NATIONAL ASSOCIATION OF INVESTORS CORPORATION
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The Leader In Investment Education

Introduction to the Stock Selection Guide

Brought to you by
Space Coast Chapter
K043

Gene Rooks - Instructor

Introductions:

Who can use this course:

A new member who isn't familiar with the BetterInvesting Stock Selection Guide at all, or has taken a class before, but just hasn't quite grasped the procedure.

Someone thinking about buying Toolkit or another stock study software who wants to better understand the principles involved, and basic judgment guidelines.

BI Philosophy in a Nutshell

- Invest Regularly
- Invest in Quality Growth Companies
- Diversify
- Reinvest Dividends

BI Philosophy in a Nutshell - These principles are the foundation of BetterInvesting's philosophy, long ago formulated when we were the National Association of Investment Clubs.

Invest Regularly – Set aside a minimum amount each month that you will invest, and stick to it. You can accumulate for 2 or 3 months before you make a purchase, but put it in your broker account each month. Consistency and self-discipline will pay off greatly as the years go by, and your portfolio grows.

Invest in quality growth companies. A growth company is generally characterized by its rapid movement in sales and earnings, more commonly found in newer and smaller companies, and faster gains in stock price. A value company, on the other hand, is an older, larger, company, whose growth has matured and stabilized, and to compensate for the slower stock price appreciation, they generally pay dividends. A balanced portfolio has room for both.

Diversify- Don't put all your eggs in one basket. Seek to buy stocks in quality companies in different sectors, and companies of different size, to minimize risk and maximize overall return. A good portfolio rule of thumb is 25% small cap growth, 50% mid cap growth/value, and 25% large cap value companies. Ten to twenty companies is reasonable for an individual or a club to keep up with.

Reinvest Dividends - Reinvesting dividends leads to increasing your wealth through the magic of compounding. Your dividends in turn are invested to continue growth and earn more dividends. While automatic reinvestment and DRIP plans accomplish this by reinvesting in the same stock that paid them, you can obtain the same compounding value by choosing to take your dividends in cash, and using that cash toward your next stock investment.

Back to the Basics

- **A share of stock is a piece of a company**
- **Companies provide products or services to make money**
- **Sales, less costs of sales = Profit**
- **Profit, less taxes = Earnings**
- **Earnings divided by outstanding shares = EPS**
- **Price, divided by annual EPS = PE ratio**

You may or may not need this information, but I figured it wouldn't hurt to review before we head on to the SSG itself.

A share of stock is a piece of a company. How well the price does is determined by how well the company does, and what 'the market' is willing to pay for that value. All companies are in business to make money, by providing either products or services. Their revenue or sales, less the cost of producing these products or services, result in a profit, hopefully. Taxes come out of the profit, of course, and what is left is their earnings. These earnings are divided by the number of outstanding shares of stock the company has, resulting in a figure referred to as EPS, or Earnings per Share. Some larger, established companies pay out a portion of these earnings as a dividend to stockholders. The balance, or all if no dividend is paid, is put back into the business to provide for future growth and costs for the next year.

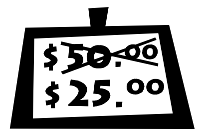
What investors are willing to pay for a share of stock in a given company is measured by a figure called the PE, or Price to Earnings ratio. This is not a static figure, it goes up and down with the winds of whispers on Wall Street which influence the price of the stock. Whatever the price of a stock is on a given day, divided by the past 12 months earnings, usually reported quarterly, is the PE. While the PE changes daily, a 'signature' or average PE can be established over a period of time, by averaging the annual high and low PE's, and using the midpoint. The average PE's are an important factor in the SSG, used to forecast potential high and low prices in five years, to establish a buy range.

In general, it is the sales/revenue that the company has that start the stock price wheel. Profits, which in part are determined by management skills, factor in to what the eventual earnings, or EPS, will be. The market watches the quarterly EPS reports closely, as this factor goes into what price investors are willing to pay for the stock.

OK, enough on business 101, let's see what use the SSG makes of these factors to help us recognize a quality company, and a good price to buy it at.

Buy when the Price is Right

- Buy Low
- Hold
- Watch
- Sell High



Buy Low, Hold, and Watch - How do you find these companies to buy stock in that will grow in value? How do you know if the price is right? BetterInvesting has developed tools to determine just exactly that. Our primary tool is the Stock Selection Guide. In this class, I'll try to acquaint you with the principal factors that go into assessing a quality company, and a fair price at which to buy it. The idea is not just Buy and Hold, but Buy, Hold, and Watch, not so much the daily price, which can drive you nuts, but the future prospects.

You use an SSG not only to determine when to buy, but also when to sell, when a holding has reached it's high targets and trends are slowing down. At that point, your return begins to dwindle.

If a company is sound and still has continuing growth prospects, ride out the crazy fluctuations of this or that analyst's comments or occasional missed forecast quarter results. But, if the price has really gotten up in the stratosphere, do another SSG. If all growth signals are still go, still in buy range or hold range, still showing an acceptable expected return, stay with it. However, if the current price is in the Sell range, and expected returns from this point are very low, then take your profit, and reinvest in another company with fresh growth prospects.

Knowing when to sell if just as important, if not more so, than knowing when to buy, and the feel for it is acquired with education and experience. Space Coast Chapter has classes to advance you in your judgment skills and portfolio management techniques.

Stock Selection Guide Overview

- **Historical Data reveals past growth in Revenue, Earnings, and Profit**
- **Future 5-year growth targets for sales and EPS can be projected from these trends.**
- **Annual data measures management skills**
- **Historical High and Low PE's show what investors have paid in the past**
- **Potential High and Low Prices can be calculated from projected EPS and average high and low PE's**

The SSG does several things. First, it shows historical trends in revenue, profit, and earnings. You learn to make a judgment as to how those trends will continue to grow five years into the future.

