BETTERINVESTING
Rocky Mountain Chapter

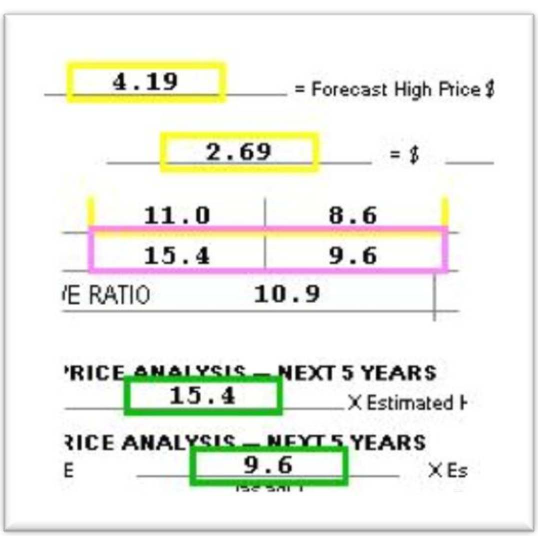
CELEBRATING 50 YEARS OF SERVICE: 1962 - 2012
JUNE 2012 e-NEWSLETTER

COMING EVENTS

> **Introduction to Investing**, 9am – noon, Sept 8, Christ Church United Methodist
> Stock Selection Guide - Learning the Basics, 9am – noon, Sept 22, Christ Church United Methodist
> Fall Investor Forum, 8:30am – 4pm, Oct 6, Colorado Christian University
> Toolkit Mechanics: Navigating Toolkit, 9:00 – noon & **Applied Toolkit Lab**, 1 - 3pm, Oct 20, Colorado Christian University
> Judgment on the SSG, 9am - noon Nov 3, Christ Church United Methodist,
> Advanced Toolkit: **Reports, Portfolios, Libraries** 9am -noon**,** & **Research Resources on the Internet** 1 – 3pm, Nov 17

TOOL TIPS

When using Toolkit 6, you see boxes bounded by colors. The color of the boxes provides important clues for actions to perform.



Yellow indicates areas that can be edited;
Magenta indicates an area that will display a graph when it is selected;
Green indicates areas where you must apply judgment.

A GOOD SSG NEEDS GOOD DATA

Valid and accurate SSG's can only be created by using suitable and timely **normalized financial data**. Normalized data is data that has been **adjusted** by a qualified analyst to eliminate the effects of unusual and nonrecurring events. Eliminating the effects of these events, gives a **truer picture** of the possible future performance of a company. The other class of data is **"as-reported"** data. As-reported data has not been adjusted and may not yet have been reported to the SEC. In fact, the quarterly data that is as-reported to the SEC isn't even audited. Thus this data is subject to change and uncertainty and may not be suitable for creating valid SSG's.

The National Association of Investor Clubs (NAIC), now known as Better Investing (BI), was created in 1951. At that time, the one and only source of normalized data available to the public was the **Value Line** Reports. Subscription to these reports has always been quite expensive; however, they have been made available through many public libraries. As a result, the Value Line Reports were adopted as the source for creating SSG's. Unfortunately, there are a number of areas where the data from these reports are either unsuited or less then optimum for creating SSG's. But, since there was no other source available, these shortcomings were ignored and now most BI members are not even aware of these deficiencies and blindly use this data.

It wasn't until nearly 50 years later in 2000, that normalized data created specifically for SSG's was made available to BI members. That is when BI contracted with S&P Compustat to provide the data on disks which were mailed every quarter to BI subscribers. Later, the data was made available on line over the internet and even later the contract was changed to **Morningstar** which is the current provider.

The Morningstar data has been **designed specifically for the SSG** and is superior to the Value Line data for creating SSG's in many ways. First, with the advent of the Toolkit software, the data can be **automatically and instantaneously downloaded** into the Toolkit software making it much more convenient, reliable and faster than the Value Line data which must be manually keyed into TK. The Morningstar data is also much timelier in that it is updated daily whereas the Value Line data is updated only every 13 weeks and added to that is the publication time. In addition, the time of Value Line's updating are not synchronized with the company's financial reporting dates which mean that the **data can be up to six months old** when published.

