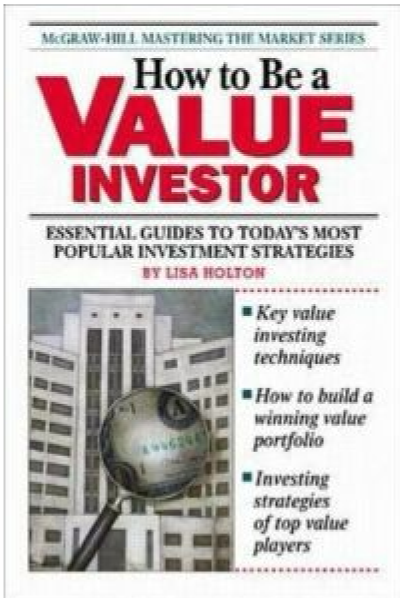

Book How to Be a Value Investor

Essential Guides to Today's Most Popular Investment Strategies

Lisa Holton
McGraw-Hill, 1999

Recommendation

Lisa Holton describes the way value investors find bargain stocks. She looks at a variety of financial formulas that can help you unearth good deals. This is a useful primer for investors, since it offers clear explanations of financial ratios. The book includes plenty of specific examples of ways to apply formulas to a company's financial statements. She clearly describes the contents of SEC documents and offers helpful advice about when to sell a stock. *BooksInShort* recommends this book for beginner to intermediate investors, for those unfamiliar with "value investing," and for those interested in basic portfolio planning. This book focuses on the United States stock market and may be less useful in other countries.

Take-Aways

- Value investors look for stock in companies that have been beaten down by short-term problems.
- A value investor typically holds a stock for two to five years before selling.
- Benjamin Graham is the grandfather of value investing.
- Graham looked at measures such as price-to-earnings ratio and sales and profit history to find bargains.
- Price-to-earnings ratio is a key measure for value investors, although one that varies widely among industries and by year.
- Value investors look at other ratios, including debt-to-equity, price-to-sales, book value, and profit margin.
- Inventory control has become increasingly important to businesses, and value investors can use ratios to calculate the pace of inventory turnover.
- Investors should keep goals in mind when building portfolios.
- Investors reduce risk by using bonds and by diversifying among sectors.
- Value investors should consider selling when a stock has risen fifty percent, or when one stock takes up a big percentage of a portfolio.

Summary

Value investors buy a stock for less than they think it's worth. Benjamin Graham, who died in 1976, created value investing theory. He outlined his strategies in two books, Security Analysis and The Intelligent Investor. According to Graham's theory, a value stock is one whose price has sunk almost to the worth of the company's assets. But Graham also told investors to look at a company's price-to-earnings ratio, financial strength, and earnings outlook. Value investors often buy stock in established companies that have been hurt by bad news. Since working out such problems takes time, value investors must be patient. They typically hold a stock for two to five years before selling.

> "Occasionally, bad news can be a great chance to buy more shares of a company with solid fundamentals."

Value investors use a variety of strategies and indicators to pick companies. For instance, David Katz, chief investment officer of the Matrix/LMH Value Fund, targets companies with well-known brands and strong market share, but with troubled stocks. Katz bought Eastman Kodak in 1997, when its PE ratio was 14. Katz reasoned that the company's brand name and 68 percent market share made it ripe for a turnaround. By the end of 1998, Eastman Kodak's PE ratio had shot to 62. Katz also looks for strong insider buying in a company.

> "Cash flow is one of those great elusive concepts where accountants, executives, and ordinary folks like to use their own definition, the one that makes their numbers look the best."

Barbara Bowles, portfolio manager for the Kenwood Growth and Income Fund, looks for a low price-to-book ratio, a depressed PE ratio, and strong cash flow. Bowles looks for leading companies in little-known industries, such as DSC Communications, a telecom equipment company that ultimately was purchased by Alcatel. Bowles also bought Citicorp in 1990 for $10 a share, after it had been hurt by financial problems in Hong Kong; in 1998, the bank agreed to merge with Travelers' Group.

