

# FINDING RED FLAGS

Goal is to make your own decisions and have a lifetime of long term profitable investing.

**TRENDS ARE VERY IMPORTANT!**

## *Top of Front Page, Right Side*

*Potential Dilution: RED FLAG - Dilution usually is not a factor.*

To find the percent of dilution divide the number of shares to be converted by the number of shares outstanding.

If the amount to be converted is given in dollars, at so much per share, divide the dollar amount by the price per share, and divide by the shares outstanding.

*Other Debt: RED FLAG - Is debt too large to allow the company to be attractive?*

A dollar figure is not very informative.

Debt as a percent of capitalization gives more information.

As a general rule, we desire debt to not be more than 33%; however, compare this figure with other companies in the industry. Some industries will always have more debt than others.

## *Top of Front Page, Left Side*

*Recent Quarterly Figures: RED FLAG - Are sales and earnings percents of growth paralleling?*

Always compare with the same quarter one year ago, not the previous quarter. Certain quarters may have more or less growth than others. If there is a discrepancy between sales and earnings growth, we want to know why.

Is there a slow down?

The percent of quarterly growth is a very important figure to compare with the historical growth.

*Earnings Reported: RED FLAGS*

Were good earnings due to extraordinary items?

Is the appearance of good earnings due to comparison with a poor quarter a year ago?

Is the appearance of poor earnings due to comparison with a quarter a year ago, which had a one-time extraordinary item?

If earnings are growing faster than sales where can the answer be found?

Has the tax rate made a substantial difference in the earnings?

## *The Visual Picture*

The visual picture evaluates management - SHOWS RED FLAGS

*Section I questions to help find RED FLAGS:*

Are the trends of sales, earnings, or profit margins below your goal?

Are recent sales and earnings keeping up with the historical trends? Do they meet my goals? Are pre-tax profits shrinking? Is debt too high?

Do the quarterly figures point to a red flag?

Are the price bars painting the picture we like?

Did the price double in the past five years, or is it on line to double the next five years?

Are the splits continuing on a regular basis?

Is the price too volatile for me to live with?

Is the price trend comparable to growth?

Have the last quarterly earnings and sales kept up with the historical earnings and sales?

Is the earnings growth parallel to the sales growth?

Does the trend line, when drawn by reason rather than emotion, meet your goal? If not it is a red flag signaling to discard the study. Were good earnings due to extraordinary items?

Is the appearance of good earnings due to comparison with a poor quarter a year ago?

Is the appearance of poor earnings due to comparison with a quarter a year ago, which had a one time extraordinary item? If earnings are growing faster than sales where can the answer be found? Has the tax rate made a substantial difference in the earnings?

Does the projection line, when drawn by reason rather than emotion meet your goal, if not it is a red flag signaling to discard the study.

## *Back of Stock Selection Guide - Section*

*Section 2, Evaluating Management: RED FLAGS*

Is management controlling costs?

2A Pre-tax profit on sales tells if management is controlling costs. The trend will indicate if there is a red flag.

Pre-tax profit margin should be plotted on the graph. If this profit margin is not keeping up with the sales and earning's trend it is a red flag.

Is management's return on equity sufficient?

2B Percent earned on equity shows what management earned on monies entrusted to them. This money is generated internally to use for growth.

If the last year figure is lower than the **five-year** average figure for either 2A or 2B, a red flag shows.

This would be especially true, if the preceding year's figures were consecutively lower.  
If the last year figure is higher than the five-year average figure, management is effective.  
If the last year figure is level with the five-year average, management may still be effective, if that figure is high for the industry.

### **Section 3 Price/Earnings History**

#### **Price/Earnings Ratio - RED FLAGS**

It is desirable for the percent of growth to be as high or higher than the P/E.  
The P/E may be **too low**, because the company may not be growing - the visual picture will show.  
A **too high** a P/E has discounted a lot of potential, because buyers are buying on emotion, not on reason.  
The best buy is at midpoint (Section 3 Line 8). That is the value most have bought.  
Compare the P/E with the company historically and with the industry.  
If the P/E has been decreasing your judgment may tell you to use the average of the last 3 years, the last year or to weight the average giving the weight of 1 to 5 years ago, 2 to 4 years ago, 3 to 3 years ago, 4 to two years ago, and 5 to the last year.

#### **Dividends**

Total earnings should not be paid out in dividends.  
A **red flag** flies, if total earnings are paid out to shareholders. **It happens** - not often, but it happens.

#### **Relative Value**

Divide the current P/E by the 5-year average P/E times 100 to determine the relative value.  
90-110 is a desirable range for the RV. (Note the RV we are interested in is not the RV on the Value Line sheet.)  
A P/E outside of its range may signal a **red flag**. Too low shows there may be problem, and too high shows the stock is priced too high.

### **Section 4 Evaluating Risk and Reward**

#### **Estimating High and Low Price Five Years Hence**

Decide if 4 "a" "b" "c" or "d" is appropriate.  
"a" is used for most growth companies; "b" & "c" are used for cyclical stocks paying little dividend; "b" in normal times; "c" for cyclical growth companies (note: "c" says recent **market** low, not low of the stock); "d" for income stocks.  
Do not average the choices. It will mean nothing! Judgment may dictate something else - especially if the low price in the last year is too near the suggested lows.

#### **Zoning 4C - RED FLAGS**

When a study shows the price is not in the buy zone, a **red flag** will fly.  
Buying when the price is in the maybe or the sell zone is risky - tells you much of the potential has past.  
When a stock has been held and has now reached the sell zone, do a new Stock Selection Guide. Yesterday stocks are not the same today.

#### **Upside Downside Ratio 4D - RED FLAGS**

Desire a 3 to 1 ratio. Too high or too low a ratio may be signaling a **red flag**.  
If the ratio is too high, recheck for accuracy of the calculations. Have you been sufficiently conservative in choosing a low price? If the present price is near the chosen low, is it reasonable the price could be at a low for the next five years?  
If the price is not a 3-1 and you believe it has good potential, calculate a 3-1 price and wait to buy at that price. (Calculation: Estimated high price minus the estimated low price divided by 4 plus the estimated low price.)  
If you buy the stock and want to know when the ratio is 1- 1, calculate the same except divide by 2 instead of by 4.

#### **Price target 4E - RED FLAGS**

If your goal to have a compounded appreciation in **five** years, less than 100% will signal a red flag. Delay your red flag decision till Section 5 C is completed.

### **Section 5 Dividend Potential**

#### **Dividend Policy 5A & B - RED FLAGS**

Is the present dividend adequate for you?  
Management's dividend policy shows the company's growth stage.  
Firms with returns in excess of 15% on shareholders' equity paying little or no dividends and reinvesting earnings are usually growth-oriented companies. When dividends remain constant the **red flag** flies.  
When a dividend is decreased the **red flag** flies.

#### **Estimated Average Annual Return over the Next five years 5C - RED FLAGS**

Does the price appreciation in 4E plus the estimated average yearly dividend in 5B meet your goal?  
(Note 20% simple interest in 5C will convert to a goal of 15% compounded rate.)

*NAIC's tools can depict problems before Value Line or any method I know!,*

**HAPPY INVESTING!!**