

# Every Picture Tells A Story

Avi Horwitz

Milwaukee Chapter BetterInvesting

## Every Picture Tells A Story



Avi Horwitz  
Director, New York Chapter

Milwaukee Chapter BetterInvesting

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## BI's Stock Selection Guide (SSG)

We will use  
**BETTERINVESTING's** Stock Selection Guide to help us  
find and study **growth** companies



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## SSG Objectives

- **Find companies with a record of consistent growth**
- **Help determine a reasonable price to pay for the stock of such a company**

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## The SSG Helps Us Answer TWO Questions

**Quality** 1) Is this a good company to buy?  
**Value** 2) If so, is it selling for a fair price?  
*Only TWO questions !*

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## An Overview Of The SSG

### Capitalization

1. Visual Analysis
2. Evaluating Management
3. P/E History
4. Evaluating Risk & Reward
5. 5-year Potential

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### Capitalization

Company \_\_\_\_\_ Date \_\_\_\_\_  
Prepared by \_\_\_\_\_ **RISK** taken from \_\_\_\_\_  
Where traded \_\_\_\_\_ Major product/service \_\_\_\_\_

CAPITALIZATION – Outstanding Amounts		Reference	
Preferred	<b>Liquidity</b>	% Insiders	% Institution
Common		<b>Level of Interest</b>	
Debt	Debt	% to Tot. Cap.	% Potential
			<b>Dilution</b>

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### 1 VISUAL ANALYSIS of Sales, Earnings and Price

100  
80  
60  
40  
20  
0  
-20  
-40  
-60  
-80  
-100

2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019

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### 1 VISUAL ANALYSIS of Sales, Earnings and Price

RECENT QUARTERLY FIGURES

SALES EARNINGS PER SHARE

Latest Quarter \_\_\_\_\_  
Year Ago Quarter \_\_\_\_\_  
Percentage Change \_\_\_\_\_

Use Chapters 8, 9, and 10 of the VINC Official Guide for complete instructions on the Scale as well as sections of INCIS, Basic Selection Guide & Report.

Present

Past Future (Projections)

10 Years of History 5 Years into Future

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### Section 1 Visual Analysis

- Growth
- Quality (growth consistency)
- Reasonable Price

We look at:

- Sales
- Pre-Tax Profit
- EPS
- Stock Price

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### SSG Part 2-Evaluating Management

- Quality
- Growth Potential

### 2 EVALUATING MANAGEMENT

Company \_\_\_\_\_

		LAST 5 YEAR AUC	TREND
		UP	DOWN
A	% Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)		
B	% Earned on Equity (EPS ÷ Book Value)		

2A % Pre-tax Profit on Sales  
✓ Cost control

2B % Earned on Equity  
✓ Making money on shareholders' equity

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Where is "Quality" On The SSG

"The worse a company performs, the better a value it appears to be. That is why we should build a big **B\*A\*R\*B\*E\*D\*-\*W\*I\*R\*E** fence between Sections 2 and 3 of the SSG, and not try to climb over that fence until we are dead sure of the quality issues." - *Ellis Traub*

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### Section 3

## Price-Earnings History as an indicator of the future

- Reasonable Price

**3 PRICE-EARNINGS HISTORY as an indicator of the future**  
This shows how stock prices have fluctuated with earnings and dividends. It is a helpful tool for tracking earnings into future stock prices.

Year	PRESENT PRICE		HIGH THIS YEAR		LOW THIS YEAR		H % High Yield F + B x 100
	A HIGH	B LOW	C Earnings Per Share	D Price Earnings Ratio A/C	E Dividend Per Share	F % Payout E/C x 100	
1							
2							
3							
4							
5							
6 TOTAL							
7 AVERAGE							
8 AVERAGE PRICE EARNINGS RATIO			9 CURRENT PRICE EARNINGS RATIO				

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### Section 4

## Evaluating Risk & Reward

- Reasonable Price

**4 EVALUATING RISK and REWARD over the next 5 years**  
Assuming one recession and one business boom every 5 years, calculate the high and low price for the stock right now. The stock-to-earnings ratio is the key to evaluating risk and reward.

