

LEX Investors

Take a Portfolio Snapshot with PERT

by Ralph L. Seger, Jr., CFA



The Stock Selection Guide is the “tool of great price” for all NAIC investors, the chief guide for building their portfolios. Once shares have been purchased, though, portfolio management becomes just as important to investment success as identifying prospective stock picks. Which holdings are doing well? Which ones should you keep? Which stocks do you sell?

Portfolio Evaluation Review Technique — PERT — is the NAIC tool for systematically tracking the financials of stocks in a portfolio. The LEX Investors of Lexington, Neb., recently sent *Better Investing* a mid-2003 PERT report (*next page*) that illustrates how useful the tool can be. Founded in September 1995, the all-women club invests chiefly to learn, with profits a secondary concern. Like many other club investors, the 15 members have a difficult time deciding when to sell.

Editor's note: Don't be overwhelmed by all the numbers. Take the time to understand one column at a time and you may be surprised at how helpful some of the information may be to you in your investing.

Getting Started

To generate a PERT report with a computer, an investor must have for each stock in the portfolio a recent SSG file, typically created in either Toolkit, Classic Plus or Stock Analyst software. The decisions and judgments made with the SSGs carry forward into the PERT file.

In the accompanying example using Toolkit software, columns F through O (*see bottom of PERT report*) display quarterly results. Columns P through AB are a continuation of the SSGs in tabular form.

LEX Investors

Company	No. Shares*	Cost	Oct. 28, 2003 Price	Value	Gain/ (Loss)	%Gain/ (Loss)	Quality Rating**	Growth Estimate***	% of Portfolio
Citigroup Inc.	31	\$1,407	\$47.08	\$1,459	\$52	4%	1	10%	4.1%
Claire's Stores, Inc.	51	910	37.91	1,933	1,023	112	1	14	5.4
ConAgra Foods, Inc.	119	3,107	23.36	2,780	(327)	(11)	1	5	7.8
Exxon Mobil Corporation	62	2,484	37.97	2,354	(130)	(5)	2	5	6.6
Harley-Davidson, Inc.	30	1,637	43.41	1,302	(335)	(21)	1	13	3.7
Hewlett-Packard Company	105	3,224	21.34	2,241	(983)	(31)	2	5	6.3
The Home Depot, Inc.	24	946	36.41	874	(72)	(8)	1	13	2.4
Level 3 Communications, Inc.	14	1,256	5.21	73	(1,183)	(94)	5	?	0.2
Lowe's Companies, Inc.	20	951	58.75	1,175	224	24	1	20	3.3
Medtronic, Inc.	40	2,013	46.61	1,864	(149)	(7)	2	14	5.2
Microsoft Corporation	60	2,154	27.16	1,630	(524)	(24)	2	7	4.6
Office Depot, Inc.	45	1,070	14.45	650	(420)	(39)	2	6	1.8
Pfizer Inc.	145	2,489	31.12	4,512	2,023	81	1	15	12.7
Wal-Mart Stores, Inc.	103	1,682	57.98	5,972	4,290	255	1	12	16.8
Walgreen Co.	50	1,553	34.01	1,701	148	10	1	14	4.8
Wells Fargo & Company	68	2,837	54.70	3,720	883	31	1	13	10.4
Cash		1,406		1,406					3.9
TOTAL		\$31,126		\$35,646	\$4,520	15%			100.0%

* Rounded to the nearest full share.

** Based on rankings published monthly in *Standard & Poor's Stock Guide* or as estimated by the author.

*** EPS growth over the next 3 to 5 years as estimated by the author, with data from Value Line. (A question mark signifies uncertain growth prospects.)

