

Stock Investing

Criteria for selection

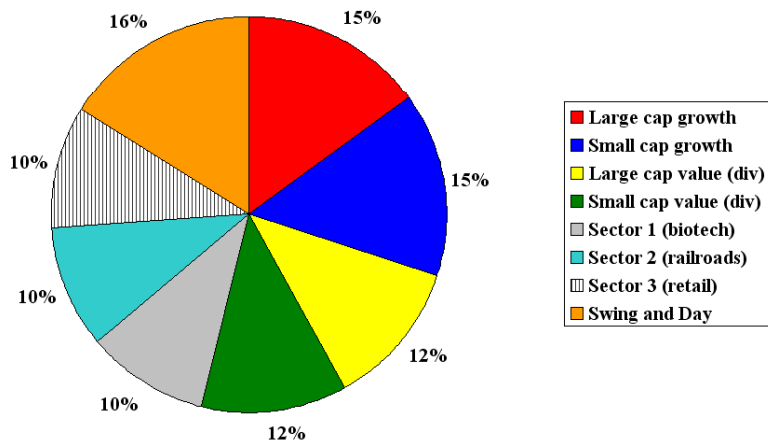


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General Advice

- ✓ Diversified **mutual funds** are likely to give better long-term yields and are less stressful (also true of index ETFs).
- ✓ Don't invest only in headline stocks or headline industries.
- ✓ Don't invest only in technology stocks.
- ✓ Buy *some* headline (hot, in the news) stocks.
- ✓ Consider **dividend** stocks.
- ✓ Find stocks that you are vaguely aware of or unaware of.
- ✓ First identify an industry that interests you, then discover stocks within that industry.
- ✓ Yields can be enhanced by writing covered calls. (?)
- ✓ **Diversify** your portfolio.
- ✓ Use online research sources and analysts comments.
- ✓ **Do it yourself, online!!**

The diversified stock portfolio ... example – by category and sector

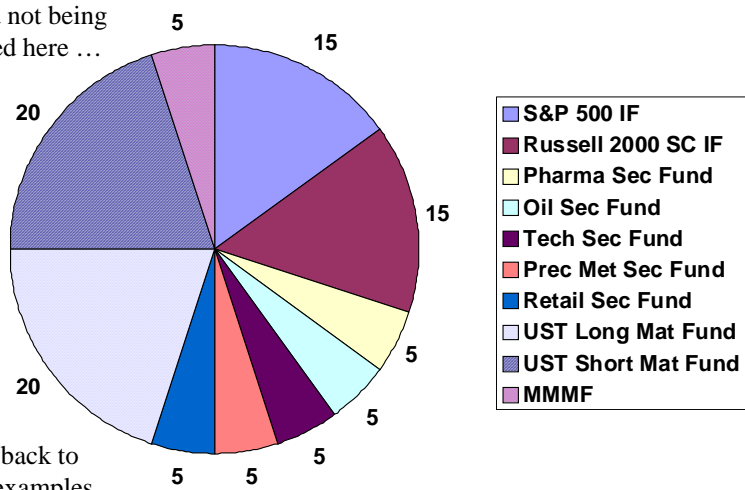


This specific mix is not being recommended here ... we will see many options later in the course. This is an example only.

... or buy one company from any of 4, 6, 10 industries.

... or MF Diversification: (example: sector-based portfolio)

This is only an example and not being recommended here ...



... we come back to many other examples later in this class.

Good online research sources

- Online accounts (Ameritrade, ETrade etc.)
 - See if they offer free S&P500 reports
- <http://online.wsj.com> under markets, then market data etc.*
- <http://finance.yahoo.com>
- <http://finance.google.com>
- <http://www.sec.gov/edgar/searchedgar/companysearch.html>
 - Use to get free audited annual report (**SEC 10-K**) and unaudited quarterly reports (**SEC 10-Q**).
 - A delay (unacceptable) in getting recently-filed reports.
- <http://edgar-online.com>*
 - does for a fee what the free site should do properly, and more
 - immediate posting in pdf format

*subscription required.

Stock selecting (by industry)

- Industry performance, analyst assessment, and comparisons are important
 - Is this industry “hot,” new, emerging, or facing growth prospects
 - What do the analysts say?
 - And how your candidate is doing in that industry
- Use *The Wall Street Journal Shareholder Scorecard* (published every February) as a to see all industries and all companies within the industries
- Obtain and read S&P reports when available free and read about industry and company
- WSJ etc. discussions about industry and companies within that industry are useful to identify candidates
 - Ex: Corning and Texas Instruments in emerging television
- Can sometimes invest in industry through ETFs

Catalysts

Is there any information that you have heard about this company that you think will identify it as a "breakaway" company in its own industry? Are they doing something that will eventually result in some nice earnings surprises or will put them in the headlines?

