit + amortization of goodwill
- federal Income tax (Paid at the company's Average rate)
- cost of stock options
- maintenance (or essential) capital expenditures
- any Income generated by unsustainable rates of return (as of 2012, anything greater than 5.2%)

where Invested Capital

IC = Total Assets
- cash (as well as short term Investments & non Interest liabilities)
+ past accounting changes that reduced invested Capital.

As a rule of thumb

ROIC ≥ 10% attractive

ROIC ≥ 6% < 10 tempting only with other exceptional qualitative/quantitative factors.

Other things to consider:

- Managers act like owners, not just managers
    - are financial statements simple to understand
    - are special charges, really special
    - focus on long term, good communication skills
    - own sizable stakes in stock (cash purchases not options)
    - do the talk more about stock the business operations
    - avoid stock options of more than 3% to managers
    - Honesty & carry through from one year to the next.

LISTEN TO COMPANYS CONFERENCE CALLS TO KNOW ABOUT QUALITATIVE FACTORS

What Warren Buffet looks at:

- Margin of Safety
- franchise companies:
    - Strong consumer brands
    - easily understandable business
    - robust financial Health
    - near Monopolies in their Market
- Undervalued Stocks due to:
    - Scandals
    - big loss
- Managers who set & meet realistic goals:
    - Build businesses from within rather than acquisition
    - allocate capital wisely
    - minimum stock options/Remunerations
- Steady & Sustainable growth in earnings.

READ BOOK ON BUFFETS ANNUAL REPORTS/MEETINGS

"BE DISCIPLINED & CONSISTENT, STICK TO YOUR TECHNIQUES & MAKE IMPROVEMENTS ONLY BASED ON YOUR THOROUGH ANALYSIS, PAY LITTLE ATTENTION TO WHAT THE MARKET DOES."