One Up on Wall Street by Peter Lynch

Notes adapted by Roshan Chikarmane

Not Contained in the Book:

Efficient Market Hypothesis (EMH): It is impossible to "beat the market" because stock market efficiency causes existing share prices are always traded at fair market value, making it impossible for investors to either purchase undervalued stocks or sell stocks at inflated prices. The only method of obtaining higher returns is to purchase riskier investments.

This hypothesis rests upon the following tenants:

- A large number of investors analyze and value securities for profit
- New information comes to the market independent from other news and in a random fashion
- Stock prices adjust quickly to new information
- Stock prices should reflect all available information

Criticism:

- Economic bubbles are said to be grounded in irrational exuberance followed by an overreaction of frantic selling

Investment Strategies:

- <u>Value Investing:</u> Targets securities at less than their "intrinsic value" and waiting for the market to recognize this misalignment and reprice the security.
- <u>Socially Responsible Investing (SRI):</u> Investments that seek to promote environmental stewardship, consumer protection, human rights, and diversity, while avoiding businesses involved in alcohol, tobacco, gambling, pornography, weapons, contraception/abortion, fossil fuel production, and/or the military.
- <u>Growth Investing:</u> Targets companies that exhibit signs of above-average growth, even if the share price appears expensive in terms of metrics such as price-to-earnings (p/e) or price-to-book ratios.
- <u>Index Investing:</u> Targets investment funds that aims to replicate the movements of an index of a specific financial market, or a set of rules of ownership that are held constant, regardless of market conditions.
- <u>Quality Investing:</u> Targets securities based on a set of clearly defined set of clearly defined fundamental criteria that seeks to identify companies with outstanding soft criteria (e.g. management credibility) and hard criteria (e.g. balance sheet stability).

Part I: Preparing to Invest

"As far as I'm concerned, the stock market doesn't exist. It is only there as a reference to see if anybody is offering to do anything foolish."

Warren Buffet, on gauging markets and ignoring company credentials

"When someone says any idiot could run a company, that's a plus as far as I'm concerned, because sooner or later any idiot is probably going to be running it."

Peter Lynch

Strategies of a Handful of Great Investors

Name	Strategy
John Templeton	● Known as the "Pioneer of the Global Market". ● His investors avoided the 1972-74 collapse in the U.S. because he had cleverly placed most of his fund's assets in Canadian and Japanese stocks. ● He took advantage of the seventeen-fold increase in the Japanese Nikkei from 1966 to 1988, while the U.S. Dow Jones had only doubled.
Max Heine	● Bought undervalued asset-rich companies and waited for market to adjust
John Neff	● Investor of out-of-favor stocks

Street Lag

Under the current system, a stock isn't truly attractive until a number of large institutions have recognized its suitability and an equal number of respected Wall Street analysts have put it on the recommended list. A method of waiting for others to make the first move is not very profitable.

Investing in Bonds

This, along with money-markets or certificates of deposit (CD's), are all forms of *investing in debt* – for which one is paid interest. The growth rate of cash invested in bonds in a given year is equal to the average interest rate charged for that year.

Long-term Treasury bonds are the best way to play interest rates because they aren't "callable" until 5 years prior to maturity. On the other hand, most corporate and municipal bonds are callable as soon as it is advantageous for the debtors to buy it back, which will likely when interest rates rise (when it would have been most advantageous to you, as an investor).

Traditionally, bonds were sold in denominations too large for the small investor, who could only invest in debt via the savings account or the boring U.S. savings bonds. However, the small investor may invest in such forms of debt via *bond funds*.

In stocks, you've got the company's growth on your side. You're a partner in a prosperous and expanding business. In bonds, you are nothing more than a source of spare change. When you lend money to someone, the best you can hope for is to get it back, plus interest. You'll never get a tenbagger in a bond, unless you're a debt sleuth who specializes in bonds in default. The tradeoff is that stocks are more volatile than bonds, even "blue chip" stocks because fortunes change. There is no assurance that major companies won't become minor, therefore, there is *no such thing as a can't-miss blue chip stock*.

Is Playing the Stock Market a Gamble?