Value Investor's Tools

An investor should use the following tools: newspaper stock listings, including popular ratios; a calculator for figuring ratios that are not listed; a notebook for tracking gains, losses, and splits; files for account statements and research; a computer with Internet access to follow stocks, check corporate Web sites, and order investment information; a business dictionary and other reference books; and a tax guide such as the one by J.K. Lasser.

Calculating Ratios

Value investors track some key ratios. Many of these ratios are already calculated in newspaper stock listings, on financial Web sites, and in the Value Line Investment Survey:

- Price-to-earnings, or PE, ratio is calculated by dividing the share price by the earnings per share. If the PE ratio is low compared to that of competitors and industry peers, the stock could represent a good value. PE ratios are a moving target. In 1998, the PE ratio of the Standard & Poor's 500 reached a record 28. In 1990, the S&P's PE was 15; in 1980 it was 9; and in 1970 it was 17.
- Price-to-sales ratio equals current market capitalization divided by the last twelve months' total revenue. Market capitalization equals the share price times the number of shares outstanding. This is useful for young companies or companies that are losing money. Many value investors look for a price-to-sales ratio below 1.
- Book value equals total assets, minus intangible assets, minus all liabilities and minus stock issues, divided by the number of shares outstanding. This calculation can be contentious, because it can be unclear whether or not a company's assets can always be sold for their listed book value. For values stock in banks, which have liquid assets, book value tends to be accurate. For valuing stock in a manufacturer with old machinery, this calculation is less useful, because the book value of the machinery is likely to be overstated. Book value of less than 1 means a company is trading below its liquidation value, which could indicate either a great buy or a deeply troubled company. Many value investors look for companies that trade at no more than 1.5 to 2 times book value
- Debt-to-equity ratio equals all current and non-current liabilities divided by total shareholder equity. This calculation shows how much would be left over if a company were liquidated. A debt-to-equity ratio of 50 percent means shareholders have $1

of equity for every 50 cents of debt. Value investors like a debt-to-equity ratio of less than 50 percent.

- Profit margin equals gross profit divided by total shares outstanding. If this number grows, the company has costs under control. Value investors look for a high number here.
- Net current asset value, also known as working capital, equals current assets minus current liabilities. Companies use this money to pay daily bills. This shows whether or not a company can pay its regular expenses.
- Current ratio equals current assets divided by current liabilities. Value investors seek a current ratio of 2, that is, the firm has $2 in assets for every $1 in liabilities. A low current ratio shows control over inventory and incoming bills, also a working capital assessment.
- Quick ratio equals current assets minus inventory divided by current liabilities. This shows whether a company could still pay its bills if revenue stopped for a while. If the quick ratio is 1 or lower, the company could pay its bills.
- Net net asset value per share, or fire-sale ratio, equals current assets minus current liabilities minus long-term debt divided by total outstanding shares. Graham devised this measure during the Depression to determine what a company's assets were really worth. It also measures the worth of a company in bankruptcy. Graham looked for stocks selling at a third below net net asset value, an exceptionally cheap price you are unlikely to find today.
- Inventory turnover is calculated by dividing revenue by inventory, and then dividing 90 (the number of days in a quarter) by the first answer. This shows how much time a company needs to sell its inventory before replacing it.
- Days needed to collect receivables is figured by dividing revenue by accounts receivable, and then dividing 90 (days in a quarter) by the first answer. This shows how long a company needs to collect payment for its products.
- Inventory turnover is calculated by dividing revenue by inventory and then dividing 90 by the first answer. After salaries, inventory is one of a business's largest costs. Some companies, such as Dell Computer, cut inventory costs by selling directly to customers and, therefore, not creating inventory until an end user requests it.
- Cash flow equals current assets minus cash divided by current liabilities. This shows cash left after bills are paid. Cash flow represents only part of profits, not the overall profit.
- Gross margin equals gross profit divided by total revenue.