A HIGH PRICE = NEXT 5 YEARS: \_\_\_\_\_ X Estimate High Earnings/Share \_\_\_\_\_ = Forecast High Price \$ \_\_\_\_\_ (AAT)  
Avg High P/E \_\_\_\_\_ (AAE) X Estimate High Earnings/Share \_\_\_\_\_

A LOW PRICE = NEXT 5 YEARS: \_\_\_\_\_ X Estimate Low Earnings/Share \_\_\_\_\_ = \_\_\_\_\_ \$ \_\_\_\_\_ (AAT)  
Avg Low P/E \_\_\_\_\_ (AAE) X Estimate Low Earnings/Share \_\_\_\_\_

(B) Avg. Low Price of Last 5 Years = \_\_\_\_\_

**Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell.**

(AAT) High Forecast Price minus (AAE) Low Forecast Price (B) Range, low to high = \_\_\_\_\_ (C) \_\_\_\_\_

(AAT) Lower 10 = (AAE) \_\_\_\_\_ to (B) \_\_\_\_\_ (Maybe)  
(AAT) Middle 10 = \_\_\_\_\_ to \_\_\_\_\_ (Maybe)  
(AAT) Upper 10 = \_\_\_\_\_ to \_\_\_\_\_ (AAE) (Maybe)

Present Market Price of \_\_\_\_\_ is in the \_\_\_\_\_ Range

D UP-SIDE DOWN-SIDE RATIO (Potential Gain vs. Risk of Loss)  
High Price (AAT) \_\_\_\_\_ Minus Present Price (B) \_\_\_\_\_ = \_\_\_\_\_ To 1  
Present Price (B) \_\_\_\_\_ Minus Low Price (AAE) \_\_\_\_\_ = \_\_\_\_\_ (C) \_\_\_\_\_

E PRICE TARGET (Note: This shows the potential market price appreciation over the next five years in simple interest terms.)  
High Price (AAT) \_\_\_\_\_ + ( \_\_\_\_\_ ) x 100 = ( \_\_\_\_\_ ) - 100 = \_\_\_\_\_ (C) \_\_\_\_\_ % Appreciation  
Present Market Price \_\_\_\_\_ = ( \_\_\_\_\_ ) x 100 = ( \_\_\_\_\_ ) - 100 = \_\_\_\_\_ (C) \_\_\_\_\_ % Appreciation

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### Section 5

## 5-Year Potential

**5 5-YEAR POTENTIAL** This combines price appreciation with dividend yield to get an estimate of total return. It provides a standard for comparing income and growth stocks.

A Present Full Year's Dividend \$ \_\_\_\_\_ Note: Results are expressed as a simple rate; use the table below to convert to a compound rate.  
Present Price of Stock \$ \_\_\_\_\_ x 100 = \_\_\_\_\_ (AA) Present Yield or % Returned on Purchase Price

B AVERAGE YIELD OVER NEXT 5 YEARS  
Avg. Earnings Per Share Next 5 Years \_\_\_\_\_ x Avg. % Payout (AA) \_\_\_\_\_ = \_\_\_\_\_ %

C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS Present Price \$ \_\_\_\_\_ (BB) \_\_\_\_\_  
5 Year Appreciation Potential (AC) \_\_\_\_\_  
Average Yield (BB) \_\_\_\_\_ %  
Average Total Annual Return Over the Next 5 Years (CC) \_\_\_\_\_ %

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- Shows potential return
- Allows comparison of a dividend paying company with a non-dividend paying company

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## Stock Selection Guide

**Helps us evaluate a company in two ways:**

- Is the company of *sufficient quality* to warrant our attention?
- Is the stock selling at a *reasonable price*?

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## IMPROVING JUDGMENT IS YOUR PASSPORT TO INVESTMENT SUCCESS

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## Stock Selection Guide

**Our goal is to find quality growth companies with:**

- Growing Sales
- Growing Earnings
- Pre-Tax Profit Margins that are above average
- Return on Equity that is above average

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### Where Growth Comes From

- **New Products**
- **New Uses for Old Products**
- **Acquisitions or Mergers**
- **New Markets**
- **Increased Efficiency**
- **Recovery** (for a cyclical business)

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### What can Section 1 (Visual Analysis) tell us about Sales and EPS growth?