The estimated future high price on the back of the SSG is calculated by multiplying the estimated future high P/E times the estimated future high earnings per share. It is important that these estimates be realistic and conservative. Value Line provides future high price information which can be used as a second opinion for high price. However, it must be understood that Value Line's definition of future High Price is different from that of BI. What Value Line calls "High Price" is an optimistic value which is their estimate of the maximum **upper boundary** of the future high price. What Value Line calls "Low Price" is their estimate of the **lower boundary** for the future high price. An **average** of these two Value Line projections is more in line with BI's definition of high price.

Also, the growth rate projections on the Value Line reports are those of a single Value Line analyst acting pretty much on their own whereas the growth rate projections from the Morningstar data is the **composite average estimate** of all financial analysts from all financial institutions which monitor the stock. One additional difference which affects the Value Line price projections is the starting point for the projections and this **starting point can make a big difference** in the price projection. BI provides the option of using the most recent annual data point, the most recent quarterly data point or the most recent trend line data point. However, Value Line uses an average of the most recent three years.

A very important area of the SSG is Section 3, where the signature P/E's for companies are calculated. However, Value Line data **should not be used** for this purpose for any companies whose **fiscal year end is different from the calendar year end**. This is because all companies provide financial data on a fiscal calendar and Value Line provides high and low price data only on a yearly calendar. If P/E is calculated by using price data for from one time period and earnings data from a different time period, the resulting P/E calculations **are not valid** and cannot be used for generating valid signature P/E's.

The PERT A reports (also called the Quarterly Trend Analysis/Quarterly

Trend Graph) are very important BI tools for monitoring the performance of stocks in portfolios. However, Value Line does not provide quarterly pretax data which is necessary in order to populate and create these reports.

The Value Line normalization process leaves a lot of decisions up to the individual analysts and thus results are less consistent among companies than that of Morningstar which provides rigid predefined rules that all analysts are to follow for all companies. When a company changes its makeup by adding or deleting operations to the company, the normalization process includes calculating pro forma[1] historic financial data to represent what the company would have looked like if those changes had been made in the past. Value Line provides only four years of pro forma data whereas Morningstar provides seven years of data. Also, some feel that Value Line tends to over normalize the data.

One other point, do not use or be confused by the fact that Value Line's definition of "Current P/E "and "Relative Value" are completely different from BI's definitions of these terms.

Although most Value Line data is inferior to the Morningstar data for SSG creation, the information in **Value Line's commentary section can be most useful**. This section provides a good and concise description of the company's business, its recent activities, operations, products and markets. Opinions are also provided for both the short term and long term growth potential for the companies. Other sources, such as your broker's research section and financial web sites, should also be used for these types of information. – by Ken Wood, Chapter Director

[1] *The pro forma accounting is a statement of the company's financial activities while excluding "unusual and nonrecurring transactions" when stating how much money the company actually made.*

KEY DATA DEFINITIONS

> Earnings per Share (Diluted) from Operations is the EPS used in ToolKit when downloading Morningstar data and is believed to be more representative of the longer term performance of the company. This figure excludes:

- Cumulative effect of accounting changes
- Discontinued operations
- Extraordinary items
- Special items

> Special Items are either unusual in nature or infrequent in occurrence but not both and are reported pretax. Examples include prior year adjustments which are unusual but not recurring, natural disaster losses, write-downs of intangibles, restructuring charges, among many others.

> Extraordinary Items are both unusual and infrequent and reported net of taxes. Examples include adjustments to prior years and tax carry-forwards.

BUFFETT'S WORDS OF WISDOM

"The beauty of stocks is they do sell at silly prices sometimes. That's how Charlie and I got rich."

"When we took over Berkshire, gold was at $20, and Berkshire was at $15. Gold is now at $1,600 and Berkshire is $120,000."

"If you're an investor, you're looking at what the asset is going to do, if you're a speculator, you're commonly focusing on what the stock price is going to do, and that's not our game." – Warren Buffett