An investment is simple a gamble in which you have tilted the odds in your favor. By asking some basic questions about companies, you can learn which are likely to grow and prosper, which are unlikely to grow and prosper, and which are entirely mysterious. Consistent winners raise their bets as their position strengthens, and they exit the game when the odds are against them, while consistent losers hang on to the bitter end with a very expensive pot, hoping for miracles and enjoying the thrill of defeat. Consistent winners also accept periodic losses, setbacks, or unexpected occurrences and start looking for the next stock.

The Mirror Test (Addressing Investor Personality)

1. <u>Do you own a house?</u>

It's no accident that people in their houses are idiots in their stocks. A house is *entirely rigged* in the homeowner's favor. The banks let you acquire it at 20% down, or in some cases less, giving you a remarkable power of leverage. If you buy a house for 20% down and the value of the house increases by 5% annually, you are making 25% on your down payment, and interest on the loan in tax-deductible. As a bonus, you will get a federal tax deduction on the local real estate of the house, plus the house in a perfect hedge against inflation and a great place to hide out during a recession. Then at the end, if you decide to cash in your house, you can roll the proceeds into a fancier house to avoid paying taxes on your profit.

The customary progression of houses is as follows: You buy a small house (a starter house), then a medium sized house, then a larger house that eventually you won't need. After the children have moved away, then you sell the big house and revert to a smaller house, making a sizeable profit in the transition. The windfall isn't taxed because the government, in its compassion, gives you an once-in-a-lifetime house windfall exemption. The never happens in stocks, which are taxed as frequently and heavily as possible.

No wonder people make money on the real estate market and lose money on the stock market. *They spend months choosing their houses and minutes choosing their stocks.*

2. <u>Do you need the money?</u>

Only invest what you could afford to lose without that loss having any effect on your daily life in the foreseeable future.

3. <u>Do you have the personal qualities to do what it takes to succeed?</u>

Patience, self-reliance, common sense, a tolerance for pain, open-mindedness, detachment, persistence, humility, flexibility, a willingness to do independent research, an equal willingness to admit mistakes, the ability to ignore general panic.

The *unwary investor* continuously passes through a triple-faceted cycle of emotional states: *concern, complacency, and capitulation*. He's *concerned* after the market has dropped or the economy has seemed to falter, which keeps him from buying good companies at bargain prices. Then after he buys at higher prices, he gets *complacent* because his stocks are going up. This is precisely the time he ought to be concerned enough to check the fundamentals, but he isn't. Then finally, when his stocks fall on hard times and the prices fall below what he has paid, he *capitulates* and sells in a snit.

Some have fancied themselves contrarians, believing that they can profit by zigging when the rest of the world is zagging, but it didn't occur to them to become contrarian until the idea had already become to popular that becoming contrarian became the norm. The true contrarian is not the investor who takes the opposite side of a popular hot issue (i.e. shorting stocks that everyone else is buying). *The true contrarian* *waits for things to cool down and buys stocks that nobody cares about, and especially those that make Wall Street yawn.*

Discipline yourself to ignore your gut feelings and stand by your stocks as long as the fundamental story of your company is pleasant.

Is This a Good Market?

No matter how we arrive at the latest financial conclusion, we always seem to be preparing ourselves for the last thing that's happened as opposed to what's going to happen next. This "*penultimate preparedness*" is our way of making up for the fact that we didn't see the last thing coming in the first place.

<u>The Cocktail Theory of an Upwards Market:</u>

1. <u>First Stage:</u> People avoid the topic of the stock market. The market has been down awhile and nobody expects it to rise soon.
2. <u>Second Stage:</u> People are willing to briefly mention the stock market, albeit that it is a risky investment endeavor. The market is up about 15%, but few are paying attention to it.
3. <u>Third Stage:</u> People are willing to ask you what stocks are interesting. The market is up about 30%.
4. <u>Fourth Stage:</u> People are willing to tell you what stocks are interesting to invest in. The market has reached a peak and is due for a tumble.

This being said, *don't believe in predicting market, believe in great companies*. Just for the sake of argument, let's say you could predict the next economic boom with absolute certainty, and you wanted to profit from the foresight by picking a few high-flying stocks. You would still have to pick the right stocks, just the same as it you had no foresight. *The only reliable buy signal is a company with solid fundamentals*. In that case, it is never too soon or late to buy shares.

