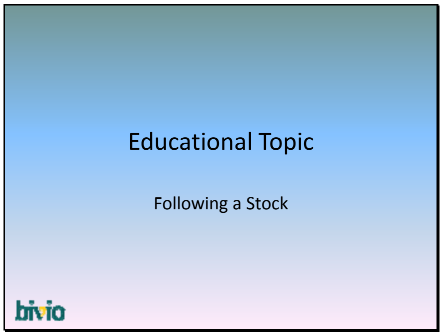
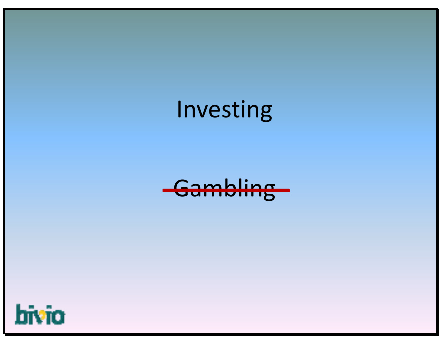



Since an investment club is about learning to invest we suggest that the final part of your meeting be an educational session. This might sound like work but if you're interested in investing, it's fun to learn new things and try them out! We'll try and give you ideas for something brief and we'll also try and give you ideas for an activity you can do to help you understand the topic better. It always helps to really learn something if you do the homework and we hope you'll have fun working on the activity together!

I thought a good topic for this month might be to begin talk further about how to watch a stock once you've purchased it.


As usual, to start, I'd like to have everyone step back and refocus on why we do what we do.




The reason we study companies the way we do is because we are interested in investing

Not gambling

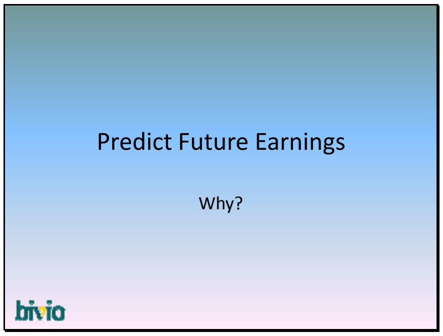

What does it mean to "follow a stock"?

It doesn't mean following it's price

It means following it's business fundamentals.

Example-ownership of small private store. You would pay attention to the business details (sales, profit) . You would very rarely look at the value of your business to an outside investor. But a business with ever improving business fundamentals would be of higher value to an outside investor than one with more shaky fundamentals.
If you were an investor would you run out and purchase a local business just because they had a good month or a good quarter?

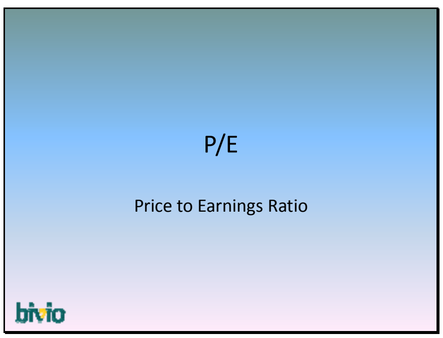
When we own stock, we own a business.




The reason we want to follow how a company's business is doing is because we want to make projections about it's future earnings.

Why do we want to do that?


Because we believe a stocks price growth follows it's earnings growth




The relationship between a stocks price and it's earnings is called it's P/E or

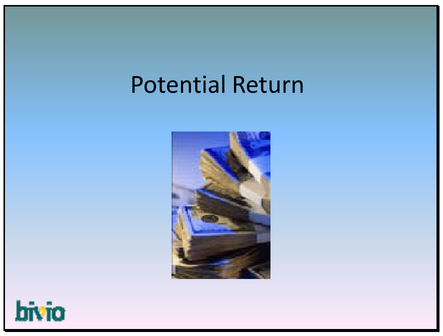
Price to Earnings Ratio

Different factors affect a stock's P/E. They include the rate at which its earnings is growing and the consistency of its growth. Over time, a stock usually develops a "signature" P/E. While its price may fluctuate from day to day, its P/E tends to stay fairly centered around this signature value unless there is some major change in the way its business is performing.