DIV	COMPANY	% YLD	EST EPS	EPS			SALES		PRE-TAX PROFIT			TRAILING 12 MOS EPS		CUR P/E	PRICE	RV	5 YR AVE P/E RATIO			EST GROWTH RATE EPS	P/E AS % OF GROWTH RATE	US/ DS	% COMPO ANNUAL RATE OF RETURN	EST FIVE YEARS	
				QTR END	\$	% CHG	MILL \$	% CHG	MILL \$	% SALES	% CHG	\$	% CHG				HI	AVG	LOW					LOW PRICE	HIGH PRICE
0.70	Citigroup	1.5	3.35	03/03	0.76		18,150.0		601,066	3,311.7%		3.02	13.5	45.22	85.4	20.2	15.8	11.0	122.6	3.1	19.3	27.1	102.2		
				03/02	0.74	2.7%	17,798.0		5,772.6	32.4%		NMF		06/17/03		11.3									
0.16	Clares	0.5	1.28	07/02	0.31		238.7		23,315.8	9,767.8%		1.16	24.4	31.13	162.6	19.2	15.0	10.0	244.0	0.9	10.1	11.5	49.2		
				07/01	0.03	933.3%	221.3		2.3	1.0%		NMF		06/17/03		10.8									
0.06	Clayton Homes	0.5	1.00	12/01	0.22		306.9		48,297	15,737.1%		0.92	12.7	12.73	90.0	18.3	14.2	9.0	141.0	2.7	15.	8.1	25.1		
				12/00	0.19	15.8%	296.4		41.6	14.1%		NMF		06/17/03		10.0									
0.95	Con Agra	3.8	1.57	11/01	0.36		6,415.0		27,730.9	432.3%		1.47	16.2	25.33	96.3	20.4	16.8	6.5	248.9	2.0	13.9	17.4	41.0		
				11/00	0.23	56.5%	6,437.0		195.1	3.0%		NMF		06/17/03		13.2									
0.92	Exxon Mobil	2.5	2.03	06/02	0.60		52,500.0		67,289.0	128.2%		1.91	18.3	37.20	78.5	25.1	21.8	6.5	281.3	8.0	10.8	34.9	55.5		
				06/01	0.30	100.0%	38,740.0		3,263.1	8.4%		NMF		06/17/03		18.5									
0.14	HARLEY-DAVIDSON	0.3	2.19	12/02	0.50		1,035.6		231,036	22,309.7%		1.90	19.1	42.00	64.0	37.1	29.9	15.5	123.5	99.9+	28.5	43.1	145.1		
				12/01	0.39	28.2%	894.4		161.7	20.3%		NMF		06/17/03		22.7									
0.00	Hewlett Packard	0.0	.95	01/03	0.29		17,877.0		11,647.3	65.2%		0.86	22.9	21.89	85.6	37.2	26.8	11.0	208.5	2.9	17.7	12.5	49.5		
				01/02	0.23	26.1%	19,597.0		917.6	4.7%		21.1%		06/17/03		16.4									
0.21	Home Depot	0.6	1.86	04/02	0.36		14,625.0		1,340.9	9.2%		1.56	18.0	33.43	45.4	53.4	39.7	19.0	94.8	11.0	43.4	18.4	198.6		
				04/01	0.36	0.0%	14,182.0		1,347.7	9.5%		1.38		06/17/03		26.0									
0.08	Lowe's	0.2	2.37	04/03	0.52		7,445.0		654,897	8,796.5%		1.93	19.1	45.29	72.8	34.3	26.2	23.0	82.9	4.7	31.8	17.1	178.7		
				04/02	0.44	18.2%	6,471.0		549.6	8.5%		1.46		06/17/03		18.1									
0.24	MEDTRONIC, INC	0.5	1.70	07/03	0.38		2,040.0		66,239.4	3,247.0%		1.47	29.6	50.31	75.6	48.8	39.2	15.5	191.2	10.1	23.3	41.4	140.5		
				07/02	0.32	18.8%	1,714.0		557.7	32.5%		NMF		07/16/03		29.6									
0.00	Microsoft	0.0	1.03	12/02	0.26		7,741.0		40,917.1	528.6%		0.94	25.2	26.08	54.0	62.9	46.7	10.0	252.2	99.9+	29.5	40.3	95.0		
				12/01	0.23	13.0%	6,585.0		3,654.4	55.5%		NMF		06/17/03		30.5									
0.00	Office Depot	0.0	1.10	03/03	0.32		3,200.0		154,257	4,820.5%		0.98	13.6	15.02	75.7	25.6	18.0	12.5	109.0	3.3	24.7	5.9	45.3		
				03/02	0.32	0.0%	3,022.0		151.9	5.0%		0.91		06/17/03		10.4									
0.52	PFIZER INC	1.4	1.84	03/03	0.44		8,600.0		354,205	4,118.7%		1.59	19.7	36.24	55.4	44.1	35.6	15.5	127.3	9.6	32.2	25.6	138.5		
				03/02	0.38	15.8%	7,747.0		3.0	0.0%		1.36		06/17/03		27.1									
0.15	WALGREEN CO	0.5	1.15	08/02	0.24		7,235.0		395.5	5.5%		0.99	26.1	30.00	61.0	54.1	42.8	16.0	163.3	99.9+	30.5	30.9	111.4		
				08/01	0.21	14.3%	6,284.0		343.6	5.5%		NMF		06/18/03		31.5									
1.10	WELLS FARGO	2.1	3.91	03/03	0.88		196,000.0		2,363.4	1.2%		3.40	13.2	51.69	69.2	23.2	19.1	15.0	88.1	47.2	26.7	49.5	155.0		
				03/02	0.80	10.0%	174,605.0		2,109.8	1.2%		2.16		06/17/03		14.9									
0.30	Walmart	0.5	2.23	04/03	0.42		61,000.0		288,421.9	472.8%		1.96	24.7	55.12	70.7	43.7	34.9	14.0	178.2	2.9	23.1	21.2	152.5		
				04/02	0.37	13.5%	54,960.0		2.3	0.0%		1.56		06/17/03		26.1									