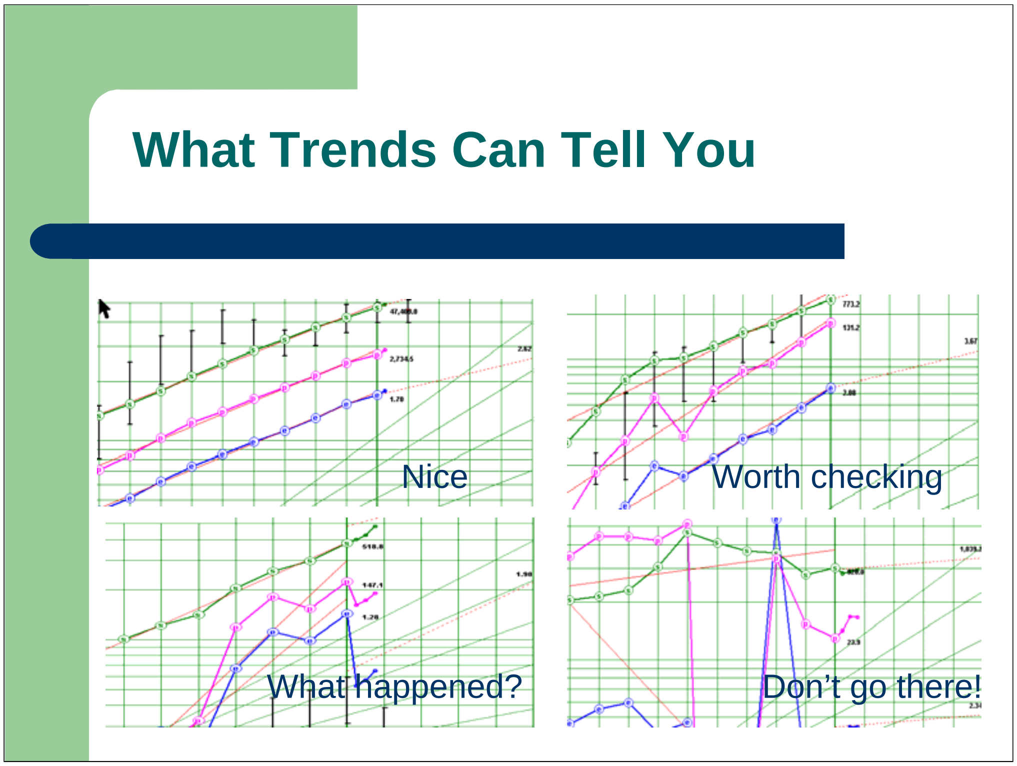
The company data gives you historical measurements of management skills, and tabular data on historical high and low prices, EPS, PE's, and dividend payments. These items are averaged, and used to project a potential five year high and low price for the stock.

This range is then divided into zones to determine if the present price is in a buy, hold, or sell position. Getting these essentials down pat will be enough for today's session, you will want to take further intermediate and advanced classes to hone judgment even more, and learn to utilize the projected return features of the SSG.

There are software programs developed by IClub that pull in the necessary company data, create the SSG ready for your judgment entries, and calculate the formulas for you, that is available through the BetterInvesting website. More details will be given on links at the end of the presentation.

It is also possible to manually input data from printed company reports like Value Line or an S&P company report, or data sheets available from BI. You can either input the data into a software program, or manually on a blank SSG form, which was the original way it was done.

Crystal ball, anyone? I'm not going to stand up here and tell you the projections we will make are fool-proof and guaranteed to produce results suggested. But, they are a lot more reliable than Bob at the water cooler or your brother-in-laws inside tip. BetterInvesting has the Rule of Five, which means using your best judgment, 3 will perform as expected, one will exceed expectations, and one disappoints.



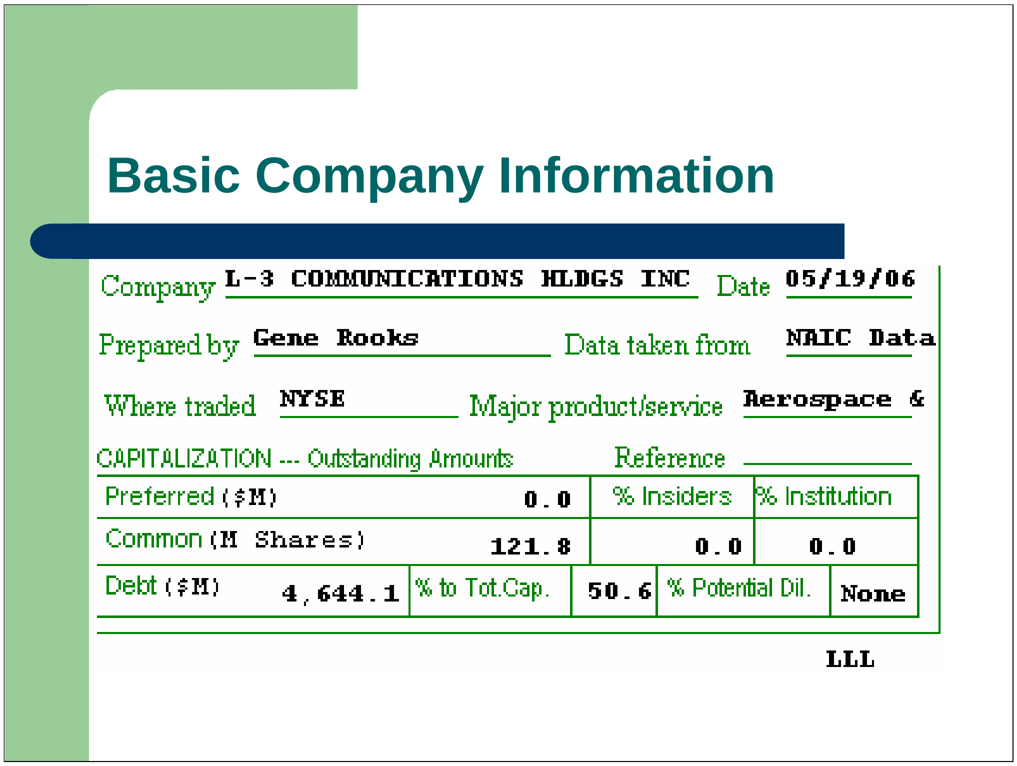
Section 1 – **Visual Analysis** –

In your handout, you have a completed Stock Study Guide, and the Data Sheet the historical information came from. Disclaimer – this is not a recommendation to buy, merely an exercise in how it works. Different growth judgments would give a different price range.

