Portfolio Management Workshop

<u>Session #1: Portfolio Management – What does it really mean?</u>

INTRODUCTION

Most NAIC education deals with the acquisition of stocks. Likewise, clubs and individual investors also spend the majority of their time on purchase decisions. The Stock Selection Guide (SSG) and Stock Comparison Guide are the most frequently used tools and they are the most frequently taught.

I believe that NAIC needs to begin to stress what happens after the fun of picking and buying is over. Councils need to begin to focus on Portfolio Management.

GOALS

NAIC investors set a goal to build a portfolio that doubles in value every five years. This means that a portfolio's growth has to average around 15% annual growth. It doesn't mean that every stock in a portfolio has to perform like that. It means that a portfolio has to average that kind of growth.

PORTFOLIO MANAGEMENT

Portfolio Management essentially consists of the activities that help investors reach desired investment goals. It is the art of optimizing holdings and increasing the value of a portfolio. And it takes some common sense and diligence to do it successfully. At times, it even takes a little courage.

This workshop will discuss the process and the tools at your disposal to make the most of your investments. It may also suggest some answers to some of the questions you may have about when or why you should sell your stocks and what you might want to do in today's market.

TWO PLATOON GAME -- DEFENSE

Portfolio Management, like football, is a *two platoon* game -- offense and defense.

For defense, you are primarily interested in preventing damage to a portfolio. The inexorable Rule of Five anticipates the damage.

RULE OF FIVE

For every five stocks you select, no matter how diligently and conservatively you do your homework, one stock will do better than expected. Three stocks will do about as expected, and one will go down the proverbial tubes.

You want to catch those bad boys before they have a chance to do any damage.

DIVERSIFICATION

The second element of defensive portfolio management deals with diversification. One of the four NAIC principles tells you to diversify. The reason for this is, obviously, not to have all of your eggs in one basket. Exercise diligence to make sure that you don't buy stocks that overpopulate any one industry sector or business.

There is always the prospect that one or another of your investments will do very well, relatively speaking. It will balloon that investment and an inordinate amount of the portfolio's dollars will represent that one stock. We will talk about this issue later.

OFFENSE

Taking the offensive involves the process of analyzing a portfolio for opportunity. NAIC counsels that, under certain circumstances, you should look to replace stocks with others of equal or better quality and with a better potential for return.

In today's high-strung market, you find that many of the most favored companies have reached such a high price that the risk of loss far outweighs the potential reward. How much is too much? And what should you do in such a case?

The diligent application of both defense and offense will help each of you meet the goal to double a portfolio's value every five years.

PORTFOLIO MANAGEMENT TOOLS

NAIC provides an excellent assortment of tools with which to perform portfolio management tasks.

The foremost, and by far the most important, tool is the Stock Selection Guide. Armed with the SSG, it is possible to do an excellent job on both defense and offense. For many years, NAIC members used the manual SSG alone to accomplish the tasks that we'll talk about over the next few days.

The additional forms are all relatively recent additions to the NAIC repertoire. They are the PERT (Portfolio Evaluation Review Technique), Portfolio Management Guide, and the Portfolio Trend Report. In addition, the PERT has two associated *feeder forms*, PERT Worksheet-A and PERT Worksheet-B.

I-CLUB-LIST WORKSHOP PORTFOLIO

For purposes of this workshop, assume that you have a small portfolio. It consists of:

100	Cisco (CSCO)	SSG

100	Forest Labs (FRX)	SSG
100	Merck (MRK)	SSG
100	Biomet (BMET)	SSG
100	Clayton Homes (CMH)	SSG

These companies illustrate most of the issues that we will discuss in next few days.

Session #2: The PERT -- First Line of Defense

FUNDAMENTAL PERFORMANCE

As with the ball game metaphor, *defense* involves vigilance -- protecting ourselves from harm.

Fundamental performance is the first and the most critical concern in a defensive plan. Unlike technical analysts who watch for telltale price movement to make buy or sell decisions, NAIC investors monitor the operations of the companies whose stocks they own.

You purchase stocks for the same reason that stock was first issued centuries ago -- to participate in the earnings of the enterprise for the long term, not simply to buy and sell for profit. For that reason, you're interested in watching just how well those companies operate and generate their earnings.

UPDATE SSGs

First, update the data and prices for all of the Stock Selection Guides (SSG) in a portfolio. Toolkit Pro 3.1.1 takes you from each company screen to Web site sources for both the price updates and the Edgar SEC filings.

REVIEW ASSUMPTIONS

Second, quickly review each SSG to make sure that the initial assumptions are correct and that you still agree with your original judgment. Be sure to modify the previous judgments if conditions have changed to warrant it. Use your current judgments in your portfolio review.