If we make a judgment about a stocks signature P/E and we can predict future earnings we can predict

Future stock price

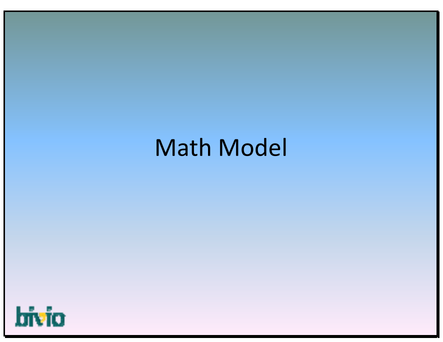

The difference between the future stock price we project and the current stock price allows us to calculate



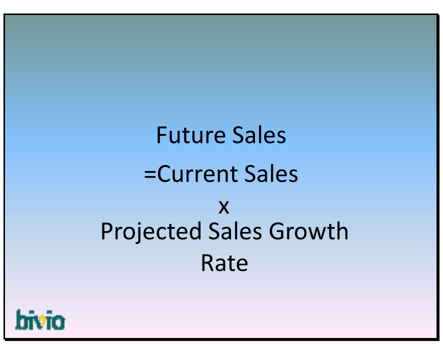

Our potential return from our investment.


How do we predict future earnings?

Some would say it's a magic art.

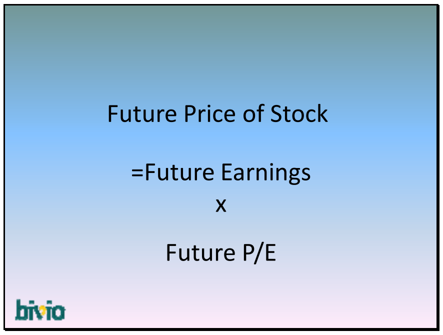



We try and make it a little more scientific than that. To predict future earnings we use a math model. In our case this is just a fancy name for a couple of mathematical formulas. Using facts from financial statements and estimates of future changes that we call judgments, we can calculate what we expect earnings in the future to be.

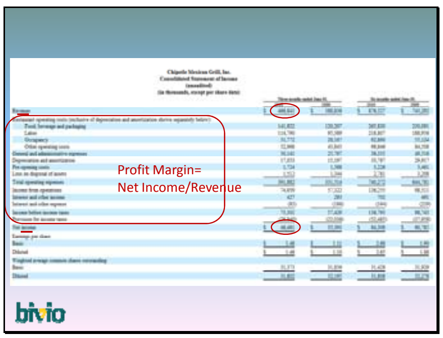



We first calculate future sales. We do this by multiplying current trailing 12 month sales by the rate we anticipate sales will grow each year for the next 5 years. Future sales growth rate is our first Judgment item.


We then calculate future earnings by multiplying the future sales we just calculated by future profit margin.  Future Profit margin is our second judgment item.




Finally, once we have calculated future earnings, we calculate the projected price of the stock by multiplying it by a projected future Price/Earnings ratio. The projected Average P/E is our third judgment item.




The information we use to make judgments about future revenue growth and future profit margin comes from one of the financial reports a company produces each quarter. Appropriately, it is called a statement of operations or Statement of income. It tells us the amount of sales a company has had,
the types of expenses it has had and how much of the sales it was able to turn into earnings.

At the top of the column of numbers on an income statement is Sales which is also called Revenue. Since this is the first number, you often hear it referred to as the top Line. When we compare sales from one period to another we can calculate sales growth. An income statement will usually show you the financial results from a different period that you can use to make comparisons with.

After the sales are listed all the costs to run the business. They are subtracted from sales to come up with the

Earnings which is also called the bottom Line. It is the part that the company gets to keep to reinvest in growing the business or to distribute to the owners of the business as a dividend.  A stocks price usually grows in relationship to growth in earnings from one period to the next.