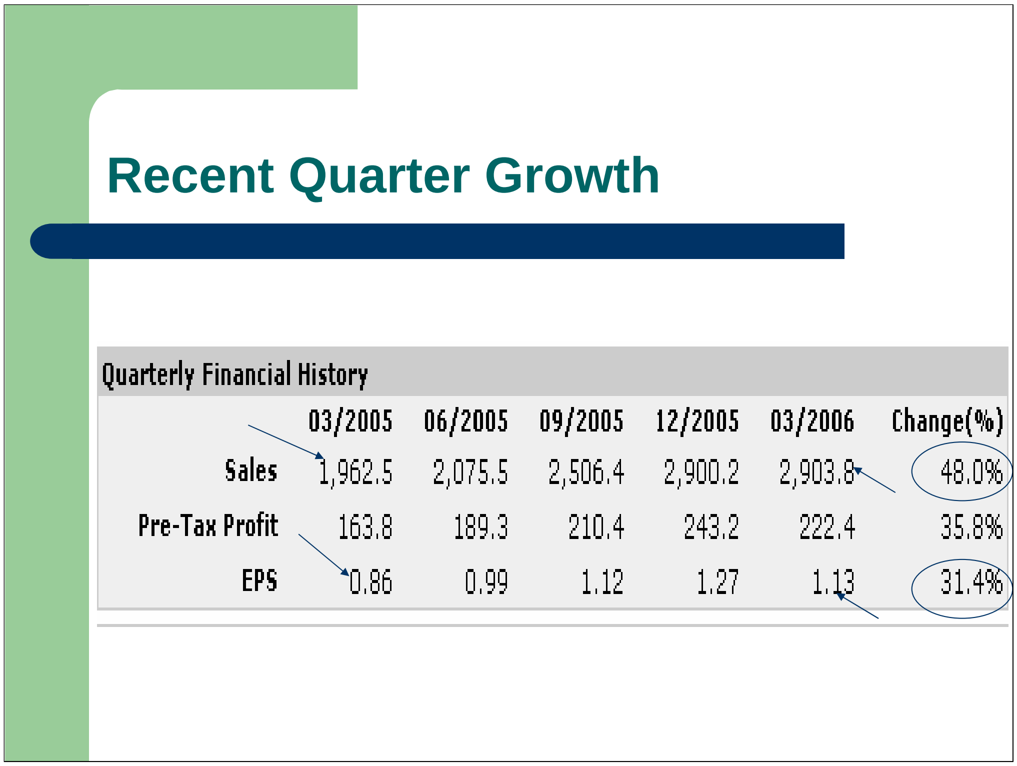
Sales, Profit, Earnings: The first thing you see looking at a completed stock study guide are three graph lines. You will note little emphasis is give to stock prices, although they are there, in the vertical candlestick bars, which show the low to high price range for the year. A company's earnings drives the price of its stock. We advocate at the very least five years of historical data, better to have ten, to see the trend lines over time.

Look at these four different trend charts, to get an idea of how much information is packed into basic fundamental trends, that are easy to grasp in this visual form on the front of the SSG. The first one has nice even upward trends, what we call railroad tracks. You can't get much better than that for stability and growth. The upper right chart shows good lines for the most recent five or six years, with a little blip in profit and earnings one year before that. Certainly worth checking further. The lower left shows a nice sales line, but profit and earnings are shaky, and took a recent dive. Something is going on here that makes forecasting difficult, you could do better. The fourth one shows not only declining sales, but extremely erratic profit and earnings. Don't waste any more time on this one.

Extending these trend lines into the next five years will give us a forecast of sales and earnings in the future. Comparing the slant of the projected trend lines with the pre-printed percentage slant lines on the form gives you the approximate past growth rates, if you are not using Toolkit, which gives you the rates. You then, using your own judgment, choose an expected future growth rate for sales and earnings. It is usually best to be very conservative, as a skyrocketing trend is not likely to continue. Average growth for large cap companies is 7%, mid cap 10-12, and a small cap company could be 15%. You are looking for better than average returns. You make this judgment, whether you are using software or doing it manually.



Stock Study Guide front – What else can you tell from the front of the SSG? It also gives information about the size of the company, what sector it is in, its debt burden, percent of inside ownership, and its last quarters results compared to a year ago. All of these items factor in your judgment. For instance, you would want to be wary of a company with a higher than 50% debt load, unless it is in a sector requiring high debt to operate, like banks or home builders. Inside ownership is usually a good marker, also, as owner managers have more incentive to see a good profit. Unfortunately, the BI data omits that bit of info, but it is included in downloaded data from StockCentral, who use the same Hemscott data used by Yahoo.

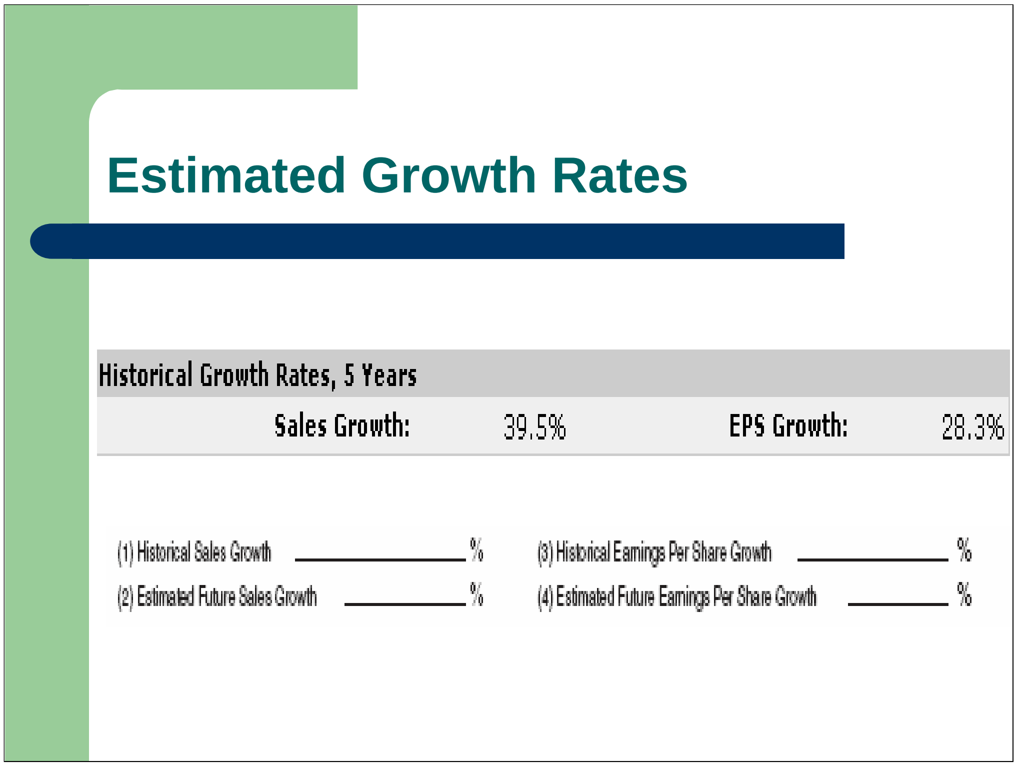


Quarterly Financial History

	03/2005	06/2005	09/2005	12/2005	03/2006	Change(%)
Sales	1,962.5	2,075.5	2,506.4	2,900.2	2,903.8	48.0%
Pre-Tax Profit	163.8	189.3	210.4	243.2	222.4	35.8%
EPS	0.86	0.99	1.12	1.27	1.13	31.4%