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### Recognizing Patterns

"Monotonous Excellence"      "The Motorcycle"

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### Recognizing Patterns

"The Bow and Arrow"      "The Arrowless Bow"

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### Recognizing Patterns

"The Rocket"      "The Flatliner"

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### Recognizing Patterns

"The Innocent Bystander"      "Coulda Been a Contender"

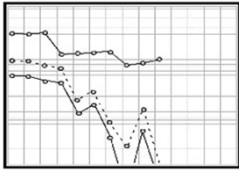
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### Recognizing Patterns



**“The Disaster”**

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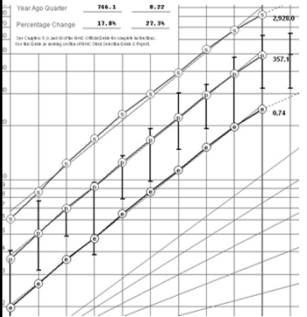
### Real World Examples

- You'll rarely see identical examples in the real world
- Nevertheless, this should give us a sense for the kinds of patterns we can recognize
- Often investigation is called for to be sure of what we're seeing

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### Real World Examples



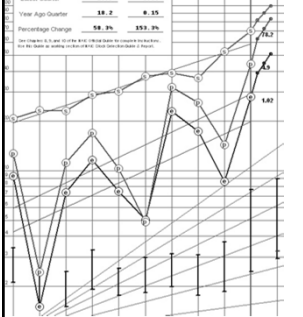
**“Monotonous Excellence”**

**BBBY (Bed, Bath & Beyond)**

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### Real World Examples



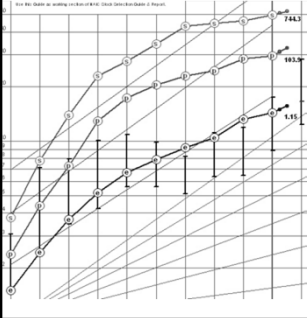
**~“Motorcycle”**

**PFMG (Peerless Mfg. Co.)**

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### Real World Examples



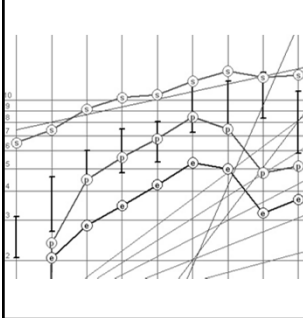
**“Bow and Arrow”, or “Arrowless Bow” ??**

**ABBP (Applebees Restaurant)**

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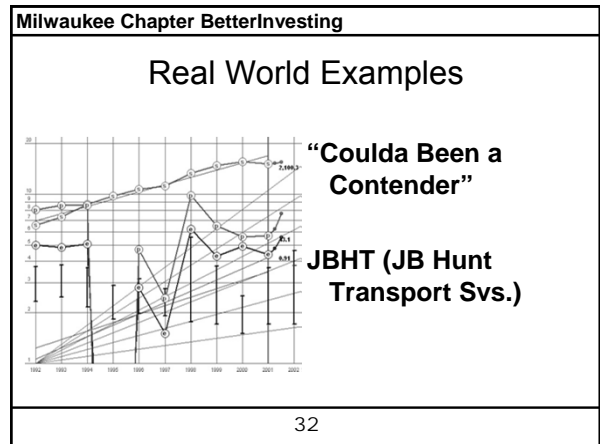
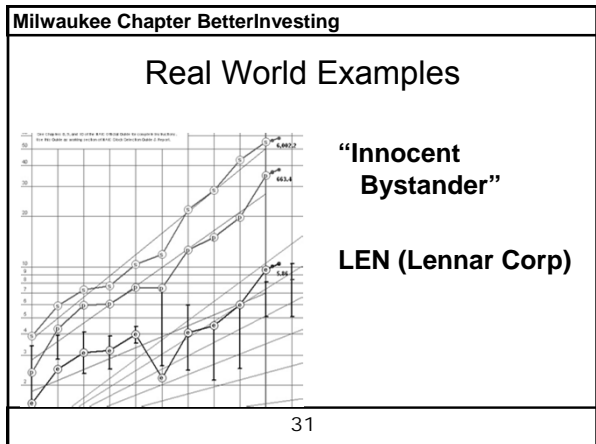
### Real World Examples