The Profit Margin is the relationship between the earnings and the sales. It tells you what percentage of total sales become earnings.

## Judgments
## 3 parameters

- Sales (revenue) growth rate over the next 5 years
- Average future net profit margin
- Average future P/E

bivio

We actually made judgments about the three parameters in our math model when we purchased a stock.   By looking at historical information from income statements and historical stock prices we projected.

Sales growth rate-
Average Net profit Margin
Average P/E

They led us to a projected return for our investment.  We decided that that projected return would add to the growth in our portfolio.  That's why we made the purchase.

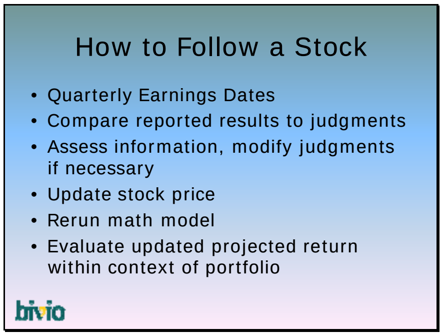
Following a stock means making a regular assessment of whether our judgments are still valid and whether we need to adjust the return we can expect the stock to add to our portfolio.

## Following a Stock

- Quarterly
  - 10-K
  - 10-Q's

bivio

We reassess our judgments whenever we are provided with new information about the state of a company's business.  Usually, this will be quarterly.   Each quarter publicly traded companies must provide a report which summarizes their financials.  These reports are filed with the Securities and Exchange commission.  There are strict rules for what and how the information in them needs to be presented.  Management is required to disclose both positive and negative factors which may affect their future business results.  A company will provide 1 annual report a year called a 10K and three quarterly reports called 10Q's.  The income statement is one of the financial reports which is provided each quarter for a company.




To follow a stock, the first thing you should know is when these quarterly earnings reports will be available. You can make a reasonable guess at this by looking at the dates historical reports were filed.

Compare results from report with the current judgments you are using in your model to project future return

In the report, you'll find current and prior year data that you can use for calculating comparisons. There is also a section in all the reports called the Management Discussion and analysis. In this discussion, management is required to discuss any significant changes to the companies business. You should use this information to determine whether any of your purchase judgments need to be modified.

After you have determined whether your judgments are still valid, you will update your stock price to the current price and

Rerun your model with updated information. As I'll demonstrate, you can use a simple spreadsheet or easily do the calculations using a calculator.

Once you've updated your projected rate of return, you should evaluate how that affects the overall projected return from your portfolio. If the growth potential for a stock has decreased, it might be a good candidate to consider replacing.


We'll go through an example of this process next but first I want to let you know where you can find the information you'll need to update your judgments. You can find the quarterly reports posted at the SEC website. Here is a link.

You can also usually find the reports posted on the Company website in their Investor Relations section. In addition, each quarter the company will have a conference call which you can listen to live or via a posted recording.

You can see how your average P/E judgment compares to current and historical levels using a graph at bigcharts.com

You can compare your judgments with Analysts judgments at sites like ManifestInvesting, Yahoo Finance, Morningstar.com and Valueline

## Example-Chipotle (CMG)

- Our Buy Judgments 2/22/2010
  - Projected Sales Growth 16.3%
  - Projected Net Margin 7.5%
  - Projected Average P/E 24.5
  - Purchase Price
  - $104.39
  - Projected Annualized Return
  - 11.5%

Here is an example of the process of following a stock for a stock which my model club owns, Chipotle Mexican Grill.

## Most Recent Quarterly Earnings Report – June 2010

## Projected Sales Growth-16.3%

- Results from Latest Quarter
  - Comparative Data on Income Statement
  - http://www.sec.gov/edgar/searchedgar/companysearch.html

The first thing we want to do is see how the results of the current quarter compare to our judgments. Go to SEC website, demo how to find report. Show report and income statement.