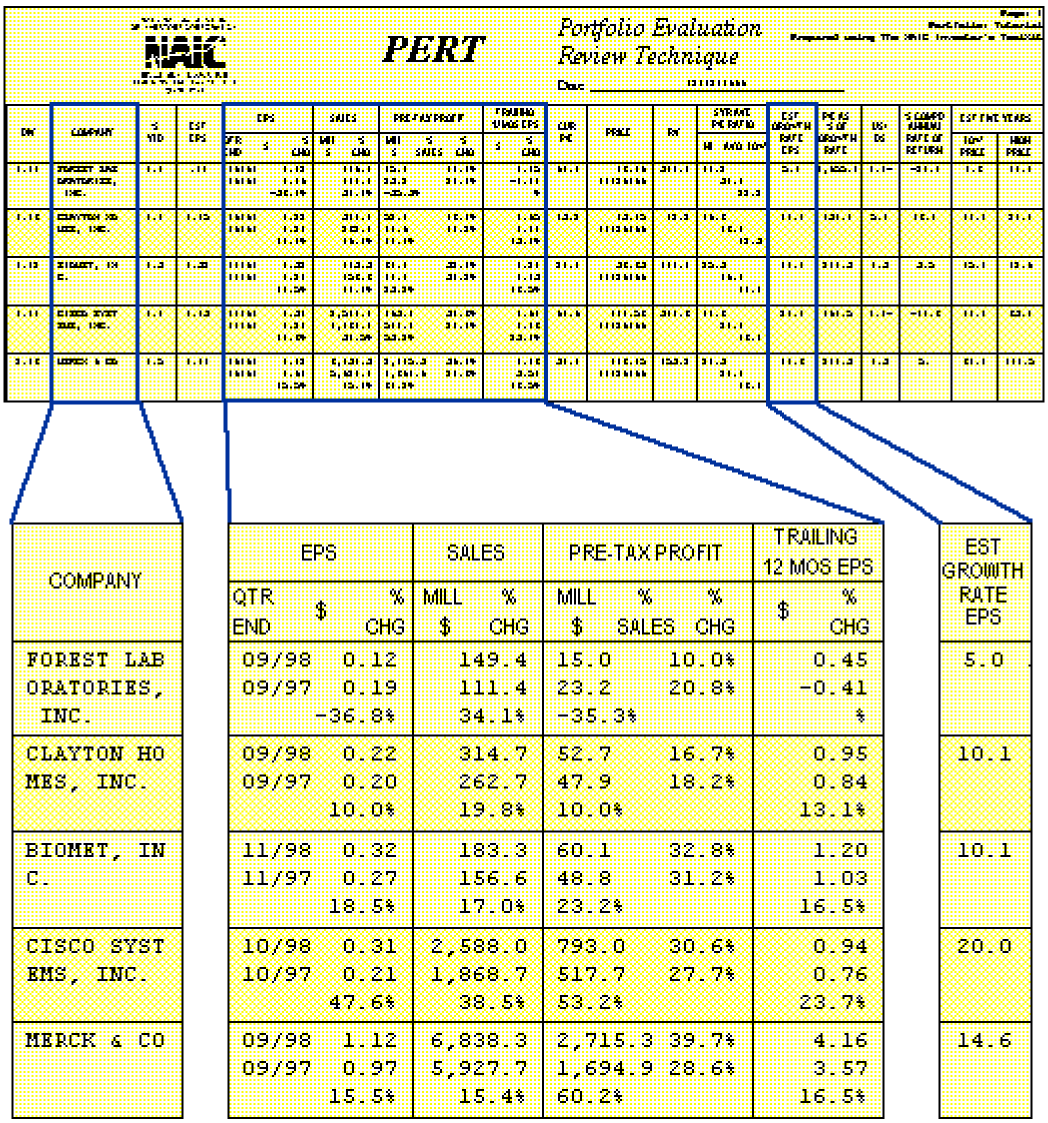
PERT: DEFENSIVE ELEMENTS

Most of what needs to be done may be accomplished with the Stock Selection Guide if it is all that you have. Most of the information that we will discuss comes from the SSG. It's certainly the first place that a problem will show up and can be a *defensive scout*.

However, the ideal place to look for trouble is in the **PERT** (**P**ortfolio **E**valuation **R**eview **T**echnique) form after you have updated the SSGs and saved them.

The PERT is a collection of the relevant data from all of the SSGs in a portfolio and it is the best place to spot problem companies. It's your first line of defense. In the Toolkit, activate the PERT to display the NAIC PERT form on the screen.

The most important elements of defense are found on the left side of the form starting with the fifth column. These are the four columns labeled EPS, Sales, Pre-tax Profit, and Trailing 12-month EPS.



COMPANY	EPS QTR END	EPS $ / % CHG	SALES MILL $ / % CHG	PRE-TAX PROFIT MILL $ / % CHG	PRE-TAX PROFIT % SALES	TRAILING 12 MOS EPS $ / % CHG	EST GROWTH RATE EPS
FOREST LAB	09/98	0.12	149.4	15.0	10.0%	0.45	5.0
ORATORIES,	09/97	0.19	111.4	23.2	20.8%	-0.41	
INC.		-36.8%	34.1%	-35.3%		%	
CLAYTON HO	09/98	0.22	314.7	52.7	16.7%	0.95	10.1
MES, INC.	09/97	0.20	262.7	47.9	18.2%	0.84	
		10.0%	19.8%	10.0%		13.1%	
BIOMET, IN	11/98	0.32	183.3	60.1	32.8%	1.20	10.1
C.	11/97	0.27	156.6	48.8	31.2%	1.03	
		18.5%	17.0%	23.2%		16.5%	
CISCO SYST	10/98	0.31	2,588.0	793.0	30.6%	0.94	20.0
EMS, INC.	10/97	0.21	1,868.7	517.7	27.7%	0.76	
		47.6%	38.5%	53.2%		23.7%	
MERCK & CO	09/98	1.12	6,838.3	2,715.3	39.7%	4.16	14.6
	09/97	0.97	5,927.7	1,694.9	28.6%	3.57	
		15.5%	15.4%	60.2%		16.5%	

Here's where you find the actual quarterly data for the current quarter and the same quarter a year ago, the percent change (growth rate), and, in the case of Pre-Tax Profit, the Profit Margin (%Pre-tax Profit on Sales).

With Toolkit, click on the label at the top of the form to rank the stocks from the worst to the best performers. (The illustration is ranked by Pre-Tax Profit.)