**“Flatliner”, or “Disaster” ?**

**CAT (Caterpillar) (a DOW stock)**

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**Section 1 (Visual Analysis) allows us to see Section 3 (Price-Earnings History)**

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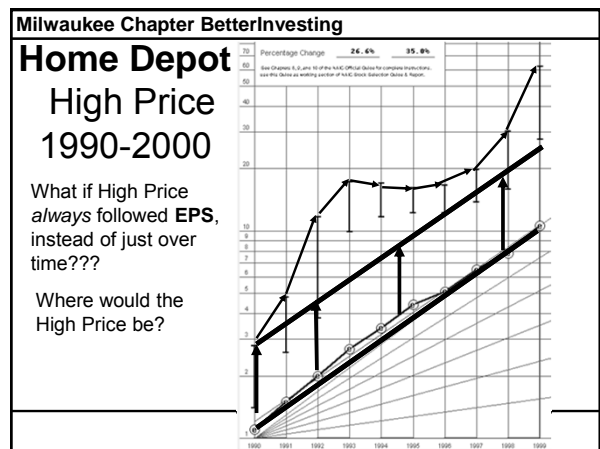
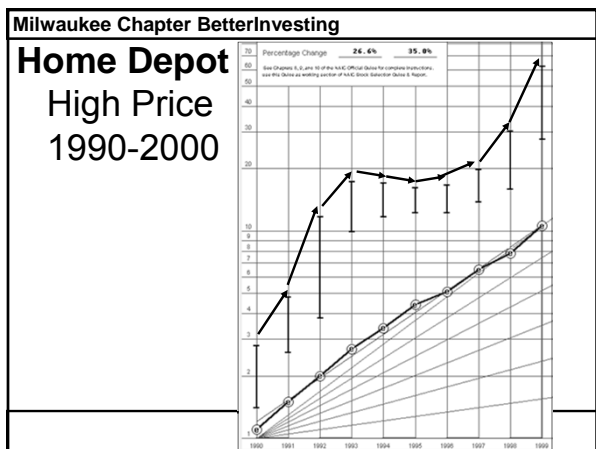
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What is a P/E?

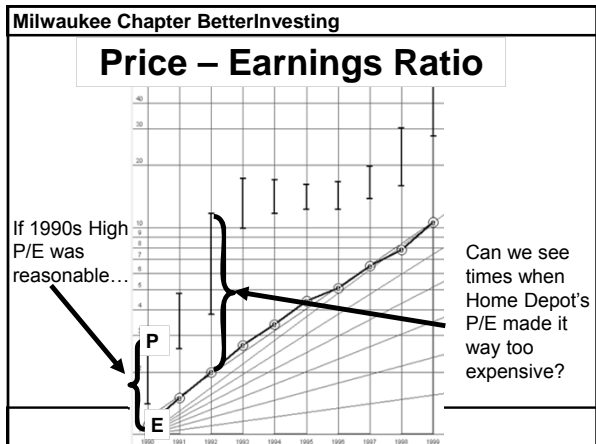
- P/E is a ratio
  - Price to Earnings
- It is calculated
  - Price divided by EPS, or
  - Price over Earnings

$$\frac{P}{E}$$

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Year	A PRICE		C Earnings Per Share	D Price Earnings Ratio	
	HIGH	LOW		High P/E = D/A	Low P/E = D/C
1 1990	2.8	1.4	0.11	25.5	12.7
2 1991	4.8	2.6	0.15	32.0	17.3
3 1992	11.7	3.8	0.20	58.5	19.0
4 1993	17.2	9.9	0.27	63.7	36.7
5 1994	17.0	11.7	0.34	50.0	34.4

Reasonable High P/E

P/E becomes too high, stock is expensive

Isn't this what we just saw in Section 1 ?

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Once you can picture what is happening, you can understand what might happen next!

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Questions?