Other value measures

In addition to ratios, value investors also look for other factors. Quarterly or annual dividends, for instance, let shareholders chose to invest some of their profits another way. Intrinsic value is a fuzzy but important measure of the value a company's brand or culture adds to the stock. Starbucks and Nike, for instance, have intrinsic value, although its worth is difficult to calculate. When it comes to initial public offerings, value investors should wait a year to see whether the company remains intriguing.

> "As much as the Internet has helped spread a wealth of useful information about investing, it has also freed a lot of people to babble about any half-baked investment theory or hot tip they have."

Benjamin Graham also measured earnings and dividends. His earnings stability rule shows whether a company had at least some profits every year for the past 10 years. Under the earnings growth guideline, a company's earnings per share should increase by at least a third in the past 10 years. Dividend payments should be uninterrupted for the past 20 years. Value investors also look at so-called "top line" calculations, so named because revenue is the first line on a revenue statement. Investors like to see annual revenue growth of 8 percent to 15 percent, cost of sales that don't outpace revenue, and a high gross margin.

Studying the financials

Company financial statements are readily available through EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system run by the Securities and Exchange Commission, which offers free access to documents. To access EDGAR, go to www.sec.gov. Through this site, you can find the 10K, a long document that must be filed with the SEC 90 days after the end of a company's fiscal year. Part I includes: a description of products and services; a list of principal plants and properties, either owned or leased; a description of pending lawsuits; and a preliminary agenda of issues to be voted on at the annual meeting. Part II lists: share price and dividend history; five-year net sales; operating revenue, income or loss; assets and other financial information; conditions such as liquidity, trends and capital resources; audited balance sheets for two years; income statements and cash flow for three years; and any items on which the company disagrees with its auditors. Part III includes officers' and directors' names and salaries, and a list of those who own more than five percent of the stock.

“A word of caution: value investors don’t often see quick profits. Many of the companies value investors buy are older firms having short-term earnings trouble that takes time to work out.”

You can find other key documents. Look for the 10Q, an un-audited report, which must be filed within 45 days after each quarter closes. It includes an analysis of changes in revenue and expenses, defaults on senior securities, and other material information. The 8K lists unscheduled events, such as a merger, bankruptcy, change of auditor, or registration of directors. The proxy notifies shareholders of items to be voted on at the annual meeting and the prospectus describes securities to be offered for sale.

“Often, analysts are the unpopular folks within brokerages who may detect the first signs of trouble in a business which will affect the stock price for all investors, including their employers.”

Value investors also scrutinize the balance sheet, which shows the value of the company’s assets and its liabilities. Assets include cash, accounts receivable, stock owned by the company, inventory, machinery, equipment, and intangibles, such as a trademark. Liabilities include accounts payable, accrued expenses, long-term debt, and shareholder equity. The balance sheet lets investors calculate debt-to-equity ratio, working capital, current ratio, quick ratio, inventory turnover, days to collect receivables, and cash flow.

"Remember that you’re not buying a stock; you’re buying a company. Act

The income statement shows revenue, expenses, and net earnings. The income statement lets an investor calculate price-to-earnings, profit margin, and gross margin.

Investing strategies

Specify your investment goals, such as retirement or your children’s college tuition. Balance your portfolio, so if one stock drops, other investments will buoy the portfolio. Diversify your investments among stocks and bonds. Younger investors saving for retirement should put less money in bonds, while older investors should put more in bonds. However, a portfolio with only Treasury bonds is actually more risky than one with 90 percent bonds and 10 percent stocks. Don’t try to time the market, but make sure your individual stocks meet investment criteria. When buying mutual funds, try to minimize fees.

"Be willing to study. Learn to pick apart corporate financial reports and

When to sell is a key concern. Benjamin Graham tells investors to consider selling once a stock has risen 50 percent. Sell a stock that has shot up so much that it accounts for a big chunk of your portfolio. You can also use stop-loss orders, which automatically sell a stock when it falls to a certain price.

About the Author

Lisa Holton is a business writer whose work has appeared in the *Chicago Tribune* and *Better Homes and Gardens*. She is the former business editor of the *Chicago Sun-Times* and a board member of the Society of American Business Editors and Writers.