COMPARISONS

Compare each of these growth rates with your expectation of the company's growth when you first bought it. Estimated earnings growth serves as the best measure of expected company growth and is found in the 13th column from the left.

Sales

Look first at sales growth because it is the most stable statistic and, should there be any serious decline in the growth from the previous year, its cause would likely not be trivial.

Even if growth rates aren't negative, you still want to see growth close to what you anticipated the company's growth would be.

Pre-Tax Profit

Next in importance is probably Pre-Tax Profit -- but only if you have access to the actual figures. If you subscribe to the electronic data sources, you will have them. If not, you can quickly obtain them by clicking on the Toolkit's Web access button at the top of the screen as you update and review each SSG. A pull-down menu takes you directly to FreeEdgar for the company you are working with.

Again, compare the percent change with your earnings growth estimate. Disappointments in PTP growth are critical because you can see them before they show up on the bottom line. It's not easy for a company to hide changes in Pre-Tax Profit, but they can tinker with the tax rate or the number of shares outstanding and keep disappointing numbers from reaching the earnings line until the end of the fiscal year.

Catching problems at this point, especially if they're serious problems, can save you lots of money because you can divest yourself of the poor performers before the rest of the world reacts to a bad earnings report. A significant disappointment in PTP is important to explore and make sure that you know what caused it. Usually a call to the Investor Relations person will provide you with a reason and you'll have to decide on its gravity.

Earnings

Finally, look at the earnings -- preferably the 12-month trailing earnings -- because this will dampen out the occasional poor quarter and smooth out the volatility of simple quarterly data. If earnings growth is lagging, then it may already be too late to do anything except to cut your losses and get out.

Benchmark: Growth Rate in EPS

The PERT "Est Growth Rate EPS" is the growth rate that is necessary to meet the expectations for the return on the investment. In a perfect world with constant profit margins, taxes, and shares outstanding, the sales, pre-tax profit, and earnings will all grow at the same rate and as fast as expected. If earnings growth slows appreciably below expectations, the rate of the return on the investment will fall short of the goal. Investors need to look for the signs that this might happen.

Since the world isn't perfect, look at each of the fundamental values independently in order to learn something from each one. Sales lags are not trivial because it takes somewhat of a catastrophe to turn that type of growth downwards. If sales growth is normal, but we find pre-tax profit flagging, we are looking at declining profit margins and can see that the problem is the way that management is handling expenses. If sales and PTP are doing fine, but earnings per share is slowing, look at tax rates and/or an increase in shares outstanding as the cause of the problem. However, that is less worrisome because they are probably not long-term problems. And so on.

Look out, though! You shouldn't simply sell when there is a single bad quarter. You will want to look a little further. We'll talk about when and why to sell in the next session.

A question on **profit margins** versus **pre-tax profit** led to this additional explanation from Ellis:

When we look at **profit margins**, we certainly hope to find a steady or up trend and not a down trend, quarter to quarter. We never make an effort to quantify a trend. If there's no growth in profit margins, that's just fine. It may well mean that the company is operating at near-peak efficiency and can't do very much to cut costs without it becoming counter-productive. For example, downsizing a company produces a short term increase in profit margin but costs a company dearly in the long run.

If there's an up-trend, that's okay too. It probably means that there was a need for efficiency and management is doing something about it.

Downtrends are bad news, though, because they mean that management's ability to contain costs is diminishing. Management may be becoming extravagant. However, when profit margins don't grow or they decrease, we don't seek to quantify a trend.

Sales, **pre-tax profit**, and EPS are quite different. Here we *are* looking for growth and we do quantify that growth.

Session #3: The Trend Report (Investor's Toolkit): A Call to Action

WHEN TO SELL

Portfolio Management, because you already own the stocks and purchased them to hold for the long term, implies that there is either a time or a cause for selling them (other than when you want or need the money). Therefore, let's talk about selling stocks.

The rules that cover this, cited in the NAIC Official Guide: Starting and Running a Profitable Investment Club, instruct you:

NEVER SELL . . . unless the company:

- Has had an adverse management change.
- Has declining profit margins.
- Has had a deteriorating corporate financial condition.
- Has been beset by effective competition.
- Has relied on a single product that is becoming obsolete.
- Has changed for the worse due to economic conditions.
- Has proven to be cyclical.
- Has upset the balance by company size in your portfolio.

All but the last of these items represent conditions that deal with the fundamentals of the company over the long term. And the list isn't restricted only to those specific items. There are many reasons why a company may falter.

(The last deals with diversification and falls into another defensive category that we'll discuss later.)

TROUBLE SIGNS

Look for signs of these kinds of problems in the PERT report. However, you should realize that the PERT does not display more than a single quarter. Like security guards viewing a bank of TV monitors in a large building, you should look at a portfolio for anything suspicious. If you find something, it's a call to investigate, not necessarily to sell. You have additional tools for your investigation.

The PERT Report excerpt shown in Session #2 is ranked by Pre-Tax Profit. Forest Labs, the worst performer, shows that sales are doing just fine as might be expected. As we said, it is difficult to make a radical change in that statistic in a single quarter. However, the Pre-Tax Profits declined 35.3% over the year before; and earnings have declined 36.8%. There is no data for Trailing 12-month earnings since earnings last year was negative and percent change can't be calculated!

