Investment Forum Program for Wednesday, February 9 at 11:45

The Forum will attempt something new this week. The entire session will be devoted to a single topic, **stock evaluation methodology**. The page below will serve as an introduction to the topic. Members are invited to participate. If the attempt at a novel effort is successful and discussion is not exhausted at the end of the session, it can carry over into next week. Also, once the topic of methodology has been fully covered, the Internet capabilities in the classroom can be utilized to apply various methodologies to selected stocks using the resources available through the Fairfax County Public Library website.

Stock Evaluation Methodology

Sector Considerations: An old bit of investing wisdom is that choosing the right sector is much more important than choosing the right stock. If an investor picks the right sector, choosing stocks within the sector is secondary. However, obtaining research on sectors is much more difficult that gathering research on individual stocks. Out-of-favor sectors can provide contrarian opportunities or can doom a stock investment if the sector is out of favor for good reason and remains so. On the other hand, buying into an overpriced sector that is widely favored can also lead to disappointment. An example would be those who bought into the technology sector in 2000. The *Standard & Poor's Outlook* newsletter is a source of information on sectors.

Price Target: The first step in buying low and selling high is buying low. There are several sources of information that, although imperfect, can potentially provide some guidance in judging if a stock may already be fully priced or overpriced. (Individual investors are often late in the game and overpay for stocks.) *Value Line* graphically displays anticipated price ranges for stocks three-to-five years into the future. *Morningstar* provides a "fair value" estimate of stocks, as well as suggested buy and sell prices. *Standard & Poor's* and several brokerage research sources offer a 12-month price target. Anticipated future price targets are educated guesswork but, if a stock appears to have already reached its price target or exceeds its fair value by a significant margin, better opportunities may be found elsewhere.

P/E Valuation: Once a judgment is arrived at on price, the next step is to relate price to earnings. If a stock is selling for a price-to-earnings valuation significantly in excess of the broad market valuation, that's a red flag that deserves attention. Some stocks are worth a valuation premium, but they should receive special scrutiny. Over time, there is a tendency for valuations to revert to their mean, thus a premium valuation is challenging to maintain. Conversely, stocks with low P/E valuations may not necessarily be bargains. Some stocks are valued cheaply for good reasons. No single metric tells the whole story about a stock.

Earnings History/Earnings Growth Rate: Has a company delivered earnings stability and steady earnings growth in the past or have earnings fluctuated significantly? How fast are a company's earnings anticipated to grow in the foreseeable future?

PEG Ratio: One way to put a stock's P/E ratio in perspective is to relate it to a company's earnings growth rate. Consistently rapid earnings growth can merit a higher P/E ratio. The PEG ratio is the P/E divided by the earnings growth rate. A rough rule of thumb is that if the PEG is one or less, the stock may be cheaply valued. If the PEG is two or greater, it is probably fully priced or overpriced.

Dividend Yield: Historically, a significant portion of total returns on stocks have been derived from dividends. But an unusually high yield can be a red flag that deserves attention. A high yield can signal

problems ahead, such as concern that the dividend is unsustainable. The dividend yield, per se, tells little about the value of a stock. Is the dividend safe (meaning is it well covered by earnings and cash flow)? Is the dividend anticipated to grow? If so, how fast might it grow in the foreseeable future?

Dividend History/Dividend Growth Rate: Is this a company that has demonstrated a commitment to dividend payments in the past? (Some corporate managers are firmly committed to paying dividends; some are reluctant to do so; some pay dividends that are too generous for the long-term well-being of the company.) Have there been any dividend cuts in the past? How fast is the dividend projected to grow in the foreseeable future?

Free Cash Flow: Earnings are an accounting artifact. In some cases, earnings reported to the IRS can be a better metric than earnings reported to shareholders. (Management is less likely to lie to the IRS than to shareholders.) Free cash flow is real money that is available for retained earnings or share buybacks or dividends. Again, no single metric defines a stock, but abundant steady free cash flow is a very favorable quality. Ultimately, however, success lies in how well management utilizes available free cash flow.

Payout Ratio: What portion of earnings is paid out in the form of dividends? If the payout ratio exceeds 50%, it bears scrutiny for its sustainability or for its effect on long-term corporate health in terms of a company's ability to generate retained earnings. And, citing the statement above, dividends should be backed by adequate free cash flow.

Debt/Equity Ratio: No single metric defines how much debt a company can safely carry on its balance sheet. Companies with steady revenues, such as consumer products makers, can carry more debt than cyclical businesses. But, if debt exceeds 50% of capital, it bears scrutiny. Also, is a company adding to its debt or is it paying down debt?

Return on Equity: This can be a measure of how efficiently a company uses its capital. (The oil industry sometimes prefers to use return on invested capital.) As a general rule of thumb, attractive stocks usually are able to generate an ROE of 15% or greater. ROE is one way to seek out high quality stocks. However, ROE can be manipulated. Adding debt to a balance sheet automatically raises the ROE because the proportion of equity on the balance sheet is reduced. The reported number always bears scrutiny in this context.

Credit Rating: Standard & Poor's provides credit ratings on companies. Coveted triple-A credit ratings are now awarded to only a handful of companies. But, A-ratings are better than B-ratings, and B-ratings are better than C-ratings. However, credit ratings are not necessarily static. A rising credit rating is a very favorable omen for a company, just as a falling credit rating is an unfavorable omen. Credit ratings are often of little significance until a period of difficulty in credit markets develops, as in the autumn of 2008. But, credit ratings also affect a company's cost of capital. Success in business is dependent upon a company's ability to earn more than the cost of its capital. Caveat: In today's world credit ratings can be manipulated and are viewed with some skepticism.

Comfort Zone: When all is said and done, an investor has to have a sense of comfort with a stock or it is not the right investment for that individual.

Footnote: Many, but not all, of the metrics cited above can be obtained from *Value Line* reports on individual stocks. Both *Value Line* and *Morningstar* research can be found online at www.fairfaxcounty.gov/library. The *Standard & Poor's Outlook* weekly newsletter can be found at Fairfax County regional libraries and the City of Alexandria libraries at the main library on Duke Street and the Old Town library on Queen Street.