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Stock Selection Guide

We look for companies with a history of steadily growing Sales and Earnings

The company measured against its own history

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Stock Selection Guide

We look for companies growing Sales and Earnings faster than the industry in general

The company measured against its own industry

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Stock Selection Guide

**We look for companies  
growing Sales and Earnings  
faster than the economy**

**The company measured against the  
economy**

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Stock Selection Guide

**We want companies  
that have the potential  
to be bigger and stronger  
five years from now**

**The company measured by its future  
potential**

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Reminder

**The purpose of the Stock Selection  
Guide is to recognize a  
*well-managed growth company*  
at a  
*reasonable price***

(Attributed to Julie Werner, BETTERINVESTING Atlanta)

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***Let's take a quick peek at...***

**IMPROVING  
JUDGMENT**

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Where Growth Comes From

*Organic Growth vs. Acquisition Growth*

**Acquisition Growth**

- ✓ Considered *less healthy* growth
- ✓ Generated by acquiring weaker companies in the same or similar business
  - Adds to the top line - Sales
  - Hopefully, because of economies of scale, will add to **bottom line**

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Where Growth Comes From

*Organic Growth vs. Acquisition Growth*

**Acquisition Growth**

- ✓ Riskier growth
  - May inherit the problems that made company weak enough to acquire

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Where Growth Comes From

*Organic Growth vs. Acquisition Growth*

**Organic (Internal) Growth**

- ✓ Considered *healthier* growth
- ✓ Generated by marketing or research and development
  - New markets geographically
  - Expanded customer base demographically
  - New products or services
    - Preferably related products

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Where Growth Comes From

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Getting from Sales to EPS

(1) Sales or Revenues  
- Costs or Expenses

**Pre-tax Profit (PTP)**

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Getting from Sales to EPS

(2) Pre-tax Profit (PTP)  
- Taxes Paid

**Earnings or Net Income**

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Getting from Sales to EPS

(3) **Earnings**  
÷  
**Shares Outstanding**  
=  
**Earnings Per Share (EPS)**

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What Do We Look At To Explain  
Different Growth Rates?

**Three Primary Causes:**

- Change in the expenses per dollar of sales
- Change in tax rates
- Change in shares outstanding

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Changes In Shares Outstanding

**Dilution occurs when**

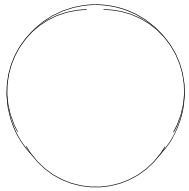
- More shares are issued
  - Exercisable options that can be exchanged for common shares
  - Convertible bonds that can be exchanged for common shares
- The earnings of the company are spread over more shares (diluted)

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Changes In Shares Outstanding

**If we have three shares outstanding, how big is every share?**

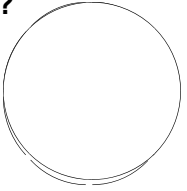


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Changes In Shares Outstanding

**If we potentially have five more shares outstanding, how big is every share?**



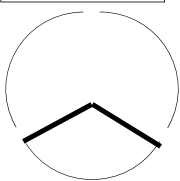
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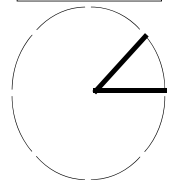
Changes In Shares Outstanding

**Dilution reduces the size of our piece of the pie**

Before Dilution



After Dilution



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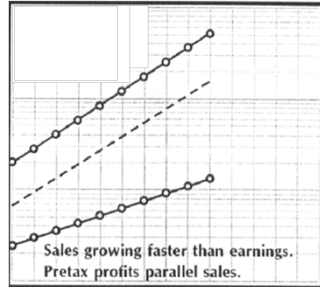
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**What can Section 1 (Visual Analysis) tell us about the relationship of Sales and EPS growth?**

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**Relationship Between Sales and EPS Growth**