## Projected Sales Growth-16.3%

- Calculate current period sales growth
  - Compare sales from 3 months ending June 2010 ($466841) to sales 3 months ending June 2009 ($388836)
- ($466841-$388836)/$388836=
- 20.06% increase
- Comparison of 6 month time periods
- 17.9% increase
- Better than our projection
- Good!

So the obvious question is, is our projection too conservative? Should we increase it?

## Should we change our projection?

## Types of Things that might affect future sales growth rate

- Product obsolescence/new products
- New/expanding markets/locations
- Purchase of another company
- New sales initiatives
- Economy

We need to look at the factors that might affect future sales growth. For Chipotle, they include things like,:

## What does Management Say?

- Management Discussion and Analysis
- Risk Factors

There are several sections in the 10Q and 10-K where management actually presents their view on the factors which are critical to their business and to increasing their sales. They are required to discuss anything that might have a material impact on their future results.

Two of the main sections you should look for are the section called

Management Discussion and Analysis

And the section called “Risk Factors”

Show the section in the actual document. Page 7,8 discuss revenue.

## Conclusion

- Sales Growth projection of 16.3% still looks good

From the material presented, it does not appear there is any significant change in the way growth will be occurring so we feel comfortable staying with our projection of 16.3%

## Projected Net Margin 7.5%

- Results from Latest Quarter
  - Net Income/Sales
  - $46461/$466841
  - 9.95%

Show where numbers came from on Income Statement. The expenses and charges that the company is incurring to get from net sales to net earnings is where you can truly take a look at how the company business is doing.

## Should we change our projection?

## Things that might affect Net Margin Projection

- Increase/decrease in cost of product being sold
- Increase/decrease in operating expense such as selling expenses
- Change in Income Tax rate
- Writeoff of Goodwill
- Increased debt causing increased interest expenses

The things that will affect the net margin are things that will show up as income or expenses on the income statement. They include things like:

## What does Management Say?

- Notes to Financial Statements
- Management Discussion and Analysis
- Risk Factors

Go to Notes to Financial statements-page 8, They mention several things which might eventually lead to slightly increased expenses.

## Conclusion

- Net Margin projection of 7.5% still looks good

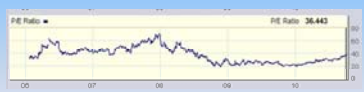
Our projection is lower than the current quarter results but it appears appropriate given the potential for some increases in their expenses.

## Projected Average P/E 24.5

- Current P/E 36.7

## P/E history

- Change in Earnings Growth Rate



This is a graph of historical P/E's for Chipotle going back to 2006. You can see where its signature P/E came down pretty significantly starting in 2008. While conservative, our projection of 24.5 seems reasonable based on the values for the last 2 years

## Conclusion

- Projected Average P/E Probably still good judgment

## Calculate Projected Return

[Chipotle Eagle]

So what is our projected return given today's price?

## How Does this Affect Our Portfolio Projected Return

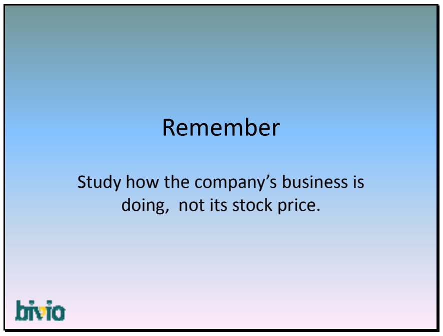
[MIParse.xls]

So what is our projected return given today's price?

## How to Follow a Stock

- Quarterly Earnings
- Compare reported results to judgments
- Assess information, modify judgments if necessary
- Update stock price
- Rerun math model
- Evaluate updated projected return within context of portfolio

Just to reiterate, what did we just do to keep track of our stock?




You might find yourself in a Chipotle watching how busy it is and what types of things people are buying!