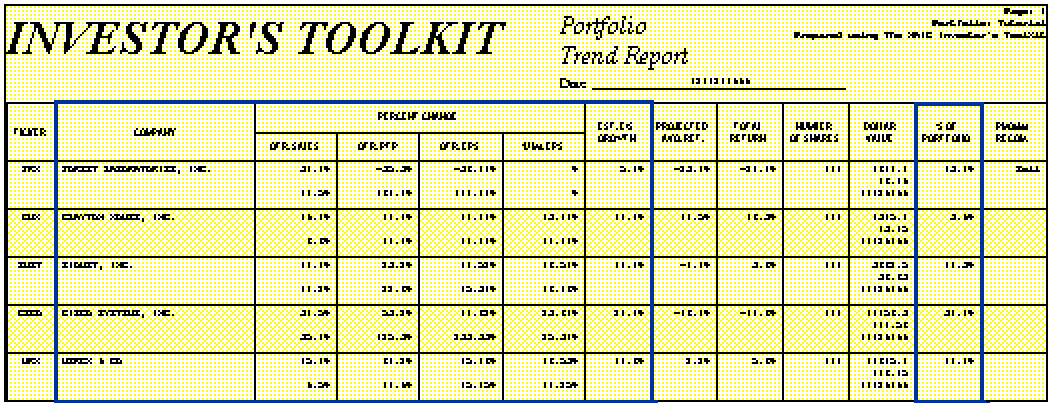
COMPANY		EPS			SALES		PRE-TAX PROFIT			TRAILING 12 MOS EPS			EST GROWTH RATE EPS
		QTR END	$	% CHG	MILL $	% CHG	MILL $	% SALES	% CHG	$	% CHG		
FOREST LAB ORATORIES, INC.		09/98	0.12		149.4		15.0	10.0%		0.45			5.0
		09/97	0.19		111.4		23.2	20.8%		-0.41			
				-36.8%		34.1%			-35.3%		%		

This is certainly a warning sign. Had you been doing PERT on a regular basis, you would probably have seen more reason to be alarmed - and much sooner.

The next step is to see if this decline in fundamentals has only just begun or is it something that has gone on for more than just this quarter. I believe that one bad quarter may be just a quirk. Two or more quarters are significant and require action.

PORTFOLIO TREND REPORT

If you had retained the PERT from the previous quarter, you would be able to compare it with the current edition and see if there are two disappointing quarters. If you have the Toolkit Pro 3.1.1 (previously referred to as the Complete Toolkit), the next step is to click on the button at the top of the PERT to bring up the Trend Report, so called because it reveals the "trend of the trends."



COMPANY	PERCENT CHANGE				EST. EPS GROWTH	% OF PORTFOLIO
	QTR. SALES	QTR. PTP	QTR. EPS	12 Mo. EPS		
FOREST LABORATORIES, INC.	34.1%	-35.3%	-36.84%	%	5.0%	13.0%
	41.5%	860.0%	700.00%	%		
CLAYTON HOMES, INC.	19.8%	10.0%	10.00%	13.10%	10.1%	3.9%
	6.6%	11.8%	10.71%	14.81%		
BIOMET, INC.	17.0%	23.2%	18.52%	16.50%	10.1%	10.3%
	18.2%	22.6%	15.38%	16.16%		
CISCO SYSTEMS, INC.	38.5%	53.2%	47.62%	23.68%	20.0%	31.4%
	35.4%	125.3%	233.33%	25.37%		
MERCK & CO	15.4%	60.2%	15.46%	16.53%	14.6%	41.4%
	9.5%	11.9%	15.05%	17.25%		

Look at the percent change in the same four columns, Sales, Pre-tax Profit, EPS, and Trailing 12-month EPS. However, the data has been removed and there are two similar lines of data for each company. The top line represents the same information that you just looked at in the PERT. The line beneath represents the percent change between the previous quarter and its counterpart in the year before. In other words, you are looking at the result of last quarter's PERT. Now you can see two quarters in a row and the growth for each.

Again, you wish to compare these growth rates with your expectation (estimated earnings growth). In the Trend report, it is placed in the column adjacent to the four fundamentals columns for convenience, labeled "Est.E/S Growth."

If you see two quarters that are satisfactory, you are happy with that company for the moment. That is true with all of the companies save Forest Laboratories (NYSE: FRX).

If you see that the previous quarter was disappointing but the most recent quarter is satisfactory, you can say that the company had a transient problem but appears to be coming back on track. If the current quarter was disappointing but the previous quarter was good, you might want to explore to find out what caused the slump; but you'll probably go another quarter to see what the company will do.

However, if both last quarter and the current quarter are down, then you need to act - and act right away. Do you sell? Not yet. A call to action merely means that, when you see two quarters in a row that are substantially beneath your expectations, you should find out why. You need to determine if the problem is long term or transient.

In the case of Forest, it appears that last quarter was anomalous, what with earnings growth exceeding 700%. This has to make us curious. For earnings to increase that much, it must mean that the data on which that growth was based must be extraordinarily poor. That demands our attention.

The next step is to look at this quarterly data in more detail. We'll talk about that in the next session.

Session #4: PERT-A and the PMG -- Looking at the Details

A look at the PERT aroused our suspicions about Forest Labs. The company had a disappointing quarter compared with the same quarter the year before. On the Trend Report, suspicions were further aroused by a 700% growth in earnings for the previous quarter over its counterpart the year before. Therefore, you will want to look at what is going on with Forest in greater detail. The PERT Worksheet-A lets you do this.

PERT WORKSHEET A

If you use the Toolkit Pro, you will find that the data is automatically recorded each time you update the quarterly data for the SSG.

Within the Trend Report (or the PERT, for that matter), double-click on the line corresponding to the company which interests you to *drill down* to the details behind that data and view its PERT-A Report. Here you can see the quarterly progress of this company along with the percent changes.