Part II: Picking Winners

Stalking the Tenbaggers

The best place to find tenbaggers is close to home – if not in your backyard, at the shopping mall, and especially where you happen to work (*professional's edge*). Though people who buy stocks bout which they are ignorant may get lucky and enjoy great rewards, they are competing under unnecessary handicaps, just like a marathon runner who decides to stake his reputation on a bobsled race.

The professional's edge is especially helpful in knowing when and when not to buy shares in companies that have been around a while, especially those in so-called cyclic industries. It gives in incredible head start in anticipating an improvement in earnings, which makes a company's stock go higher. Additionally, instances where the value of assets per share exceed the price per share of the stock, you can truly buy a great deal of something for nothing. Whatever edge applies, the exciting part is you can *develop your own stock detection system* outside the normal channels of Wall Street, where you'll always get the news late.

Following Up

However a stock has come to your attention, the *discovery is not a buy signal*. What you've got so far is simply a lead to a story that has to be developed. Investing without research is like playing stud poker without ever looking at your cards.

If you are considering a stock on the strength of some specific product that company makes, the first thing to find out is: What effect will the success of the product have on the company's bottom line? The *size of the company* has a great deal to do with what you can expect about the stock. Success tends to be diluted in hulking companies relative to smaller companies. There is simply no way that certain massive companies can could accelerate their growth very much without taking over the world. Meanwhile, a competing product may launch a smaller company into a strong growth period and are more fruitful investments.

Six Stock Classifications

1. <u>Slow Growers</u>

Typically these large and aging companies are expected to grow slightly faster than the gross national product (2-4% annually). They used to be a fast grower and eventually pooped out, either because they had gone as far as they could, or else they got too tired to make the most of their chances. When and industry at large slows down, most of the companies within the industry tend to lose momentum as well and, sooner or later, every fast-growing industry becomes a slow-growing industry.

The chart of a slow grower resembles the topographical map of Delaware, which has no hills. They also tend to pay a generous dividend. If growth in earnings is what enriches a company, then what's the sense of wasting time on sluggards?

Buy: Since you buy these stocks for the dividends (why else would you own them?) you want to check to see if dividends have always been paid and whether they are routinely raised. When possible find out what percentage of earnings are being paid out as dividends. If it's a low percentage, then the company has a cushion in hard times. It can earn less money and still retain the dividend. If it's a high percentage, then the dividend is riskier.

Sell Signs:

- When there is 30-50% appreciation or when the fundamentals have deteriorated, even if the stock has declined in price.
- If the company has lost market share for two consecutive years and is hiring another advertising company.
- No new products are being developed, spending on research and development is curtailed, and the company appears to be resting on its laurels.
- Two recent acquisitions of unrelated business look like parasitic diversifications and the company announces it is looking for further acquisitions "at the leading edge of technology". The company paid so much
- The company has paid so much from no debt and millions in cash to no cash and millions in debt. There are no surplus funds to buy back stock, even if the price falls sharply.
- Even at lower stock price the dividend yield will not be high enough to attract much interest from investors.

2. Stalwarts

Multi-billion dollar hulks that are not exactly agile climbers, but are faster than slow growers. Depending on when you buy them and at what price, you can make a sizeable profit from investing in these. It may take several years for your money to double or triple at best, but they offer pretty good protection during recessions and hard times.

Check for possible bad diversifications that may reduce earnings in the future. Check the company's long-term growth rate, and whether it has kept up the momentum in recent years. If you plan to hold the sock forever, see how the company has fared during previous recessions and market drops.

Sell Signs:

- New products introduced in the last two years have had mixed results, and others still in the testing stage are a year away from the marketplace.
- The stock has a p/e of 15, while similar-quality companies in the industry have p/e's of 11-12.
- No officers or directors have bought shares in the last year.
- A major division that contributes 25% of earnings is vulnerable to an economic slump that's taking place (in housing starts, oil drilling, etc.)
- The company's growth rate has been slowing down, and though it's been maintaining profits by cutting costs, future cost-cutting opportunities are limited.