Examples:

- Paul Jacobs talk about Qualcomm's IP at HMC
- WSJ's comments about the role of GLW and TXN in emerging large-screen TV market.
- Compliance products made necessary by Sarbanes-Oxley law
- Jerome Jackson's talk at HMC about bioengineering medical technology
- Paul Frankel's email to be about DNDN and biomed research in general.

Checklist of Performance Variables (compare to industry and S&P 500)

- 5-year and most recent year **earnings growth**
- Trailing (ttm) and forward **P/E ratios**
 - PE is price per share divided by annual earnings
- 5-year and most recent year **sales (revenue) growth**
 - especially for younger, growing companies
- **Debt** relative to size (see ratios in a later slide)
- **Dividend payout rate** (for value candidates)
 - Return on investment or equity
 - Free cash flow (or at least cash position)
 - Ranking in industry (AMD vs. INTC)

P/E Ratios

The Price to Earnings ratio at any moment is the price per share of a stock divided by its annual earnings (ttm), either actual, or the most recent quarter annualized (mrq).

Price to Earnings ratios are a good starting point for evaluating a stock, although not much information can be gleaned from a PE ratio.

High growth companies will typically have PE ratios that are higher, sometimes much higher, than value stocks.

Both trailing and forward (forecast, based upon earnings forecasts) PE ratios should be compared to the industry average. Probably the most useful application of the PE ratio is to determine if the stock is **overpriced**, yielding a PE that is much higher than the industry average.

Some samples (Sep 10): Intel: 11, Calpine: 185, Dendreon: none (no earnings), Ford: 7, Bank of America: none, Target: 15, Exxon Mobile: 12
S&P 500: 22 (data not always using the same earnings measure)

Earnings, revenues, and earnings and revenue growth

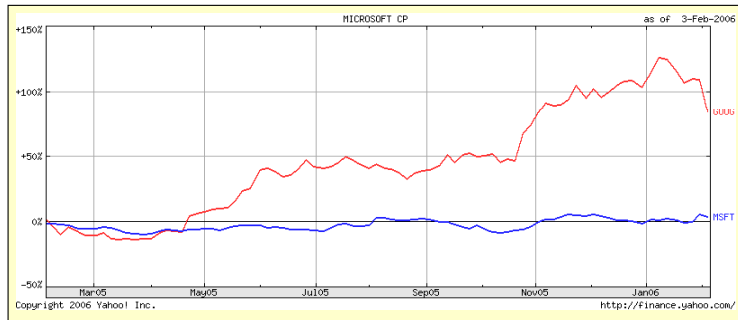
When considering an individual stock *earnings* will normally matter more than any other variable. But in today's sophisticated markets static earnings, how much the made last year, is only the starting point. In the eyes of many investors, *earnings growth* matters much more than the *level* of earnings. Many investors will prefer and pay a premium (in the form of a higher PE ratio for example) for a company with relatively low earnings per share but *high projected growth* in those earnings to a company with higher earnings per share but with lower projected earnings growth.

For younger companies, especially in emerging industries with ill-defined markets, sometimes *revenue* or *sales growth* matters more than earnings growth. This is because investors will place a high value on a company that is grabbing market share and increasing its share of the market, and especially so if it appears that the company in question might dominate the market. It is assumed that the profits will come later.

Example: GOOG vs. MSFT in 2005

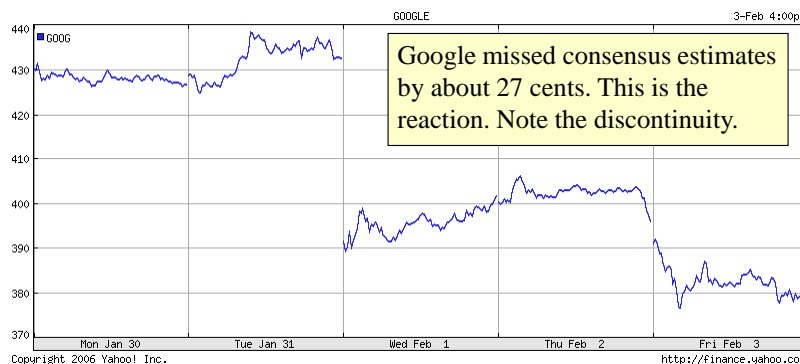
As an example, in 2005, investors seemed to prefer upstart Google over stodgy Microsoft because Google was growing faster than Microsoft. At the end of the year, Google was trading at a PE of about 75 to 1, whereas Microsoft was trading and a PE of less than 25 to 1!