Stock Snapshot. This PERT report for LEX Investors displays the financial status of holdings within the club's portfolio.

(Editor's note: Data for Level 3 Communications, Inc., wasn't provided in the club's PERT report. Clayton Homes, Inc., which the club also listed as part of its portfolio, has since been acquired by Berkshire Hathaway Inc.)

Column E is estimated earnings per share about 12 months in the future. The default values are mathematical extensions of EPS based on the estimated growth rates in EPS (Column V). It's important that estimated EPS in column E be based on published analyst estimates. Good sources are *Barron's* weekly magazine and First Call as published at my.yahoo.com.

Analyst Estimates Adjusted

Simple math will adjust analysts' fiscal-year estimates to the periods ending 12 months later. Assume it's February 2004 and a company's fiscal year ends in May, three months later. It's another nine months from May 2004 to February 2005.

Assume the EPS estimate for the fiscal year ending May 2004 is \$1 and the estimate for the fiscal year ending May 2005 is \$1.17. The calculation goes as follows:

$3/12 \times \$1.00$	=	\$0.25
$9/12 \times \$1.17$	=	\$0.88
12-month estimate	=	\$1.13

In Toolkit the procedure is to left click, open Portfolio PERT and click OK, which opens the PERT report for the portfolio. Next, select Options and enter Estimated EPS. You are then presented with Override Calculated Estimates for EPS. You can then enter each stock's estimated EPS adjusted for 12 months in the future.

When entering quarterly data, round off the numbers to millions of dollars so that you don't end up with long numbers as shown in pre-tax profit (columns K, L and M) for the LEX Investors portfolio. Also, if NAIC Online Premium Services (OPS) files are used, you can be



LEX Investors. From left: Jeanette Richardson, Ginger Bode, Marian Kline, Shirley Reynolds, Bev Fellers, Jane Hibberd, Muriel Shea, Mary Hodges, Marge Kopf, Carole Philpot, Jeanne Kelly and Lynette Phillips. Not pictured: LaVere Brinkman, Sally Leu and Pat Post.

reasonably confident they were updated within seven to 14 days of the company's latest earnings release.

Performance Measured

By reviewing quarterly percentage changes in EPS, sales and pre-tax profit (*columns H, J and M*), you can ascertain short-term performance. Pre-tax profit margin — pre-tax profits as a percentage of sales or revenues — is displayed under pre-tax profit (*Column L — difficult to see in the illustration, which has been reduced significantly in size*). Any significant decline in pre-tax profit margins calls for further investigation.

If it reflects a trend, a significant decrease in profit margin warns of declining price-earnings ratio and price. Compare the percentage change in quarterly EPS, sales and pre-tax profits with the estimated growth rate in EPS (*Column V*).

Depending on how the economy is faring at that point in the business cycle, any significant deterioration may call for some digging. The quarterly changes for **The Home Depot, Inc.**, compared with **Lowe's Companies, Inc.**, for example, may be reason for concern. Likewise, the percentage changes for **Office**

Depot, Inc., suggest changes may be in order.