3. Fast Growers

Small, aggressive, new enterprises that grow at 20-25% annually. They don't even necessarily have to belong to a fast-growing industry. They just have to have a good balance sheet and be making substantial profits. The trick is figuring out when they'll stop growing, and how much to pay for the growth.

Investigate whether the product that's supposed to enrich the company is a major part of the company's business. Find out what the growth rate in earnings has been in recent years (20-25% growth rate is Peter's favorite, he's wary of companies that seem to be growing faster than 25%. Those fifty percenters usually are found in hot industries, avoid these.) See if the company has duplicated success in more than one city or town, to prove that expansion will work. See whether the stock is trading at a p/e ratio near the growth rate. See whether expansion is speeding up or slowing down.

Sell Signs:

- Same store sales are down 3% in the last quarter.
- New store results are disappointing.
- Two top executives and several key employees leave to join s rival firm.
- The company recently returned from a "dog and pony" show, telling an extremely positive story to institutional investors in twelve cities in two weeks.
- The stock is selling at a p/e of 30, while the most optimistic projections of earnings at 15-20 percent for the next two years.

4. Cyclicals

A company whose sales and profits rise and fall in regular, if not predictable, fashion. The autos and the airlines, tire companies, steel companies, chemical companies, and defense companies are examples of cyclicals, since their profits rise and fall depending on some fluctuating external variable (economy-based demand, cost of raw materials, policies of various administrations, etc.).

Coming out of a recession and into a vigorous economy, the cyclicals can flourish, and their stock prices tend to rise much faster than the stalwarts. On the flip side of the coin, you can lose more than 50% of your portfolio if you buy cyclicals in the wrong part of the cycle, and it may be years until you see another upswing. Timing is everything in cyclicals and you have to be able to detect the early signs that business is falling off to picking up. The *professional's edge* can be very valuable in this stock category.

Keep a close watch on inventories, and the supply-demand relationship. Watch for new entrants into the market, which is usually a dangerous development. Anticipate a shrinking p/e multiple over time as business recovers and investors look ahead to the end of the cycle, when peaks earnings are achieved.

Sell Signs:

- Inventories are building up and the company can't get rid of them, which means lower prices and lower profits.
- Falling commodity prices.
- Competition businesses, which forces everyone to cut prices and leads to lower earnings for all producers.
- Two key unions contracts expire in the next twelve months, and labor leaders are asking for a full restoration of the wages and benefits they gave up in the last contract.
- Final demand for the product is slowing down.
- The company has doubled its capital spending budget to build a fancy new plant, as opposed to the old plants at low cost.
- The company has tried to cut costs but still can't compete with foreign producers.

5. <u>Turnarounds</u>

These are stocks that are slated to crash and burn but manage to revive themselves before the terrible end. These stocks make up lost ground very quickly and, of all the categories, their ups and downs are the least related to the general market. There are several types of turnaround stocks:

- *Bail-us-out-or-else turnaround:* The whole thing depends on a government loan guarantee, such as the case of Chrysler or Lockheed.
- *Who-would-have-thunk-it turnaround:* Like Con Ed in 1974, when the stock dropped from $10 to $3. Who would have believed you could lose money in a utility?
- *Little-problems-we-didn't-anticipate turnaround:* Tragedies such as the Bhopal disaster in the Union Carbide plant in India or the meltdown of the nuclear reactor on Three Mile Island that devastated the price of General Public Utilities, its owner.
- *Perfectly-good-company-inside-a-bankrupt-company turnaround:* Such as the successful Toys R Us being spun out of the failing Interstate Department Stores, the result was 57 bags.
- *Restructuring-to-maximize-shareholder-values turnaround:* Restructuring is a good way of getting rid of unprofitable subsidiaries it should have never acquired in the first place.

How much cash does the company have? How much debt? What is the debt structure, and how long can it operate in the red while working out its problems without going bankrupt? If it's bankrupt already, then what's left for the shareholders? How is the company supposed to be turning around? Has it rid itself of unprofitable divisions? Is business coming back? Are costs being cut? If so what will the effect be?

Sell Signs:

- Debt, which has declined for five straight quarters, just rose by $25 million in the latest quarterly report.
- Inventories are rising at twice the rate of sales growth.
- The p/e is inflated relative to earnings prospects.
- The company's strongest division sells 50% of its output to one leading customer, and that leading customer is suffering from slowdown in its own sales.