Although Microsoft had an earnings growth rate of 24%, the same for Google was 82%. Probably more important, revenue growth at Microsoft was only 6% compared to Google's 86%!



Earnings projections, surprises, disappointments

When companies release their quarterly earnings reports, they almost always do so at the end of the business day after markets are closed. If a company makes an earnings announcement that far exceeds or fall short of the consensus earnings estimates made by analysts, the stock can rise or plunge severely, by more than 10% in some cases. Further, the price may exhibit a *discontinuity*, where the price does not smoothly move from the old price to the adjusted price, but instead opens the next morning at a price discretely higher or lower than the old price by many dollars.



... and forward-looking statements

Often even though when a company reports quarterly earnings and those earnings meet expectations and are robust, the stock plunges. This may happen because when during the report the company makes a forward-looking statement, they may warn that because of changing business conditions, the same level of earnings growth is not expected to continue. And the opposite can happen when a report is unexpectedly optimistic.

Cisco shares fell \$1.84, or 8 percent, to \$21.24 in after-hours trading after the company posted second-quarter results that matched Wall Street's subdued expectations but gave disappointing guidance.

Excluding one-time charges, Cisco made a profit of 38 cents per share, matching the figure predicted by analysts polled by Thomson Financial.

yahoo news release 2/7/08



Debt and Liquidity Ratios

You should always check a company's debt position by at least looking at its liquidity **debt/equity ratio**, which is the ratio of the company's total debt to its shareholder equity. A D/E ratio above 2 is very high. For example, Hertz's (HTZ) debt-to-equity ratio is 6.17 to 1, whereas Intel's is only 0.052 to 1 (Sep 2010).

A company may have a high D/E ratio if it is growing through acquisition, which is generally acceptable if the acquisition is working.

If a company has a D/E ratio above 2, then the company's credit and bond ratings should be checked through Standard and Poors. A downgrade of a credit or bond rating can very adversely affect a stock's price.

Other liquidity ratios include debt/assets, short-term debt to liquid assets and so forth.

Note: I am guessing that Hertz will eventually go bankrupt because of its debt. I used to use Calpine as an example and Calpine did finally go bankrupt.

Old slide, but still relevant ...

Mudd Finance

Cramer: Why Walgreen is "cheaper" than Rite Aid

The debt-to-equity (DE) ratio is determined by dividing total debt by shareholder's equity on the balance sheet. Average for the industry (drug stores) is 0.30. Data are from February 7, 2008

	RAD	WAG
Price	2.73	34.54
EPS	-0.22	2.06
PE	N/A	16.77
DE	2.29	0.10

RAD now less than \$1.00 per share ...

Even if RAD was making a small profit, say \$0.05 per share, its PE would be 55. And it is making a loss. Industry average is about 20, so WAG is cheap. More important, because of an earlier leveraged buyout, RAD is choking on \$5.4 b of debt. In their last reporting quarter ending December 1, 2007, they were running an operating loss of \$21m, but had to add an interest expense to that of \$130m.






Mudd Finance

More questions to ask

- Does this company grow by M&A?
 - Will be a hi-growth candidate with heavy debt
- Is this company a possible takeover target?
 - Stock will pop on takeover announcement
- How do analysts rank this stock?
 - This ranking can be seen on any good financial website (such as yahoo)
 - IMHO not all that reliable

Using stock screeners to seek ...

Exchange Sector

Criteria	Min	Company Distribution	Max
Market cap ?	<input type="text" value="275M"/>		<input type="text" value="600M"/> <input type="button" value="X"/>
P/E ratio ?	<input type="text" value="6"/>		<input type="text" value="50"/> <input type="button" value="X"/>
Div yield (%) ?	<input type="text" value="3"/>		<input type="text" value="10"/> <input type="button" value="X"/>
Last price ?	<input type="text" value="5"/>		<input type="text" value="100"/> <input type="button" value="X"/>
5y EPS growth rate ?	<input type="text" value="6"/>		<input type="text" value="20"/> <input type="button" value="X"/>

This is a sample ... only 5 stocks (CPSI) fit these criteria (9/2010).
See the homework where you are being asked to do this ...