Unfortunately, LEX Investors did not enter data for pre-tax profit in a consistent manner. The calculated profit margins and percentage changes therefore aren't always correct in the example.

SSG Continued

The right side of the PERT report (*columns P to AB*) is an extension of the SSGs. Estimated EPS in Column E represents projections 12 months in the future, while the calculations for columns Y through AB are for an additional four or five years in total.

The five-year average P/E ratios (*columns S, T and U*) are from the SSG files in the club's computer. The usefulness of the resulting calculations will only be as valuable as the judgments made in the SSG analysis. By striking out annual P/E ratios that don't seem to be plausible for the future, the resulting calculations of relative value (*Column R*), compound annual rate of return (*Column Z*), estimated five-year low price (*Column AA*) and estimated five-year high price (*Column AB*) will be more realistic.

For example, I see average P/E ratios of 39.7 for The Home Depot, Inc., 39.2 for **Medtronic, Inc.**, 46.7 for **Microsoft Corporation** and 35.6 for **Pfizer Inc.** (*see box*). If we calculate the PEG ratios — in PERT, the P/E as a percentage of growth rate — we can easily see how unrealistic these valuations appear to be.

	Estimated EPS Growth Rate	Average P/E	PEG
Home Depot	13%	39.7	305%
Medtronic	14	39.2	280
Microsoft	7	46.7	667
Pfizer	15	35.6	237

Valuations Pinned Down

The estimated growth rates are my estimates, as opposed to the even higher figures shown on the spreadsheet for the club's portfolio. It follows as the night follows day that if the estimates for the EPS growth rates are in the ballpark, then the expected high P/E ratios are outrageous. (PEG figures of 100 percent to 150 percent are viewed by many NAIC investors as attractive valuations in the current market.)

This all gets back to the decisions made on the SSGs. Unless realistic judgment is employed, the results

for the SSGs and the PERT reports will be deceiving. The solution is to calculate each PEG ratio — the P/E ratio as a percentage of the estimated EPS growth rate — and see whether they're realistic.

When a PEG ratio exceeds 150 percent (also expressed as 1.5), it looks to me as if the investor is discounting not only the future, but also the hereafter. Using average P/E ratios that are unrealistic relative to estimated EPS growth rates will produce figures for relative value (*Column R*) suggesting stocks are reasonably priced when the reverse is true. Use future P/E ratios that are reasonable.

Problems Tagged

Some specific red flags are evident on the club's PERT report. The upside-downside ratios of **Harley-Davidson, Inc.**, and Microsoft Corporation are 99.9 to 1. That's because the current prices (*Column Q*) are less than the estimated low prices (*Column AA*). Perhaps the estimated future low prices entered on the SSGs were far too optimistic.

Level 3 Communications, Inc., has no history of earnings. It's a speculative investment. The club may also want to re-examine **Hewlett-Packard Company** — results are disappointing.

Patterns Watched

Generally speaking, when the current price of a stock falls below a conservatively estimated low price on an SSG, this pattern signals problems and a possible sell decision. Consider Cisco Systems, Inc., Lucent Technologies Inc. and Time Warner Inc. (formerly AOL Time Warner Inc.). If investors had sold these and other highfliers when the current prices fell below conservatively estimated low prices in SSGs, big losses might have been avoided.

The club shows estimated future EPS growth rates of 6.5 percent for **Exxon Mobil Corporation** and for **ConAgra Foods, Inc.** I would not disagree with these estimates.

Such modest growth rates aren't, however, likely to produce profitable investments unless the stocks can be purchased at P/E ratios that appear to allow for considerable expansion. Again, what's a reasonable P/E ratio for such a modest growth rate?

The SSG and PERT can be valuable tools for investment success. They must, however, be used with logic and reasonable expectations. ■

Ralph L. Seger, Jr., CFA, serves as chairman of Seger-Elvekrog Inc. (www.seger-elvekrog.com), a Bloomfield Hills, Mich., investment management firm. He is an NAIC trustee and a member of Better Investing's Editorial Advisory and Securities Review Committee. The opinions expressed in the article are solely those of the author and do not reflect positions of either Better Investing or NAIC.