QUARTERLY DATA

PERIOD	EPS		PRE-TAX PROFIT			SALES	
	$	% CHANGE	$ MIL	% SALES	% CHANGE	$ MIL	% CHANGE
06/92							
09/92							
12/92	0.22		32.67	33.7%		97.00	
03/93	0.24		34.85	37.6%		92.58	
06/93	0.24		34.68	37.5%		92.55	
09/93	0.26		38.24	39.9%		95.78	
12/93	0.23	2.2%	32.70	33.0%	0.1%	99.00	2.1%
03/94	0.24	0.0%	34.90	36.7%	0.1%	95.20	2.8%
06/94	0.24	0.0%	34.70	36.6%	0.1%	94.90	2.5%
09/94	0.26	-1.9%	38.20	38.9%	-0.1%	98.20	2.5%
12/94	0.27	17.4%	40.30	36.5%	23.2%	110.30	11.4%
03/95	0.29	20.8%	43.00	42.4%	23.2%	101.40	6.5%
06/95	0.28	16.7%	41.40	37.4%	19.3%	110.70	16.6%
09/95	0.31	19.2%	45.50	40.1%	19.1%	113.60	15.7%
12/95	0.27	0.0%	38.70	31.0%	-4.0%	125.00	13.3%
03/96	0.24	-17.2%	36.80	33.3%	-14.4%	110.60	9.1%
06/96	0.23	-17.9%	31.50	28.2%	-23.9%	111.80	1.0%
09/96	0.06	-80.6%	8.10	8.8%	-82.2%	92.20	-18.8%
12/96	-0.38	-240.7%	-49.90	-116.9%	-228.9%	42.70	-65.8%
03/97	-0.23	-195.8%	-28.80	-46.1%	-178.3%	62.50	-43.5%
06/97	0.01	-95.7%	1.00	1.1%	-96.8%	90.30	-19.2%
09/97	0.19	216.7%	23.20	20.8%	186.4%	111.40	20.8%
12/97	0.24	NMF	29.10	22.4%	NMF	130.10	204.7%
03/98	0.01	NMF	1.50	1.0%	NMF	142.90	128.6%
06/98	0.08	700.0%	9.60	7.5%	860.0%	127.80	41.5%
09/98	0.12	-36.8%	15.00	10.0%	-35.3%	149.40	34.1%
12/98							
03/99							

On the left side of the form, the percent changes are recorded for each quarter as compared with the same quarter the year before. As you can see, the numbers are all over the lot on the left (quarterly)

section. On the right side of the form, you will find the sum of the trailing four quarters for each quarter, and the percent change between that and the same period the year before.

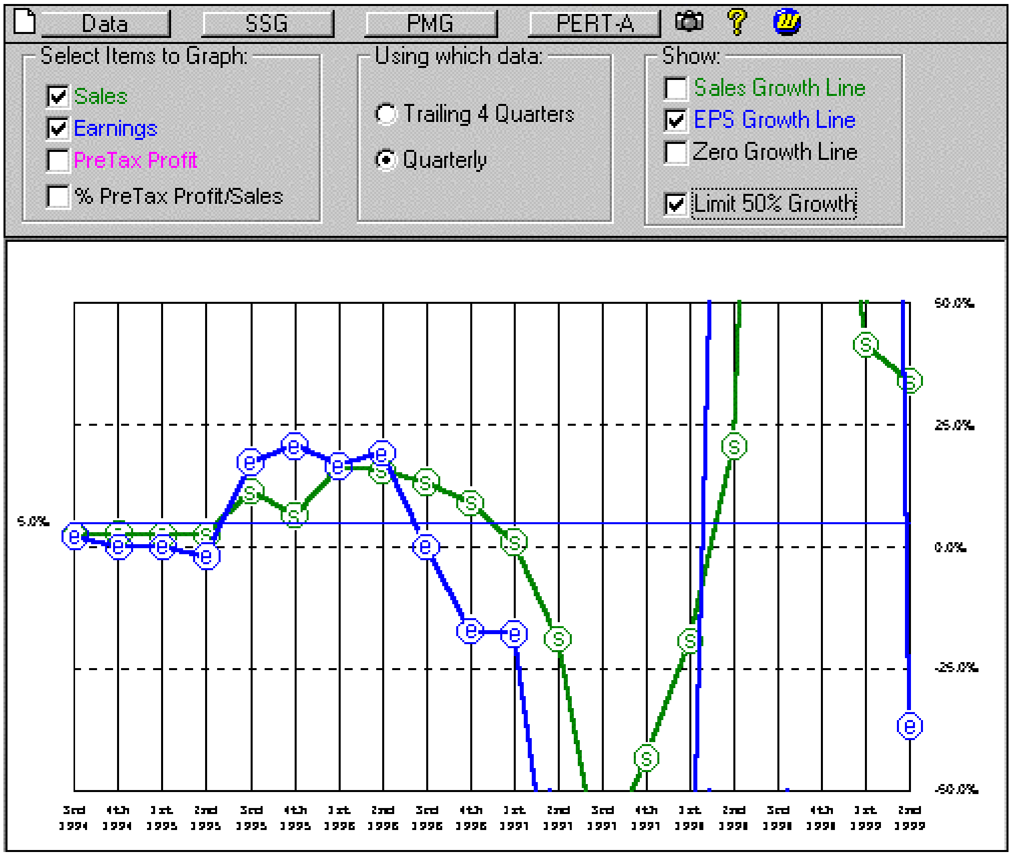
The value of looking at the trailing 12 months (on the right) is that the trends are easier to identify because the data is smoothed by using the moving sum of the trailing data.