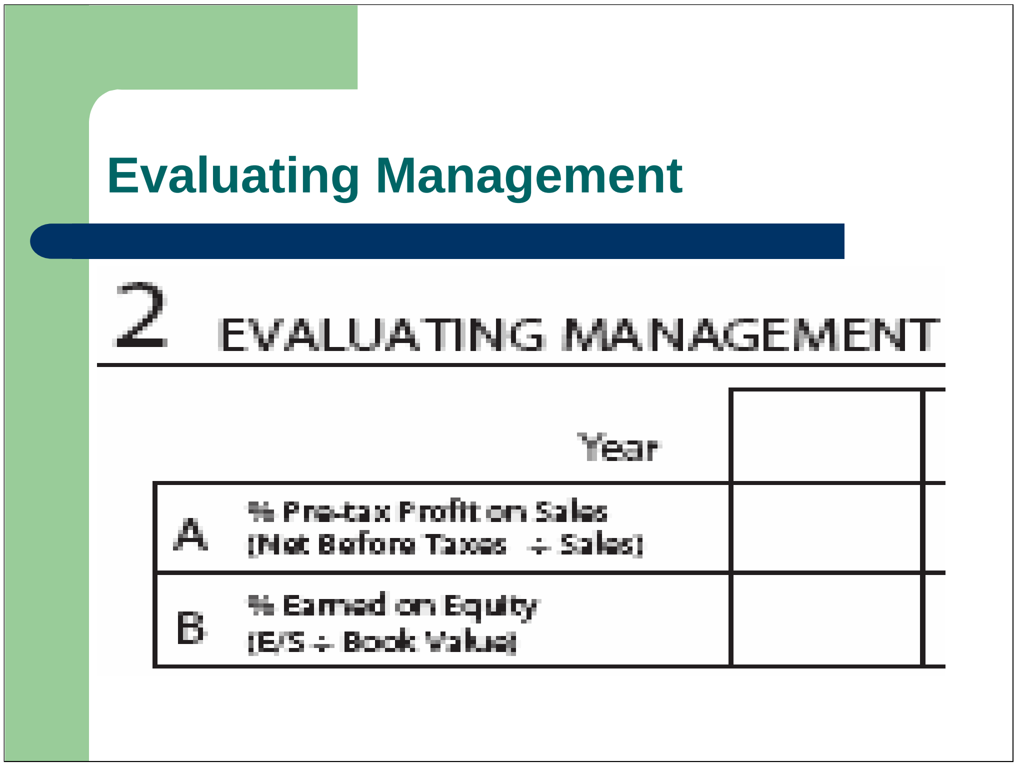
These figures in the company data sheet for Recent Quarterly Figures show the % change in Sales and EPS of the most recent quarter from the same year ago quarter. The SSG itself only shows the beginning and end year later quarters. You would look for better than 15%, as a rule of thumb.

The total of the last four Sales figures, expressed in millions, also give you an idea of the size of the company. While the guidelines fluctuate between sources, usually small cap is $500M or lower, mid cap can run as high as $5 billion, anything over is large cap. So, LLL is a large cap stock. This front page visual analysis of the company you are studying has already told you a lot about it’s growth trends and stability, what its primary business is, how large it is, and how much debt it has.



We now come to the first point where your judgment comes into play. We can see where the growth has been over the last five years. We now want to begin the process of forecasting where it will go. Since price follows earnings, and earnings follow sales, you want to make a conservative estimate of how fast this company will continue to grow. We really would like to see at least 15% or better forward growth. Actually, most companies start off at a high rate, and taper off, so you would not want to forecast anything more than it's history has displayed. Regardless of past history, you would hesitate to forecast over 30% as a rule of thumb.

Considering the industry, and factors that might affect it, and keeping expectations reasonable and conservative, you will put in an estimated annual percentage for this company's sales and earnings growth. In general, the two would be about the same, though you would not want to forecast earnings higher than sales growth.



Sect. 2 on the reverse of the SSG is for Evaluating Management. Two metrics which shed light on this are the percent of Pre-Tax Profit the company makes on it's sales/revenue, less it's overall costs of sales/revenue. The other metric is the percent Earned on Equity. This is the percent of profit earned on the percent of the companies assets that are not encumbered with debt.

These figures, drawn from the financial statements filed by the company, are calculated and listed for you, and a five year average is shown. The older a company is, the less variance there will be in these figures. If any figures are way out of proportion, caused by some one time event, you can cross out the outlier and revise the average. What we are looking for here is either an upward trend, or a stable line. Examine the last five year history. You want the latest annual figure to be higher than, or very close to, the five year average. On a newer company, it should be rising, on an established company, it should be relatively even. Different sectors have different norms.

Ellis Traub, author of Take Stock and developer of the TakeStock program available as software or online at StockCentral, calls the end of section 2 the barbed wire fence. In other words, if the trends on the front page, and the management metrics in section 2 don't meet quality standards, don't waste your time going further.

