BETTERINVESTING™
Rocky Mountain Chapter

MARCH 2012 e-NEWSLETTER

COMING EVENTS

>**StockTalk:** March 10th, and April 14th at Christ Church United Methodist, 9 – 10:30am.

> **ToolKit – Beyond the Basics:** March 17th, 9am to noon followed by a ToolKit Lab in the afternoon for practice and questions

> **Supercharge Your SSG With Sound Judgment:** March 31st, 9am to noon (notice date change for this class)

> **Spring Investors' Forum:** April 28th, 8:30am to 4pm, Guest speaker John Dierks

SPECIAL ONLINE OPPORTUNITIES

***The Puget Sound Chapter will be holding the last of their "Core Classes" online this month.*

> **SSG Portfolio Management**, Tuesdays, March 20, March 27, April 3 from 8- 9 pm MST with instructor Carol Theine

***The Heart of America Chapter speaks to the need for current income with*

> Master Limited Partnerships (MLPs)

This is an informative presentation by Carol Clemens on March 12th, from 7pm to 8pm MST. *MLPs are often considered as income vehicles because of generous distributions. Carol explains the advantages of MLPs and their risks.*

HIGHLIGHT: StockTalk

- Saturday, March 10, 2012
- 9:00am - 10:30am
- Christ Church United Methodist
- FEE: $10

This month we study the internet security software industry and Symantec (SYMC) in particular. With the guidance of the discussion leader, we will put together a consensus Stock Selection Guide (SSG). There is no better way to hone our skills of investing analysis than working together with a group of like-minded individuals in analyzing a company and preparing an SSG. This is a great way to learn and have fun at the same time! **REGISTER TODAY!**

WHAT'S IT ALL MEAN???

Section 2 of the Stock Selection Guide (SSG) measures the quality of company managements in two ways. Section 2A shows the pre-tax profit margins (PTPM) for the past ten years. The concept is easily understood as it is just what is left of sales revenue after all expenses are paid but before taxes are paid. But Section 2B is somewhat mysterious. It shows the Return on Equity (ROE) for the past ten years. It is the ROE that ties together the earnings growth rates, reinvestment in the business by management, dividends paid, and stock buy-backs. So the ROE is very important and the better our understanding, the better we can evaluate management's performance. Let's take a look at how it works.

We'll begin tying these different factors together by looking at the "Sustainable Growth Rate" or SGR. We know that ROE just represents the return we may get for every dollar of equity invested. So if the ROE is 20%, I expect to get back 20 cents each year for every dollar I buy in stock. That return will come from dividends and earnings growth. The dividend is a hard and fast number. The return we get from earnings growth depends upon someone recognizing the growing value of the company and are willing to pay me proportionately more for the stock.

That's capital gains and unlike dividends, it can be quite "iffy". That's the reason we pay attention to P/E ratios. While stock price follows earnings over the long haul, the actual price at any given moment is quite variable and is reflected in the P/E.

Now what if the company decides to reinvest all its earnings back into the company? All things being equal, management expects to get a return on that investment of 20 cents on the dollar too. That is a growth rate of 20%. But what if the business has already matured and the market simply will not support a 20% growth rate? What then? The company can pay a dividend, buy back its own stock, or do an acquisition or merger.

The best way to understand a concept is by illustrating it through a real life example. Let's take a look at Stryker (SYK) with the most recent Value Line report (February 24, 2012). The stock price is $53.52. The 2012 dividend is estimated to be $0.85 for a yield of (.85/53.52) 1.6%. Value Line reports the ROE is 15%. If Stryker could profitably invest ALL of its earnings back into the company, it COULD grow 15% per year. But it is already committed to paying a dividend, so 1.6% of the 15% ROE is already spoken for. So the best it could do is to reinvest all its earnings AFTER paying the dividend. Since 15% - 1.6% equals 13.4% that is the fastest it could grow.

But wait a minute! Value Line projects an earnings growth rate over the next several years of only 7%. What gives? Well, Stryker is a large, mature company and its market, in Value Line's estimation, can only support a growth rate of 7% going forward. So only (7/13.4) 52.2% of its earnings can profitably be redeployed in company growth. Value Line expects EPS to be $4.10 in 2012. Of that $4.10, $0.85 will be paid to shareholders as a dividend and $2.14 (52.2% of $4.10), will be profitably reinvested in the company. So $4.10 minus $2.14 minus $0.85 equals $1.24 which is the amount earned by the company that is free to be used to increase cash reserves, buy back stock, or acquire another company. Since only about 1 in 3 mergers actually work out profitably, stock buy backs are usually a good use of cash for investors when done ***prudently*** (*Note: The sad fact is that stock buybacks are commonly NOT done for the right reason, but to cover management's stock options instead*.). Stryker could also increase the dividend as the payout ratio is only 20.7% ($0.85/$4.10). But dividends are taxed currently while capital gains are tax deferred.

So let's assume that $1.24 earnings surplus is used to buy back stock. Well 1.24/53.52 is just 2.32% and that adds to our total return on investment. For simplicity, let's assume that stock price follows earnings strictly (neglecting the P/E ratio), then total return on investment is just 7% plus 1.6% plus 2.32% equals $10.92. See how dividends and stock buybacks can increase our total return? Looking at only cap gains, we'd only have a 7% return, but adding dividends and buybacks, our total return is increased by 56%. And all of this depends on the ROE! John Dierks will cover this topic in more detail at the Spring Investors Forum. We'll see you there!

WORDS OF WISDOM

"To be a successful investor, what you need is a successful process and the ability (or mental strength) to stick to it." – Vitaliy Katsenelson