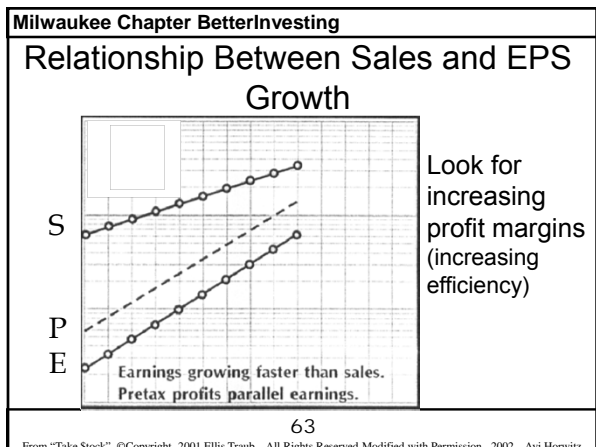
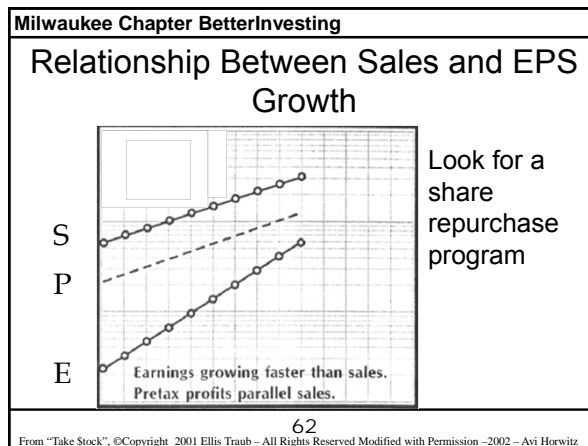
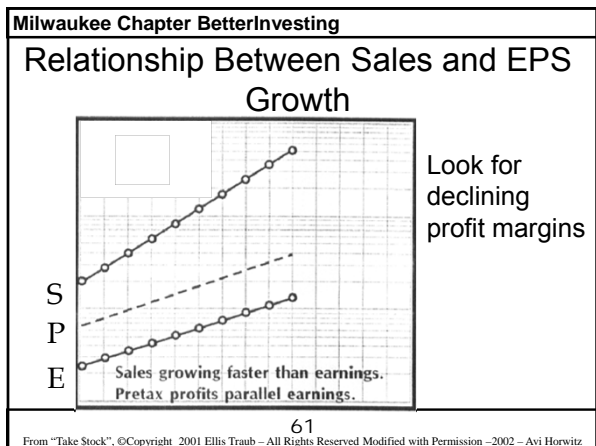
Look for increase in shares outstanding

EPS is growing slower as earnings are spread over more shares - this is why dilution affects us

Sales growing faster than earnings. Pretax profits parallel sales.

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**Section 1 (Visual Analysis) allows us to see Section 2A (% Pre-tax Profit on Sales)**

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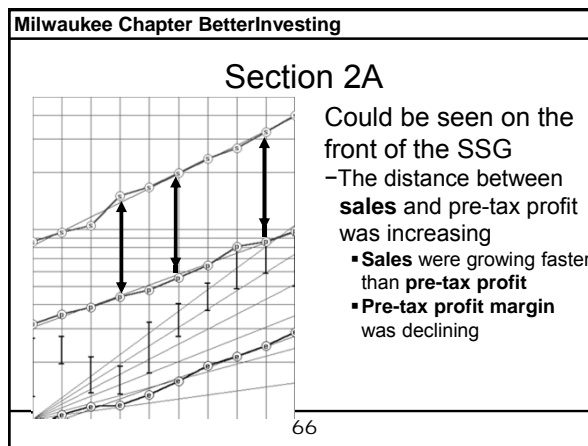
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### Section 2A - Merck

	1991	1992	1993	1994	1995
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	36.8	36.9	36.9	29.5	24.8
	1996	1997	1998	1999	2000
	28.0	27.3	30.2	26.4	24.5
	LAST 5 YEAR AVG.		TREND		
	27.3		UP	DOWN	
			DOWN		

- After the 1993 acquisition of Medco, Merck's pre-tax profit margin began to slip
- Over time, Medco which was a lower margin business, became a larger percentage of Merck's Sales

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**We have taken a quick look at what story the pictures tell !**

**Let's finish up with a few thoughts on judgment**

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**Corry Dalmaso on Judgment**

**Judgment uses the SSG to understand something about the company**

**What is the *normal* operation of the company?**

- Growth Area
- Management Area
- Valuation Area

**History helps us find out what is normal for the company**

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**Corry Dalmaso on Judgment**

**Four Critical Judgments**

1. Projection of Sales Growth
2. Projection of EPS Growth
3. Estimated High Price
4. Estimated Low Price

***These have one thing in common – they are dealing with the future !***

**The rest of what we record is history – or what is normal for the company**

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**We have tried to improve your understanding of what is happening with a company!**

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**Once you can picture what is happening, you can understand what might happen next!**

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**Make A Difference In Someone's Life**

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**Questions?**

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