6. <u>Asset Plays</u>

Any company that is sitting on something valuable that you know about, but the Wall Street crowd has overlooked. An asset play is where the *professional's edge* can be used to the greatest advantage. The asset may be as simple as a pile of cash, real estate, oil, newspapers and TV stations, patented drugs, or a new hot product. Asset opportunities are everywhere. Sure they require a working knowledge of the company that owns the assets, but once it's understood, all you need in patience.

What is the value of the assets? How much debt is there to detract from these assets? Is the company taking on new debt, making the assets less valuable? Is there a raider in the wings to help shareholders reap the benefits of the assets?

Sell Signs:

- Although shares sell at a discount to real market value, management has announced it will issue 10% more shares to help finance a diversification program.
- The division was expected to be sold for $20 million only brings $12 million in the actual sale.
- The reduction in the corporate tax considerably reduces the value of the company's tax-loss carryforward.
- Institutional ownership has risen 25% five years ago to 60% today – with several Boston fun groups being major purchasers.

The Perfect Stock

1. <u>Simple Name</u>

Fancy names can attract investors that have not checked the fundamentals of a company and will overvalue the stock.

2. <u>It Does Something Dull</u>

If a company with terrific earnings and a strong balance sheet also does dull things, it gives you time to purchase the stock at a discount. Then when good news finally reaches Wall Street, the stock price will shoot up.

3. It’s a Spinoff

Spinoffs of divisions or parts of companies into separate, freestanding entities often result in astoundingly lucrative investments. Large parent companies do not want to spin off divisions and then see those spinoffs get into trouble, because that would bring embarrassing publicity that would reflect poorly on the parents. Therefore, spinoffs typically have strong balance sheets and are well-prepared to succeed as independent entities. Once these companies are granted their independence, new management, and are free to run on their own, they can cut costs and take creative measures that improve the near and long-term earnings. Spinoff companies are often misunderstood and get little attention from Wall Street, making them a fertile area for the amateur shareholder.

4. It’s in a No-Growth Industry

In a no-growth industry, there’s no problem with competition. You don’t have to protect your flanks from potential rivals because nobody else is going to be interested. This gives you the leeway to continue growing and gaining market share.

5. It Has a Niche

Companies that are a virtual monopoly in their market have the ability to control prices and are often given large tax breaks. Drug companies and chemical companies (ex. peticides/herbicides) have niches – products that no one else is allowed to make.

Brand names such as Robitussin or Tylenol, Coca-Cola or Marlboro, are almost as good as niches. It costs a fortune and years of persistence to develop public confidence in a soft drink or a cough medicine.

6. It’s a User of Technology

Invest in stocks that use technology and therefore benefit from the seemingly endless price war between tech companies.

7. The Insiders and Buyers

When insiders are buying like crazy, you can be certain that, at a minimum, the company will not go bankrupt in the next six months.

Sine bigger companies tend to pay bigger salaries to executives, there’s a natural tendency for corporate wage-earners to expand the business at any cost, often to the detriment of shareholders. This happens less often when management is heavily invested in shares. However, it’s even more significant when employees at the lower echelons add stock to their positions. Remember that there’s only one reason that insiders buy: They think that the stock price is undervalued and will eventually go up.

Several newsletter services, including *Vicker’s Weekly, Insider Reporter*, and *The Insiders* keep track of these filings. Your local library may subscribe to these publications. There’s also a tabulation of insider buying and selling in the *Value Line* publication.

8. The Company is Buying Back Shares

This only happens if the company has faith in its own future. Long-term these buyback s can’t help but reward investors by stabilizing markets during panicked times. When stock is bought by a company, it is taken out of circulation, therefore shrinking the number of outstanding shares. This can have a magical effect on earnings per share, which in turn has a magical effect on the stock price. If a company buys back half its shares and its overall earnings stays the same, the earnings per share have just doubled. Few companies get that kind of result by cutting more costs or increasing sales.

Common alternatives to buying back shares are: Raising the dividend, developing new products, starting new operations, and making smart acquisitions.