Look at Forest and you can readily see, at best, that the company has been through some really bad times. Sales started declining in the first quarter of 1996. Only within the past five quarters have they picked up again. You'll be able to see this clearly on the graph we discuss next.

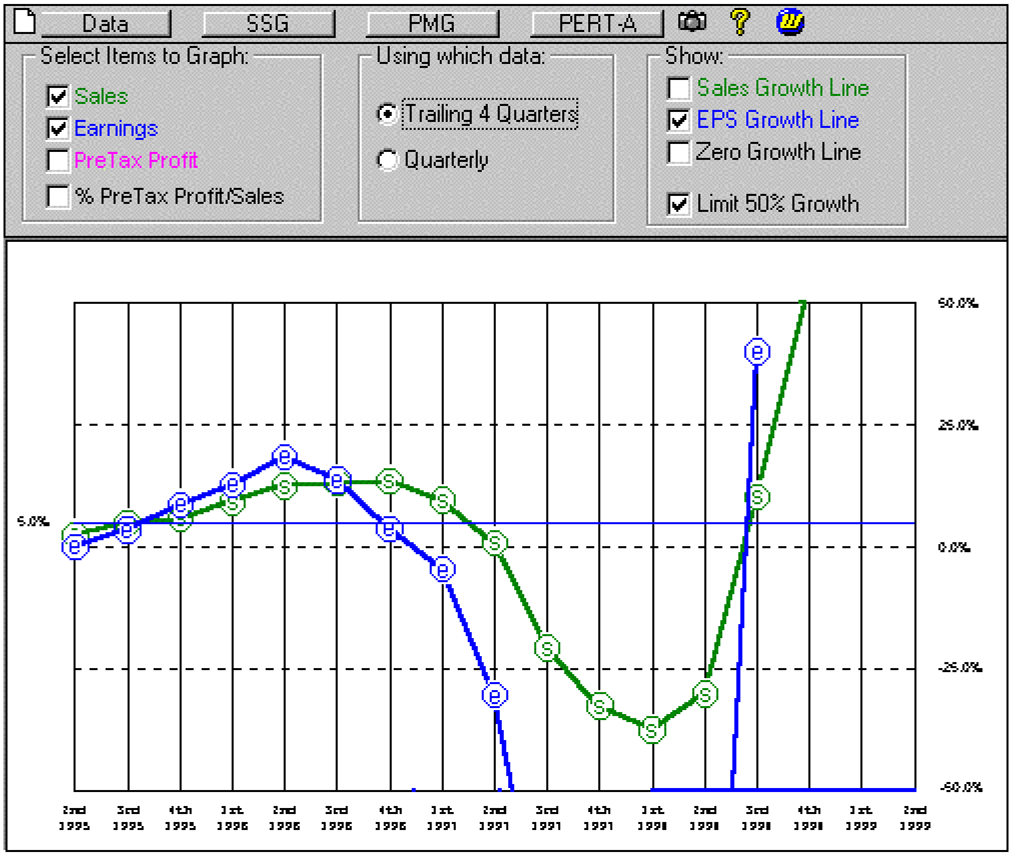
PERT-A GRAPHS

Using the Toolkit Pro 3.1.1, click on the button at the top of the PERT-A labeled **Graphs** to learn still more. This gives you the opportunity to view a graphic representation of the percent changes for each quarter. Click on the appropriate check boxes to display Sales, Pre-Tax profit, and/or EPS growth. You may also display the profit margins (Pre-Tax Profit/Sales), quarter to quarter.

Because these parameters have been so volatile -- ranging from (in the case of earnings) plus 700% to minus 240%, the line will seem flat. However, you may restrict the growth or decline to 50% and the variations are more pronounced.



The final, and perhaps most telling view of the data, is when it is plotted as trailing four quarters. This will reveal a distinct and steady trend downwards commencing in the 3rd quarter of 1996. It is unbroken until the 700% spike in the 3rd quarter of 1998 followed by continued negative growth (which you have to shift back to the quarterly calculation to see).



INTERNET SLEUTHING

If the numbers scare you, as they should, then the next place to go is out to the Internet to find out why this kind of performance took place. Is it long or short term? Or will the company's management be able to see it through the crisis?

Access the Web by clicking on the little blue **W** (web access) button at the top of the [company screen](). Perhaps the first place to go is the company's own Web site. You should be able to find at least the company's spin on why they are where they are and what they're doing about it. Unfortunately, Forest Labs does not have a Web site. (That might say something in itself.)

PORTFOLIO MANAGEMENT GUIDE

A word about the [Portfolio Management Guide]() is in order here. When the PMG was originally conceived, it was a means to determine if a company met the basic requirements to be either a *sell* or a *buy* each month when a new price was obtained.

This purpose has been made obsolete by the computer which can instantaneously perform those calculations and display the result just as soon as the price is updated.

So, unless you're a technical analyst, the graph on the back of the PMG has little value except for its historical perspective. (Gee! If you'd paid attention to the PERT way back there, you'd not be *here* now! <g>)

It does have a useful purpose, however, when viewed in conjunction with the graph on the PERT Worksheet-A form. By comparing the movements of the fundamentals shown in the PERT-A to the movement of the price and P/E on the PMG graph, you can get a good picture of the reaction of the investing public to changes in those fundamentals. You may also see how prices moved up and down when the fundamentals did not provide the reason. This comparison gives a good lesson in how the public tends to react to issues. It may help you to get an idea of how much time you have to make a decision when a reason for selling seems at hand.

Getting back to Forest Labs, however, the moral of this story is that, had you been minding the store as you are now, you would have been out of it long ago. If you're still in it, you probably shouldn't be!

