

*Ensuring a Consistent Process*

## A Recipe for Stock Study

by Bonnie Biafore

I often hear complaints from investment club members about inconsistency, deficiencies or even a total absence of stock studies. Many clubs require new members to attend classes to learn how to complete a Stock Selection Guide. But there's more to filling out an SSG than what's taught in that class.

My first SSG was a lot like my first batch of brioche. The cookbook said the dough should have the consistency of whipped cream, while I held a heavy lump of floury paste in my hands.

You can increase the consistency and comprehensiveness of stock studies by creating guidelines for club members to follow. The process of defining these standards can be educational for your entire club. Animated discussions about which items to include can help your junior members understand the purpose and value of SSG features.

### Starting Simple

The thought of building a checklist could seem overwhelming if you're still struggling with basic issues such as defining judgment. But guidelines can grow with your experience.

You might start with a simple list that includes explaining the choice of forecast growth rates; explaining any outliers; and recommending buy, sell or hold. As your club gains more experience, you could add the choice of the earnings per share figure for calculating the low price, the technique for setting the forecasted high and low price-earnings ratio, and the methods for calculating the implied growth rate or comparing the company's pertinent ratio measures with its industry.

The NAIC Denver Chapter hosts a monthly sector study-education club meeting. People are joining the group all the time and actively participate in researching companies. We needed some kind of standard so that we could effectively compare the companies in the sector when we meet.

Many people mistakenly consider the SSG calculations a stock study. But it's also extremely important to understand the prospects for a company, which are usually difficult to quantify. The guidelines that follow document and explain the types of qualitative research the Denver Chapter undertakes. (This is our first attempt at guidelines, so be nice if you write a letter to the editor.)

### Purpose

The purpose of the stock study is to present the results of research on the company, not to summarize the Value Line analysis. It should clearly support the recommendation you give on investment in the company. Convince the members why they should or should not invest their money in this company.

### Qualitative Analysis

**Business Summary:** In one or two paragraphs, summarize the company's business: What does the company do to make money? Are there different divisions or strategic business units?

**Business Outlook:** In one to six paragraphs, discuss positive and negative influences on the company, such as successful strategies, acquisitions or divestitures, cost cutting or cost increases, the economy, currency exchange rates, war and competition. Summarize its business strategy: Does business grow from acquisitions, increased market share, more volume, more stores, better margins or new products?

For example, Oracle used its productivity products at its own business to cut costs. Home Depot eliminated the middleman to increase its profit margins.

**SWOT Analysis:** SWOT stands for strengths, weaknesses, opportunities and threats. SWOT analysis provides a framework for analyzing a company's strengths and weaknesses as well as the opportunities and threats posed by the environment within which it operates.

Start by looking at the company's strengths and weaknesses, such as its existing product range, fixed asset base, and human resources and managerial capacity. Then follow by discussing the opportunities and threats in its operating environment.

You might examine issues such as its competitors, changes in demand for the company's products and services, and the effect of technological change on the company and its products. This isn't an exhaustive list, just examples to stimulate ideas. Items can appear under more than one heading: A weakness in one section can be an opportunity elsewhere.

Include any comments or items of interest you discover while creating a SWOT list.

## Quantitative Analysis

This section focuses on the analysis of the company using the SSG and ratio comparisons. Make sure to research and explain any unusual numbers or patterns, or figures that are significantly below or above industry averages.

The following table lists what to consider when filling out the SSG and comparing ratios:

### SSG Section 1: Growth Rates

- Provide opinion on quality of historical growth.
- Estimate future growth; explain reasons for forecast.
- Explain unusual occurrences and outliers in Section 1 graph (dips, spikes, deficits, changes in growth rates).

### SSG Section 2: Management

- Provide opinion on Section 2 numbers and trends.
- Explain any unusual occurrences and outliers; compare with industry numbers.

### SSG Section 3: P/Es

- Provide opinion on historical P/Es and outlook for future.
- Explain any outliers and decisions on averages.

### SSG Section 4: Risk and Reward

- Explain choice of high and low P/E.
- Explain choice of low EPS and low price.
- Consider relative value.

### Ratio Analysis

- Explain ratios chosen.
- Compare ratios with industry data.

## Investment Recommendation

Summarize the reasons for your recommendation, including categories such as:

- Not a good company.
- Buy (at what price?).

- Hold but watch for changes; these include dropping profit margins and market share.

## Creating a Standard Document

If you take the time to define standards, you can create an electronic template to provide stock studies with the same headings and paragraph styles. Visual consistency of documents helps me find the information I want from study to study.

The instructions in this section are based on Microsoft Word 2000. Similar features are available in other programs as well.

The fastest way to create standard documents in Word is to build outlines. Click **Outline** in the View menu, then use the **Promote** and **Demote** icons on the far left side of the Outlining toolbar (shown in Figure 1 below) to create and organize headings. To add content paragraphs, click the **Demote to Body Text** icon next to the **Promote** and **Demote** icons. Outlining in Word is a fabulous way to create document drafts because you can rearrange topics easily.

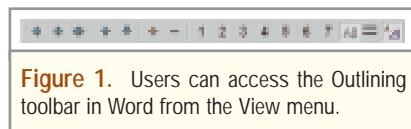


Figure 1. Users can access the Outlining toolbar in Word from the View menu.

You can save your standard document as a Word document. Later, when you open this document to start a stock study, click **Save As** on the File menu, then save the file with the name of the stock study to avoid overwriting your standard.

## Creating a Template

As someone who regularly forgets to send attachments with e-mails, I prefer to use a Word template. With a Word template, there's no chance of mistakenly saving a specific stock study into your standard document. Keep your custom templates in a special folder on your computer.

With your current guidelines in place in the document, click **Save**

**As** in the File menu. To create a new folder for templates, click a drive or folder in the Save in box where you want to add the template folder.

Click the **New Folder** icon (a folder with an asterisk at the top) in the toolbar in the Save As dialog (shown in Figure 2 below). Type the name of the folder in the Name box in the New Folder dialog. When you click **OK**, your new folder is selected. Now enter a name for the stock study template in the File Name box. Most importantly, in the Save File as Type box, click **Document Template (\*.dot)** before clicking **OK**.

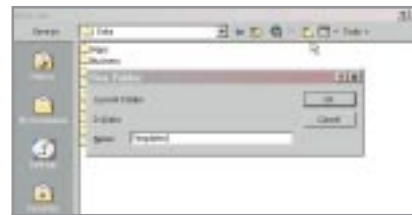


Figure 2. To save templates in a special folder, click the New Folder icon in the Save As dialog.

To access a template, click **New** in the File menu. Do not click the New button in the toolbar. When it's time to save the document, just click **Save** in the File menu and give the document a new name.

## Link of the Month

In February, I mistakenly said that you couldn't get *The New York Times* crossword puzzle online. At [www.nytimes.com/diversions](http://www.nytimes.com/diversions), you can click **Classic New York Times Crossword Puzzle** to work on a puzzle from the online archives. You can complete these puzzles only online, but it's free. For \$19.95 a year, you can get the daily and Sunday puzzles, access ones in the archives and download puzzles. ■



Bonnie Biafore, NAIC Chapter director in Denver, writes and teaches about investing. She wrote the *Complete Idiot's Guide to Online Personal Finance* (MacMillan, 2000).