Stocks to Avoid

1. High growth stocks in hot industries

They attract a very smart crowd that wants to get into business. Entrepreneurs and venture capitalists stay awake nights trying to figure out how to get into the act as quickly as possible. If you have a can't-fail idea, but no way of protecting it with a patent or a niche, as soon as you succeed, you'll be warding off the imitators. In business, imitation is the sincerest form of battery. Remember what happened to disk-drives? The experts said that this exciting industry would grow at 52% annually – and they were right, it did. But with thirty or thirty-five rival companies scrambling in the action, there were no profits. Negative-growth industries do not attract flocks of competitors.

2. The "Next Something"

Avoid stock in a company that has been touted as the next IBM, the next McDonalds, the next Intel, or the next Disney. It often remarks the end of prosperity not only for the imitator, but also for the original to which it was being compared.

3. Avoid Diversifications for the Worst, or "Diworsifications"

The dedicated diworsifier seeks out merchandise that is overpriced and/or completely beyond his or her realm of understanding. This ensures that losses will be maximized.

Why do these companies stumble? The concept of synergy, or the two-plus-two-equals-five theory of putting together related businesses and making the whole things work. If a company were to acquire something, it would be preferable that they are related businesses. There's a strong tendency for companies that are flush with cash and are feeling powerful to overpay for acquisitions, expect too much from them, and then mismanage them.

4. Beware the Whisper Stocks

Often the whisper companies are on the brink of solving the latest national problem: the oil shortage, drug addiction, AIDS. The solution is either (a) very imaginative, or (b) impressively complicated. Whisper stocks have a hypnotic effect, and usually the stories have an emotional appeal, but lack substance. Usually there are no earnings. Why not put off buying the stock until later, when the company has established a record? When in doubt, tune in later.

IPO's if brand-new enterprises are very risky because there's so little information. It's better to invest in IPO's of companies that have been spun out of other companies, or in related situations where the new entity actually has a track record.

5. Beware the Middleman

These companies are risky because they tend to rely on too few clients. The loss of one customer could be catastrophic to a supplier.

What Makes a Company Valuable?

Earnings

The earnings trend for a given stock type usually parallels that of the stock price. There are five basic ways that a company can increase earnings:

1. Reduce costs
2. Raise prices
3. Expand into new markets
4. Sell more of its product in the old markets
5. Revitalize, close, or otherwise dispose of a losing operation

P/E Ratio

Like the earning line, the P/E ratio is often a useful measure of whether any stock is overpriced, fairly priced, or underpriced relative to a company's money-making potential. It is derived by dividing the current price of a stock by the company's fiscal earnings (earnings from the prior 12 months.

It can be thought of as the number of years it will take for the company to earn back the amount of your initial investment – assuming, of course, that the company's earnings stay constant. P/E levels tend to be the lowest for the slow growers and highest for the fast growers, with the cyclical vacillating in between.

A broker can give you the historical record of a company's P/E. It's useful to know whether what you're paying for the earnings is in line with what others have paid for the earnings in the past. *Value Line Investment Survey*, available in most large libraries and from most brokers, is another good source for P/E histories. In fact, *Value Line* is a good source for all the pertinent data that amateur investors need to know. It's the next best thing to having your own private securities analyst. Remember to avoid stocks with excessively high P/E's (>100), it set unusually high expectations for the future and it's decrease is sure to result in a decrease in the stock price.

Building a "Story" of a Company Across the Stock Classifications

1. Slow Grower: Change in dividend size?
2. Cyclical: Improved business conditions, a decrease in inventory, and increase in prices.
3. Asset Play: Worth of the assets increases.
4. Turnaround: Has the company gone about improving its fortunes and it the plan working so far?
5. Stalwart: P/E ratio. Has the stock had a dramatic run-up in price in recent months, and what, if anything, is happenings to accelerate growth rate?
6. Fast Grower: Where and how can it continue to grow fast?

Getting the Most out of Your Broker

They can provide the S&P reports and investment newsletters, the annuals, quarterlies and prospectuses and proxy statements, the *Value Line* survey and the research from the firm's analysts. Let them get the data on the P/E ratios and growth rate, in insider buying and ownership institutions. They'll be happy to do it once they recognize that you're serious.