Session #5: On the Offensive

The defensive part of the game involves a certain amount of urgency. If you don't take appropriate action, you can get hurt. The sooner that you take such action, the less hurt you're liable to be.

The offensive part of the game can be more deliberate and is less likely to involve *pain* from failure to act quickly. However, it is fully as important a part of portfolio management strategy if you are to be a *winner*.

CHALLENGE TREE

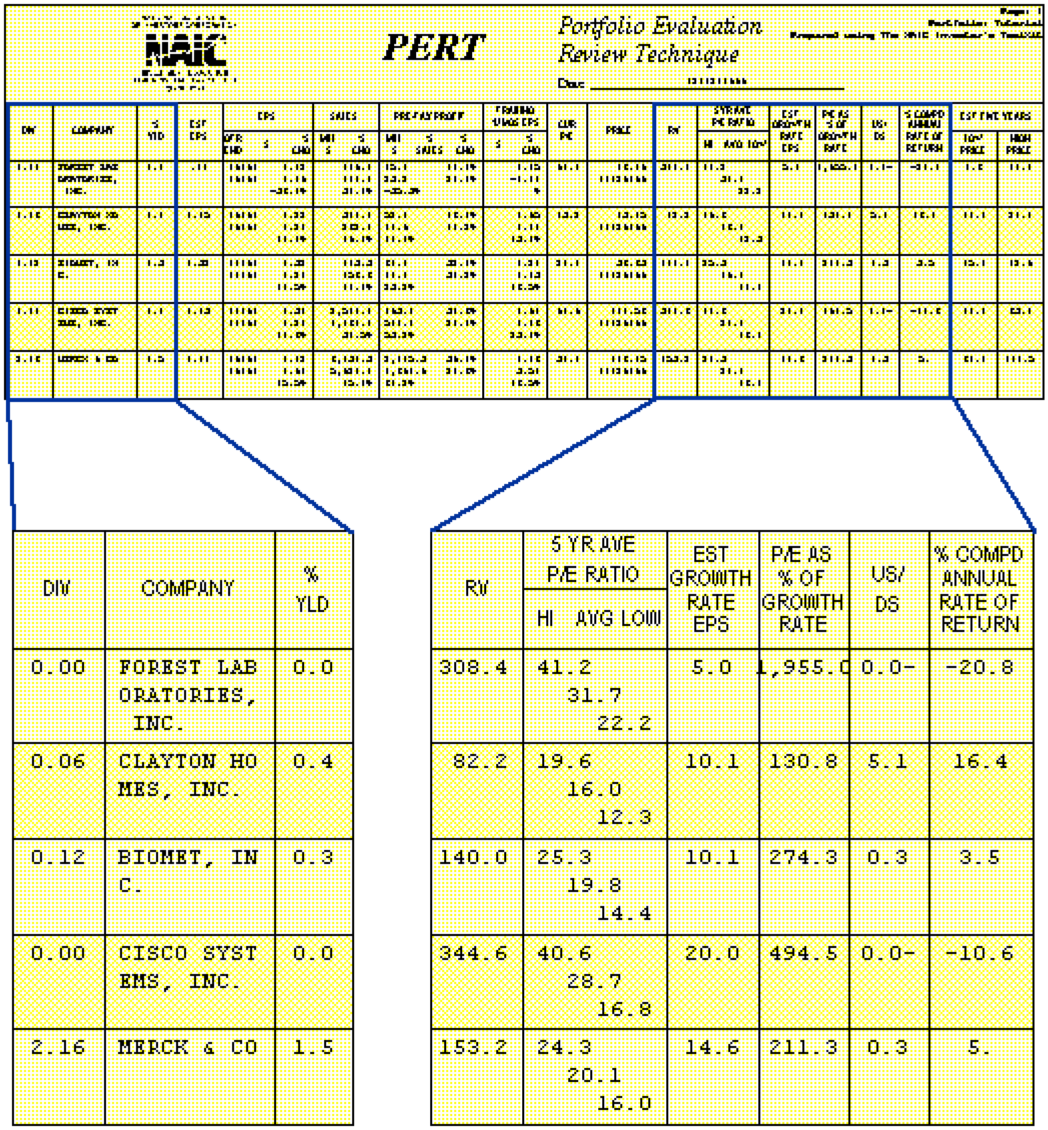
The authority for the offensive strategy is in the Challenge Tree chapter of the NAIC Official Guide: Starting and Running a Profitable Investment Club. It has specific guidelines for taking the offensive. Here's the thrust of what it says. When you find that a stock has passed the point where it has greater risk than reward, replace it with one of equal or better quality and a better potential for return.

The Official Guide, p. 150, goes on further to say (believe it or not) that, if you can't find a company that meets those criteria -- at least a 3 to 1 Upside/Downside Ratio -- consider putting 20% of the most speculative part of the portfolio into good quality bonds. Then wait until the market makes stocks attractive once again!

PERT REPORT

The PERT Report serves a dual purpose, as does its companion, the Trend Report. In a sense, the PERT is a mini version of the SSG. PERT first deals with the trends in the quality issues (SSG Sections 1 - 2) with items such as EPS, Sales, and Pre-Tax Profits.

PERT also deals with the value issues in SSG Sections 3 - 5. They are P/E Ratio, Relative Value, and Upside/Downside Ratio.