Price, Earnings, and PE History

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

PRESENT PRICE 46.040 HIGH THIS YEAR 51.600 LOW THIS YEAR 39.550

	Year	A PRICE HIGH	B PRICE LOW	C Earnings Per Share	D Price Earnings Ratio HIGH A÷C	E Price Earnings Ratio LOW B÷C	F Dividend Per Share	G % Payout F÷C X 100	H % High Yield F÷B X 100
1	2002	40.7	28.7	0.98	~~41.5~~	~~29.3~~	0.145	14.8	0.5
2	2003	36.2	26.9	1.12	32.3	24.0	0.156	13.9	0.6
3	2004	37.8	30.2	1.30	29.1	23.2	0.182	14.0	0.6
4	2005	49.0	35.1	1.53	32.0	22.9	0.223	14.6	0.6
5	2006	50.0	39.6	1.70	29.4	23.3	0.273	16.1	0.7
6	TOTAL		160.5		122.8	93.4		73.4	
7	AVERAGE		32.1		30.7	23.3		14.7	
8	AVERAGE PRICE EARNINGS RATIO	27.0		9	CURRENT PRICE EARNINGS RATIO	25.7			

Proj. P/E [23.38] Based on Next 4 qtr. EPS [1.97] Current P/E Based on Last 4 qtr. EPS [1.79]

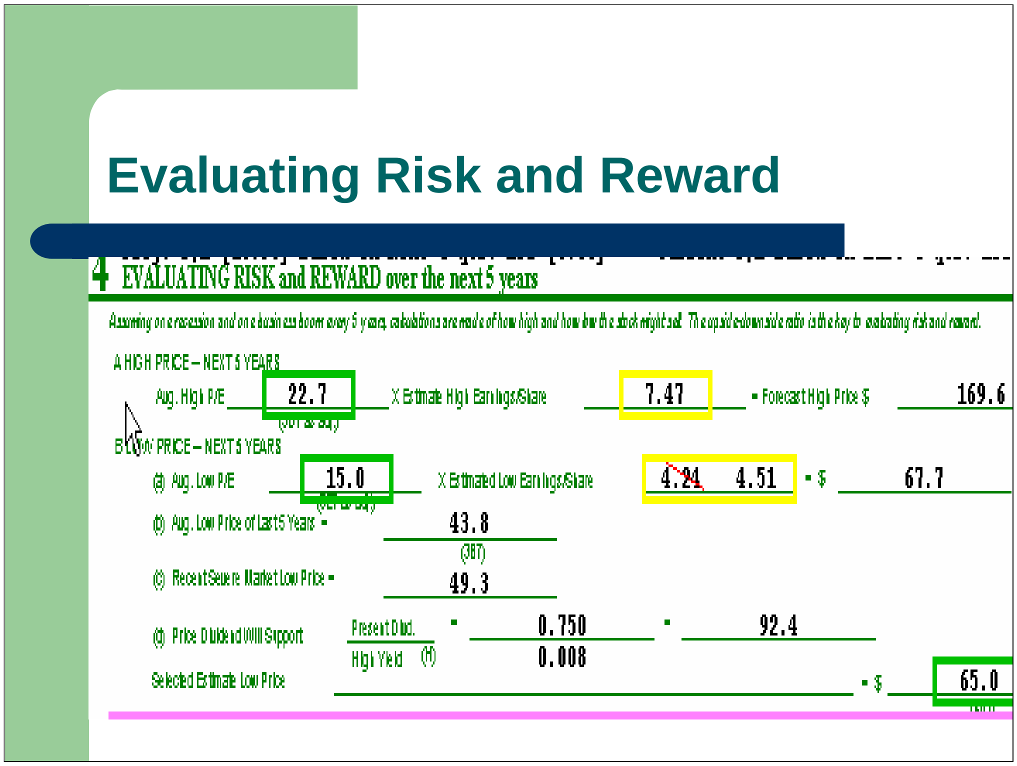
Section 3 – **Price/Earnings History** as an indicator of the future. The top line gives your current price, and the high and low for the last 12 months.

This is a five year history as of fiscal year ends of the stock price, EPS, PE ratios, and dividend payments. You can tell a lot just looking at the figures, even without the averages, to see if stock price changes are steadily growing, and not too erratic between highs and lows. You want to see rising Earnings per Share, and relatively steady PE highs and lows. You can also review dividends, paying special attention to the High Yield, as this represents gain on your investment, even without much stock price change.

The averages of some of these columns come into play in the section below, where the buy price ranges are forecast, and future returns are calculated. The most important averages you need are for the high and low PE's. This screen shows one year crossed out. You can use your judgment to cross out a year's results, if they are noticeably different than the others. These are called outliers, caused by some onetime event in the company's past. Eliminating them makes for a more rational average.

If you are using Toolkit, you can click on the pink box, and get a table for the last ten years, as a further guide to PE trends. Generally, newer companies just beginning to make earnings show an erratic pattern with lofty PE's, which gradually stabilize and move down as the company matures. In this section, you have an average high PE, average low, and on line 8, an overall average PE, which is sometimes called the signature PE. As a very rough estimate of whether the current price may be good to buy now, if the current PE is at or lower than the average, chances are it could be. If it near the high average PE, it is becoming overvalued.

Beneath the graph are some other figures input by the data service. They take into consideration the more recent quarters, not included in the fiscal year figures in the graph. One is a projected 4 quarter forecast, the second one is based on the last actual four quarters. These can be helpful in the calculations below in section 4.