Another thing that the broker can do is get you a company's number. Lead off with a question that shows you've done some research on your own. Even if you have no script, you can learn something by asking two general questions about a company: "What are the positives of this year?" and "What are the negatives of this year?"

Reading the Reports

<u>Consecutive Year Balance Sheet</u>

Overall-Cash Position = Cash and Cash Items + Marketable Securities

Compare *Overall-Cas*h Positions from year to year to see if the company has been accumulating cash. If this number has been increasing, it is a sure sign of prosperity.

If overall-cash position is increasing faster than the "*long-term deb*t", this is a sign of debt reduction, another sign of prosperity.

Net-Cash Position = *Overall-Ca*sh Position – *Long-Term Debt*

If *net-cash* is a positive number, this is favorable.

<u>10-Year Financial Summary</u>

Are the number of *shares outstanding* decreasing? If so, the company has been buying back its shares.

Net-Cash/Share = Net-Cash Position / # Shares Outstanding

You can get the annual S&P reports from your broker, or from *Value Line* (easier to read than a balance sheet).

Valuable Numbers

<u>Percent of Sales</u>

If you are interested in a company because of a particular product, know what the product means to the company in question. What percent of sales does it represent?

<u>Price/Earnings Ratio</u>

If the P/E ratio is less than the growth rate, it may be a bargain. If your broker can't give you a company's growth rate, you can figure it out for yourself by taking the annual earnings from *Value Line* or an S&P report and calculating the percent increase in earnings from one year to the next.

Use this to compare growth rate to earnings, while also taking dividends into account:

(Long-Term Growth Rate + Dividend Yield)/(P/E ratio)

Less than 1 is poor, 1.5 is okay, 2 or better is great.

Debt Factor

A normal balance sheet has 75% debt to 25% equity. More equity and less debt is constitutes a strong balance sheet. This metric is particularly important for identifying turnarounds because it is debt that decides which companies survive and which will go bankrupt in a crisis. Young companies with heavy debts are always at risk.

Bank debt is the worst kind of debt because it is due on demand. If the borrower can't pay back the money, it's off to Chapter 11. Creditors strip the company, and there's nothing left for the shareholders after they get through with it.

Funded debt (the best kind, from the shareholder's point of view) can never be called in mo matter how bleak the situation, as long as the borrower continues to pay interest. This gives companies time to wiggle out of trouble.

Book Value

Stated book value often bears little relationship to the actual worth of a company. It often understates or overstates reality by a large margin.

Hidden Assets

This is where you get the greatest asset plays. Companies that own natural resources carry those assets in their book at a fraction of the true value. These inventories are carried on the books at the prices that they had originally paid for it.

There are also hidden assets what one company owns a share of another company.

Tax breaks are also a wonderful hidden asset in turnaround companies.

Cash Flow

Companies that have to spend lots of cash to make cash will tend to move slowly. Invest in companies that don't depend on capital spending. The cash that comes in doesn't have to struggle with the cash that has to come out. Many people use cash flow numbers to evaluate stocks, for instance, a $20 stock with a $2 per share in annual cash flow has a 10% return on cash. The higher the return on cash, the better.

Inventories

Check to see if inventories are piling up. When inventories grow faster than sales, it's a red flag.

Growth Rate

The only growth rate metrics that really matters is earnings. Also, if you find a company can raise prices year after year without losing customers you've got a terrific investment.

Bottom Line

Inspecting the profit after tax can tell you about the company's profitability. Pretax profit margin (profit before taxes) is a good metric of comparison between companies in the same industry. The company with the highest pretax profit margin is, by definition, the lowest-cost operator, which gives it a better chance of survival should business conditions deteriorate.

Rechecking the Story

There are three phases to a growth company's life:

1. The Start-Up Phase, during which it works out the kinks in the basic business. This is the riskiest phase for the investor, because the success of the enterprise isn't yet established.
2. The Rapid Expansion Phase, during which it moves into new markets. This is the safest phase, because the company is growing simply by duplicating its success formula.
3. The Mature Phase (Saturation Phase), when it begins to prepare for the fact that there's no easy way to continue to expand. This is the most problematic phase, because the company runs into its limitations. Other ways must be found to increase earnings.

Each of these phases may last several years.