

Deductive Reasoning Can Lead to the Correct Answer

20 Questions to Ask Before Your Club Buys a Stock

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Did you ever play 20 Questions with friends or family when you were a child? This month, I have another way of playing the game that doesn't involve guessing whether the answer is animal, vegetable or mineral.

Instead, here are 20 questions your club should be considering whenever they're thinking about buying a stock for the club's portfolio.

- **1. Has the company grown its sales and earnings per share consistently in the past?** Past results don't predict future performance, but management that's been able to constantly grow the business produce the kinds of companies that long-term investors like to own. On the Stock Selection Guide graph, these are companies that show trends of "straight and parallel" growth.
- **2. Has the company grown its sales and EPS strongly relative to its size?** A flat line is also an indication of consistent growth, so we want to see an uptrend in historical performance. The Toolkit 6 user's guide suggests a minimum of 7 percent annual growth for companies with revenues greater than \$5 billion and growth above 12 percent for companies with annual revenues below \$500 million (and minimum growth between 7 percent and 12 percent for mid-sized companies).
- **3. Are you confident that the company can grow sales and EPS at an acceptable rate over the next five years?** Here you can take a look at analysts' expectations or review what the company has to say about its future expected performance in any guidance it provides.
- **4. What are the primary drivers of growth (tailwinds)?** It can be helpful to consider what economic trends or market forces may be in place that can help the company reach its objectives. Are the same factors in place that helped the company grow in the past? What new influences may have arisen that can contribute to future growth?
- **5. What are key obstacles to growth that should be monitored (headwinds)?** Likewise, you should be aware of any hurdles that may impede the company's future growth. There are always risks in investing in stocks, but ignoring them is never wise.
- **6. Are the company's pre-tax profit margins consistent or growing?** Perhaps the best indicator of a good management team is the trend of the company's annual pre-tax profit margins as displayed in Section 2 of the Stock Selection Guide. Declining margins are a red flag and indicator of potentially serious problems. A company with stable margins throughout all economic cycles offers greater confidence that it will perform well in the future.
- **7. Are the company's pre-tax profit margins above average compared with its industry and peers?** Profit margins vary by industry, so it's wise to compare a company's margins to that of other similar businesses. If the company's margins exceed those of its competitors, it stands a better chance of performing well in economic downturns or when industry-related problems strike.
- **8. Are you confident the company can maintain or expand pre-tax profit margins over the next five years?** It can pay to look ahead and consider what factors might be in place that will enable a company to continue maintaining — or even growing — its profit margins over time.
- **9. What are the primary drivers of margin expansion (tailwinds)?** Is the company managing its costs or achieving efficiencies in its operations? Small savings in costs can greatly increase profitability.
- **10. What are problems that would cause margins to contract (headwinds)?** Are competitors putting pressure on its prices? Are raw material and labor costs under control? Small increases in the costs of doing business can greatly impede profitability.
- **11. What competitors should be reviewed and monitored?** Know who the company's key competitors are, both the longstanding rivals and brash upstarts. Occasionally you might even be able to find a better investing opportunity in one of these companies.
- **12. Is the company's stock price currently selling below or close to its average price-earnings ratio?** Relative value measures the company's current P/E ratio relative to its five-year average P/E, so if the relative value is at or around 100 percent, the company may be selling at a reasonable price. (As the relative value approaches and falls below 70 percent, the stock may no longer be a bargain, since this indicates that investors have lost confidence in the stock. Further research is required.)
- **13. Is the company currently selling below or close to its projected average P/E ratio?** In your Stock Selection Guide, you set the expected high and low P/E ratios that fit your projected growth rate. Often these are lower than the company's past actual high and low P/E ratios, given the tendency of growth rates to decline as a company matures. It's a good idea, particularly for faster growing companies, to compare the stock's current valuation with its expected future valuation levels.

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- **14. At its current price, can a stock purchase support a potential 15 percent total return with more than three times the upside to downside?** Buying a great stock at an expensive price more often than not leads to disappointment.
- **15. How will the current and near-term economic climate affect this company's business?** Generally, BetterInvesting suggests staying away from companies in highly cyclical industries. These companies are not well-suited for analysis on the Stock Selection Guide. But other companies may be adversely affected by economic slowdowns, so it's important to consider how they may have performed in the last recession to give you a clue how they might perform in the next one.
- **16. How stable and competent is the company's board and management team?** You can look behind the numbers to the individuals who are responsible for the company's success and consider how long key management team members have been in place, for instance. A diverse board that includes independent directors is often beneficial to a company's long-term success. You might also review whether insiders own lots of company stock and whether they've been buying or selling lately.
- **17. Are there poorly performing holdings that should be sold or replaced in your portfolio?** Before you buy a new stock for your portfolio, it pays to give a little attention to your existing holdings. If you're holding companies about whose futures you're uncertain, perhaps now is the time to replace those stocks with better prospects.
- **18. How does the size of this company fit with the other holdings in your portfolio?** Many investment clubs make the mistake of overloading on large-company stocks, which drags down their overall performance. If a stock is yet another large-cap in a portfolio dominated by larger companies, reconsider your decision.
- **19. How does the industry group of the company fit with other holdings?** Another common mistake that clubs make is focusing too heavily on consumer-related stocks and brand-name companies. Diversify by industry so that you include many different types of companies and so that you don't overload in any particular sector. Those who overloaded on technology stocks before the dot.com crash of 2000 learned the hard way that it doesn't pay to concentrate in any sector. As of Dec. 31, the Nasdaq Composite Index has still not returned to the all-time high it reached in March 2000.
- **20. Would buying this company improve the overall quality and return of the club's portfolio?** Unless the answer is a clear "yes," then perhaps you should consider other possible investments. Invest with confidence whenever you're faced with a purchase decision. Those nagging doubts at the back of your mind are not to be ignored and are signals that further research may be a good idea before making the buy motion. **B**