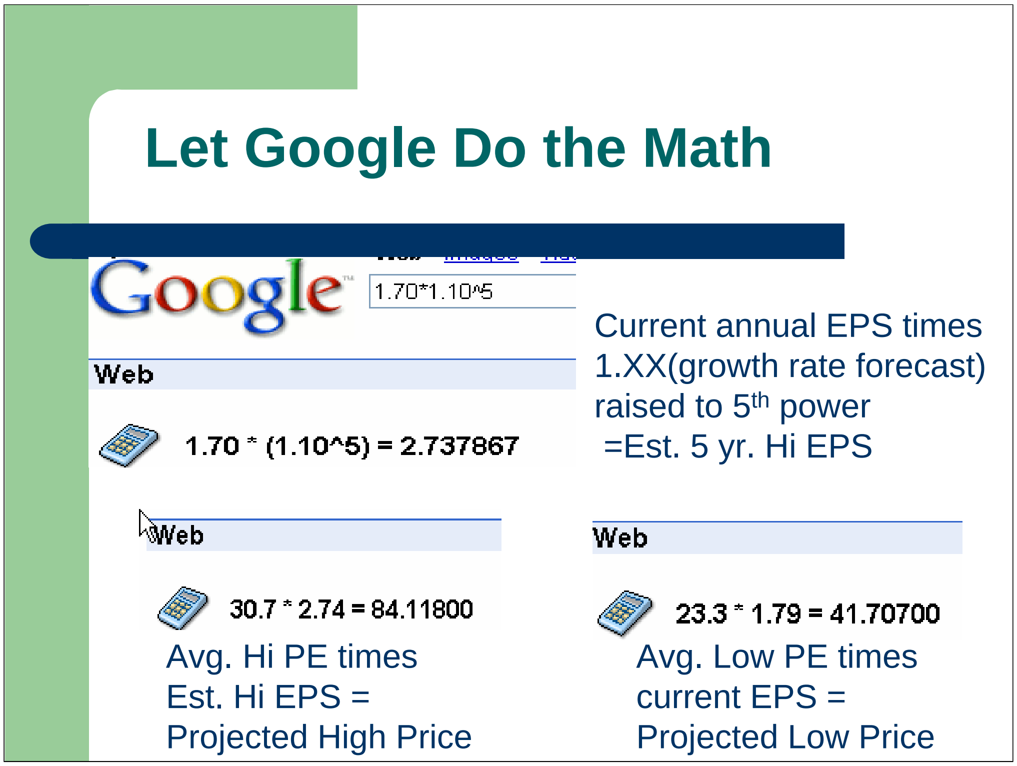


Next comes the fun part, figuring out the buy range. Even in ToolKit, this requires your judgment before the calculations can take place.

Section 4A will determine your expected high price in five years. It begins with the Average High PE from Section 3, column D, line 7. This is multiplied by the Estimated Earnings Per Share indicated by the EPS growth forecast on the front page extended out five years in Toolkit, to get your Forecast High Price. (These screens are not all from the same sample you have). If you aren't using a software program, these items can be calculated by using Google, which I will show you on the next screen.

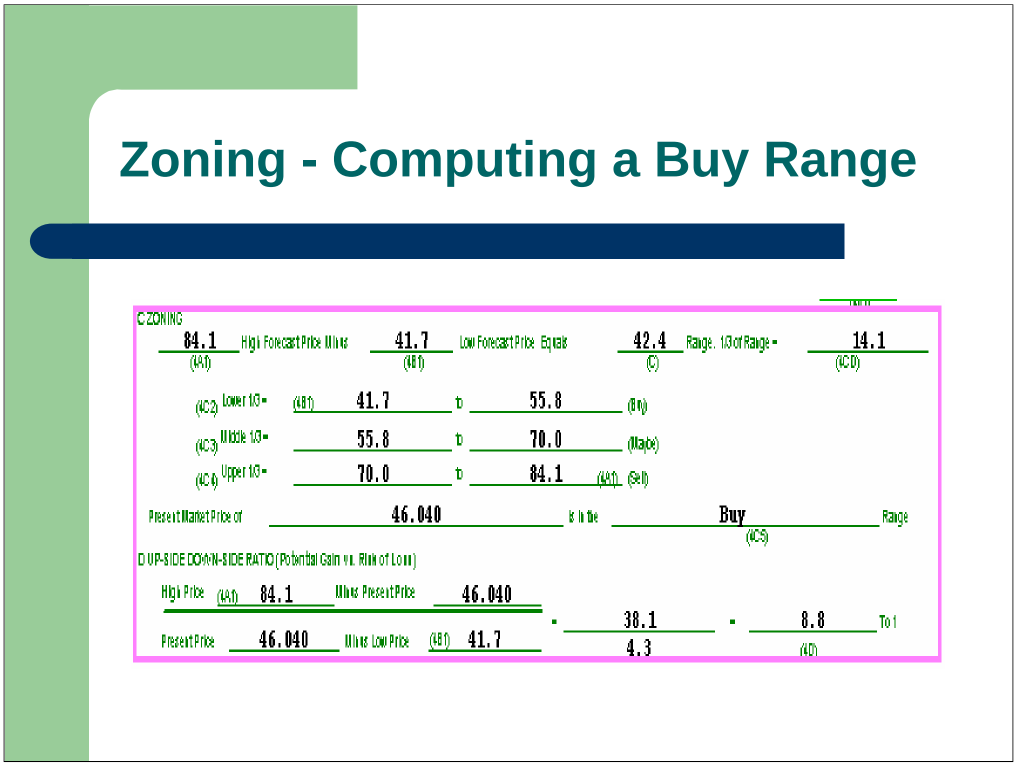
OK, now for determining the possible low price this stock could be at in five years. There are several options. The first starts with the average low PE shown after you have tweaked any outliers, multiplied by either the latest annual EPS, or the total of the last 4 quarters EPS from Sect. 3, as one choice. You could also use the average low price from Sect. 3, line 7, or you could use the lowest price it has gotten to in the last couple of years. You could even take a more involved computation of what the dividend paid could support for a low price. You are given a box in the software to select which of these pre-calculated options you want to choose. I generally take the first one, multiplying avg. low PE by last four quarters EPS.

Or, by George, you can look at all of those choices and come up with your own SWAG to fill in for your Selected Estimate of a Low Price in 5 years. Just remember to be somewhat conservative, and hope it won't go much lower in the next five years than it has this year or last. This is not rocket science, this is your best educated guess..