DIV	COMPANY	% YLD
0.00	FOREST LAB ORATORIES, INC.	0.0
0.06	CLAYTON HO MES, INC.	0.4
0.12	BIOMET, IN C.	0.3
0.00	CISCO SYST EMS, INC.	0.0
2.16	MERCK & CO	1.5

RV	5 YR AVE P/E RATIO HI AVG LOW	EST GROWTH RATE EPS	P/E AS % OF GROWTH RATE	US/ DS	% COMPD ANNUAL RATE OF RETURN
308.4	41.2 31.7 22.2	5.0	1,955.0	0.0-	-20.8
82.2	19.6 16.0 12.3	10.1	130.8	5.1	16.4
140.0	25.3 19.8 14.4	10.1	274.3	0.3	3.5
344.6	40.6 28.7 16.8	20.0	494.5	0.0-	-10.6
153.2	24.3 20.1 16.0	14.6	211.3	0.3	5.

As with the SSG, be cautious about passing judgment on the *value* side of the PERT without first being certain that the quality issues are not overstated or overestimated. Remember that **the worse a company performs, the better a value it will appear to be**.

Why? Because investors pay a lower price for the stock and you'll see a higher U/D ratio, a lower P/E, a lower Relative Value, and a much higher Total Return. That is simply because of the low current price when compared with the company's earlier history. So beware!

This is why it is so important to update the company data and prices and review SSG's before attempting to pass judgment on the value side of the PERT. That, however, is where you will go for your offensive *game*.

COMPANY	RV	COMPANY	US/DS	% COMPD ANNUAL RATE OF RETURN
FOREST LABORATORIES, INC.	308.4	FOREST LABORATORIES, INC.	0.0-	-20.8
CLAYTON HOMES, INC.	82.2	CLAYTON HOMES, INC.	5.1	16.4
BIOMET, INC.	140.0	BIOMET, INC.	0.3	3.5
CISCO SYSTEMS, INC.	344.6	CISCO SYSTEMS, INC.	0.0-	-10.6
MERCK & CO	153.2	MERCK & CO	0.3	5.

With these things in mind, lets take another look at the workshop portfolio.

PERT REPORT - SELECTED VALUE ITEMS

Aside from Forest Labs, the PERT shows a pretty good looking portfolio. Sorted in order of the quality issues, it appears that you are looking at a great bunch of performers. However, shift your attention to the right. The first telltale item that you come to is the **RV** column (Relative Value). Only Clayton Homes is within a safe and reasonable range. According to the PMG criteria, a Relative Value of more than 150% would suggest that you consider selling at least a portion of your holdings. Biomet approaches the line and the other stocks are well over the line.

Moreover, look a couple of columns further to the right. Clayton Homes is the only remaining holding with reward greater than the risk. Remember that, with an Upside/Downside ratio of 1:1, the risk is equal to the potential reward. Even Merck and Biomet have a 0.4 and 0.3 U/D ratio, respectively. That translates roughly into a potential to gain only another 25-30% should the price go all the way to your 5-year projected high, versus a potential loss of 70-75% should it go down to your potential low price. This *reverses* the desired risk to reward ratio, giving you three times as much risk as reward!

You know that Forest Labs should go. What should you do with the rest? According to NAIC, you should replace any stocks with risk greater than the potential reward with stocks of equal or better quality and a better potential for return.

Of the remainder, Clayton Homes, with an Upside/Downside ratio of 5.1 to 1 reflects a holding with plenty of upside potential. It's growth rate, while only 10%, is consistent with your expectations when you bought the stock. And it has a potential total return of 16.4% -- enough to more than double in five years.

The remaining holdings are excellent companies with a great capacity to grow their earnings. However, the numbers tell you that, at best, based upon what they are now worth, you would grow your investments (even after dividends) at no more than 5% for Merck and 3.5% for Biomet over the next five years. Moreover, if Cisco were priced at your projected high price five years from now, you would LOSE money!

COST OF TRADING

Our next step, then, will depend upon the cost of trading. If this were a tax deferred portfolio -- an IRA or 401K -- and we traded online with Waterhouse, where it costs $12 for a trade, there would be little question but that we should replace Biomet and Merck with companies of equal or better quality and a better potential for return.

We should sell Cisco outright because we could make a greater return in the money market with virtually no risk.

However, most of you aren't so fortunate. The cost of replacing your companies may be prohibitive. You must weigh the cost of paying taxes on your gains, plus the commissions on the round trip for your trades, and be able to see your way clear to covering that loss with the improvement in your potential within a year or, at most, two. *[The Challenge Tree will be studied in depth at a later time.]*

Editor's note:
Nancy Isaacs contributed a step-by-step procedure that summarizes the portfolio managment activities discussed in the I-Club-List workshop.

Portfolio Management Step-by-Step Procedure

1. Update data
2. Update prices
3. Modify SSG judgments if appropriate
4. Open PERT
    1. Rank by Pre-Tax Profit (PTP)
    2. Look for *decline* in Sales growth rate
    3. Determine if Sales growth is lower than projected Sales growth rate
    4. Use only reported PTP figures (Do *not* use PTP projected by the software.)
    5. Compare PTP growth with projected EPS growth rate
    6. Compare Trailing 12 Month EPS growth rate with original EPS projection
5. Open Portfolio Trend Report
    1. Check EPS/Sales/PTP/Trailing EPS
    2. Compare each one to projected EPS growth rate
    3. Problem? Drill down to PERT-A and PERT-A graph
       -- Determine if transient or long term
       -- Investigate on the internet
       -- Company's Web site
       -- Investorama, etc.
       -- Contact Investor Relations
6. Return to PERT
    1. Sort by Upside/Downside Ratio (Descending)
    2. If Relative Value is over 150% *and* U/D is under 1:1 - Consider selling
7. Return to Portfolio Trend Report
   If holding is more than 10% of portfolio - Consider selling part
8. Use New Challenge to find profitable replacement
    - Another stock of equal quality
    - Money Market Fund