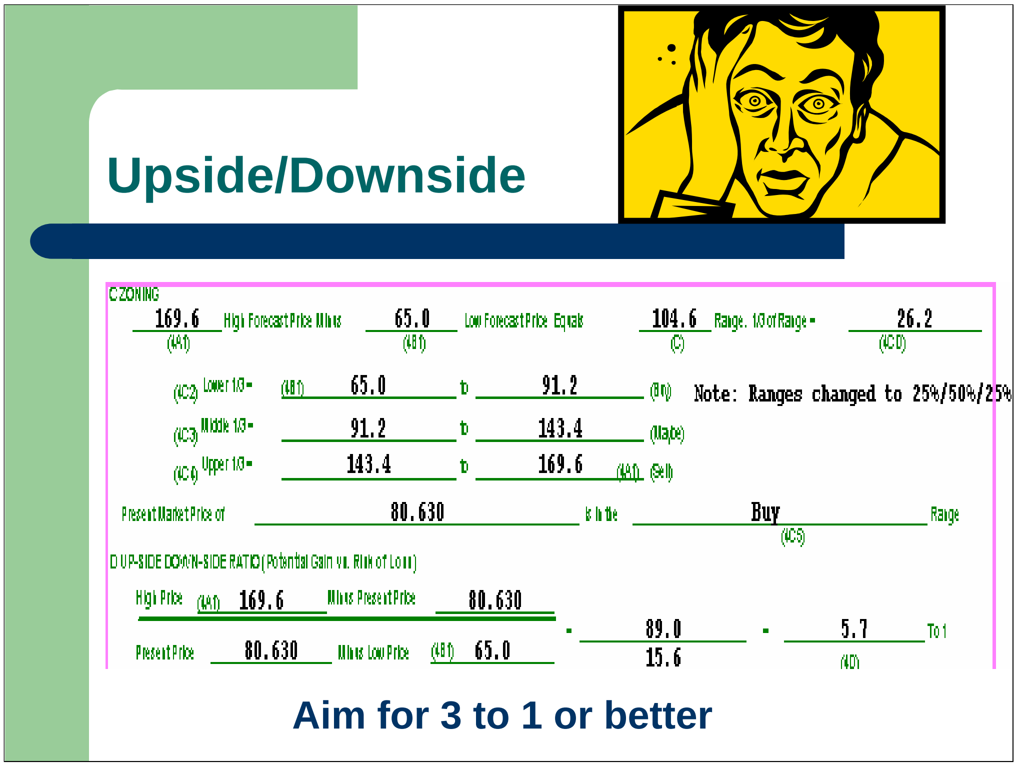
Let Google Do the Math - The stock study software calculates this for you on the front of the form, but if you are doing it just from a data sheet, let Google do the math. Yes, Google is good for more than just searching, it will do math problems for you. From your data sheet, you enter the amount of EPS for the last fiscal year, $1.70 in this sample, or alternately the total of the last four reported quarters. Use the asterisk* to indicate multiply, by 1 plus the percentage of growth you forecast, in this sample case that would be 1.10, raised to the power of five for the five years, indicated by the ^5 figure. Voila, it gives you the answer, if all goes as projected, the EPS five years from now will be $2.74, and the high price would be that multiplied by the average high PE, an answer of $84.11.

So, how do you compute the possible low price in five years? That is calculated more simply by multiplying the average low PE from column E, line 8 above, by either the last full year, or the last four quarters EPS from your data sheet, which is $1.79. You could also put down a recent low price, or the average low price of the last five years, or if none of those seem likely to you, hey, put in your own guesstimate, just be conservative. Using that formula, the projected low price is $41.70.



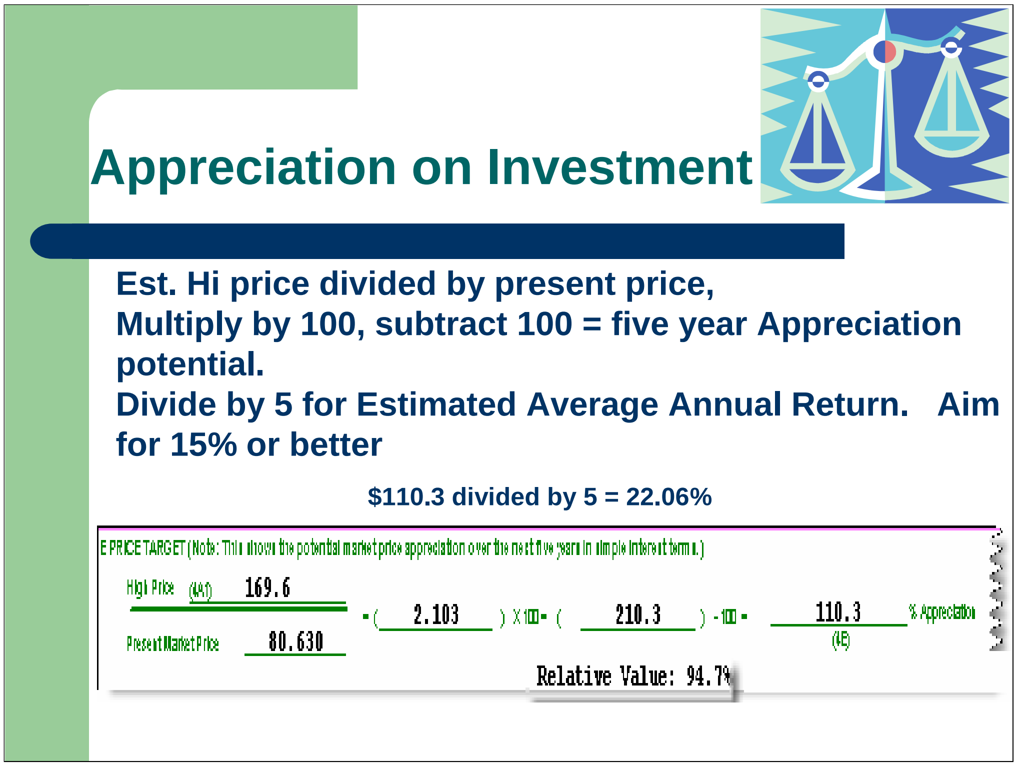
Now you have a forecast five year High Price, and a forecast five year Low Price. From these, we can establish Buy, Hold, and Sell Zones. There are two methods. One is the 33/33/33 range. The other is 25/50/25 range. Both subtract the forecast low from the forecast high. You can make a selection in Toolkit Options for which you prefer, and it is calculated for you.

If you are calculating manually, using the 33/33/33 range, divide that number by 3. Add the third to the low price, and together, they make up the buy range. Add another 3rd, you have the hold range. Add the final third, which takes you back up to the forecast high, and this is the Sell zone. To use the 25/50/25 method, divide the price difference by four. Add one fourth to the low price for the Buy range, add 2/4 to that for the larger Hold range, and the final fourth takes you to the high price for the sell range. This is the more conservative method to use. Position the current price in these zones to indicate whether it is currently buy, hold, or sell.



No, this is not your grandma saying she will slap you up side of the head if you don't behave, or down side if you don't stop what you're doing right now. Section 4D will compute your upside/downside ratio. All this means is where is this stock positioned between its potential high and low. A 3 to 1 ratio is desirable along with 15% growth to give you double your money in five years. The calculation starts with the High price, subtract the present price. This is the top of the fraction. Then it subtracts the low price from the present price for the bottom of the fraction. Dividing the top number by the bottom number gives you the ratio to 1 of your upside. This means the odds are 5.7 to 1 that this stock will move upwards instead of downwards.

Anything higher than 10/1 is suspect of overoptimistic forecasting, anything much lower than 3/1 won't be as safe a buy.



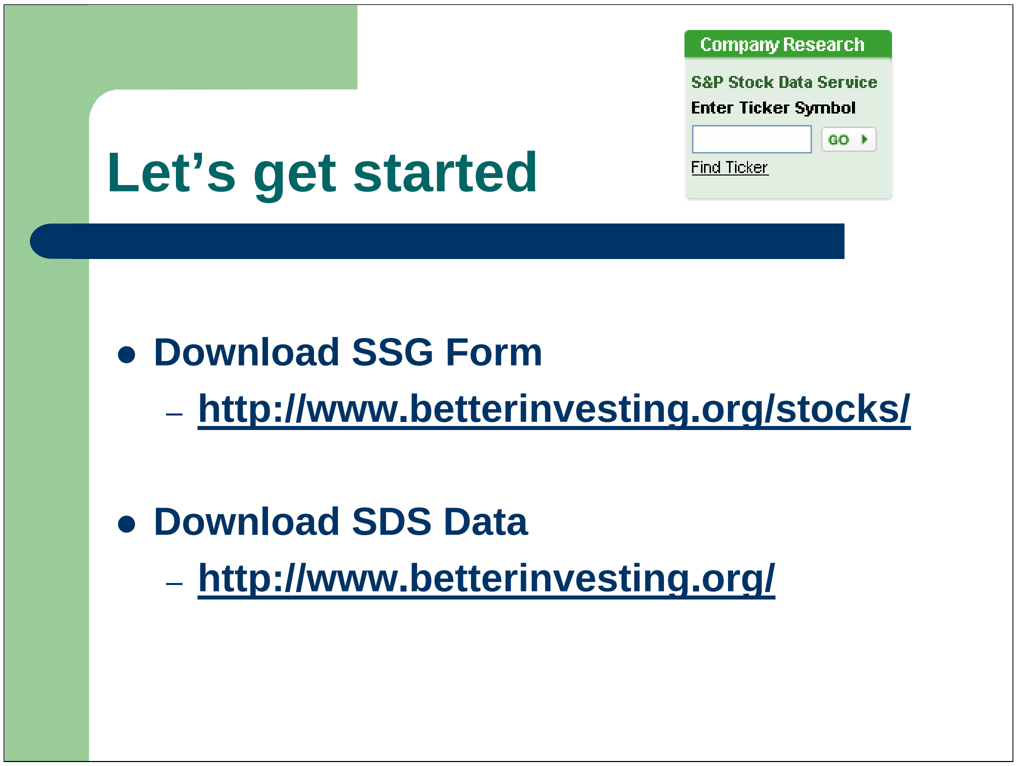
Assuming this stock raises in value to it's highest price estimate of $169.60, how much will your investment have grown? Block E breaks this down for you. The potential high price is divided by the present price. Multiply that by 100, then subtract 100. Toolkit calculates it for you, if you are doing it manually, you don't have to remember these formulas, they are given in the green print. The resulting percentage shows your total appreciation at the end of five years, in this case, 110.03%. (Not all screens are from the sample you have been given)

The final section of the SSG gives you the estimated Average Annual Return over the next five years, and several other return calculations. We aren't going to go into all of them, they can wait til you are ready for a more advanced course. BI's goal is an annual return of 14.87, or 15% for convenience, which will double the amount of an investment in five years. In a balanced portfolio, some stocks hopefully will do better than that, some not as well, though they are still quality, growing companies. You should seek an overall average, and not be too concerned about a slightly lower performer unless the company is losing ground in its fundamental areas.

Another metric supplied by ToolKit, can also be computed as an aid in valuing this company. It is called the Relative Value, and it is a ratio of the present PE to the average PE. Divide present PE by Average PE. The resulting percentage is your Relative Value. A rule of thumb, be suspicious of an RV below 80, or one over 130. If the RV is too low, something you need to know about may be affecting the current low price of this stock. Did the CEO run off with the CFO? Is someone suing them big time? Or is it just an overreaction to a slight miss on the quarter's earnings. If it is too high, it is most likely overvalued, but your buy ranges would already be telling

Take My Money? Not yet

So now you have a completed SSG, indicating a quality stock, in a buy price range. Should you run out and place your order? I hope not. This is only a tool that tells you this company is worth further study. You can find much information in Yahoo Finance or MSN Money websites. Read their profiles on the company, check out the company website. Consider the sector it is in. Will demand for its products or services likely grow, or is it peaking out? Check the headlines for that symbol, and read the stories. Any mention of accounting malfeasance, large lawsuits, loss of patent? What are the primary sources of this company's revenue or sales? Any factors on the horizon that could negatively impact it? Look at two or three competitors. How will it fit in with the rest of your portfolio? You can also download from the BI website where you got the data sheet, a Stock Check List already filled in with data on this company if you subscribe to SDS, or a blank one to guide your research, that asks pertinent questions for you to consider. This is all called 'due diligence', or look before you leap.



You have been handed an SSG with data downloaded as it would appear in Toolkit, or as you could fill in manually if you wished from a BI company data sheet. Below are the links and directions to do so. With the time we have left, we will work on applying the methods we have discussed to arrive at a conclusion on this company. I chose PPDI, which did meet a preliminary quality check, but this is no recommendation, just an exercise in the methods.

To download a blank SSG form, go to the BI website

http://www.betterinvesting.org/stocks/

click on the software/worksheets tab, and print off a blank SSG.

To download an SDS data sheet after you have signed up for the service, enter your ticker symbol in the Company Research field, and when the company data comes up, choose Print view, and print it out. The data sheet you receive includes every item that goes on the SSG, with percentages already calculated. While you are there, you can also print out the Stock Check List, preloaded with your company's data.

If you sign up for a 90 day free trial with StockCentral, you can download a company data sheet from them to use for manual computations as well. At present, it is not as easy to follow as the BI data sheet.

BETTERINVESTING™
Space Coast Chapter

Tips, Tricks, Techniques

http://www.naicspace.org/

Class Schedules

www.betterinvesting.org/chapter/space

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Here are website links for the Space Coast Chapter's own website. It is filled with training tools, articles, class schedules, and our contact information. Please check it out often to stay up to date with your chapter.

Thank You!

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Thank You for attending our introductory class. If you are a BetterInvesting member, you can sample the SDS company data at the BetterInvesting website, as well as the new online stock and mutual fund analysis tools that are now being offered.

If this exercise has whetted your appetite to go ahead and invest in ToolKit, you can download a free demo from the website of IClubCentral. Your Space Coast Chapter also has a CD presentation on the use of Toolkit for SSG's, including more emphasis on the judgment factors, and the other features in Toolkit which are great for portfolio management. You may purchase this CD through our website at www.naicspace.org