FEBRUARY 2013 e-NEWSLETTER

COMING EVENTS

Click on class titles to register and get more detailed information.

> SmallTalk focuses on smaller companies, *FREE*, February 13th, March 18th, and April 17th via the internet using Webinar.

>Beginning ToolKit & Lab, February 23rd, 9am to Noon, $35, Colorado Christian University Computer Lab

>Applied ToolKit Lab, February 23rd, 1pm to 3pm, $10, Colorado Christian University Computer Lab (included with the Beginning Toolkit registration)

>Advanced ToolKit, March 9th, 9am to Noon, $35, Colorado Christian University Computer Lab

>Research Resources on the Internet, March 9th, 1pm to 3pm, $10, Colorado Christian University Computer Lab (included with Advanced ToolKit)

>Supercharge Your SSG with Sound Judgment, March 23rd, 9am to 12:30, $35, Christ Church United Methodist

>Portfolio Management, April 6th, 9am to 12:30, $35, Christ Church United Methodist

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PROOF OUR METHOD WORKS

The Investors Advisory Service is a team of analysts that employs the exact same methodology as taught by Better Investing. They prepare an SSG for every stock they study. The IAS publishes a monthly newsletter and once again, for the fourth year in a row, it's been named to the Hulbert Digest Honor Roll.

Quoting from the February issue of the newsletter: "For the fourth year in a row, the IAS has been named to the *Hulbert Financial Digest*'s prestigious Investment Newsletter Honor Roll. The Newsletter Honor Roll acknowledges those newsletters that exhibit above average performance in both up and down markets. The 2013 Investment Newsletter Honor Roll includes 14 letters that have exceeded the market since March 31, 2000, thus identifying newsletters that display a high level of consistency during all phases of the stock market's cycles. Hulbert began tracking the IAS's performance in the mid-1990s, so the IAS was first eligible for inclusion on their Honor Roll in 2010. That year also marked the IAS's first year on the Newsletter Honor Roll. IAS has received the honor every year since then as well, giving it a perfect four-for-four record. Since March 31, 2000, the IAS's stock picks have earned an exceptional annualized 8.9% gain through November 30, 2012, quadrupling the mere 1.9% annual return of the Wilshire 5000 Total Stock Market Index during the same period. According to Mark Hulbert, editor of the *Hulbert Financial Digest*, just 17% of all *HFD*-monitored newsletters made it onto the Honor Roll, suggesting that making it onto the list 'really means something.'"

ARE STOCKS A GOOD VALUE

We use the PE ratio to determine if a stock is a good value relative to the market, company history, and the competition. We use the PE ratio of the S&P500 Index to find if the market overall is pricey or a good bargain. But how about valuing the stock market against other investments such as bonds? The PE ratio is no help here because bonds don't have a PE to compare against stocks. But there is a metric that can compare bonds and stocks and their relative value as an investment. Introducing the **risk adjusted earnings yield**.

We know how to calculate the dividend yield. It's just the dividend divided by the stock price. The dividend itself is just a portion of the company's earnings. Dividing the dividend by the earnings per share gives us the payout ratio. But what if the payout ratio were 100%? That is, what if the company decided to pay ALL of its earnings as a dividend? No company actually does that, but it is a metric easily calculated and it can be measured against a bond to determine which the better investment is. Let's do some examples.

Let's look at a low risk "steady Eddie" like club favorite McDonalds (MCD) and then at a riskier "high flyer" like club favorite Apple Computer (AAPL).

McDonalds TTM EPS is $5.36 and it pays a dividend of $2.87. So the dividend payout is 53.5% and the yield is 3% at today's stock price of $94. But if it paid out ALL of its earnings as a dividend, the payout would be 100% and the yield would be 5.7%. That yield is called the "earnings yield" and can be directly compared to a bond yield to help determine the better investment. The earnings yield is a way of rolling the actual dividend and the company's growth into one convenient metric. The current 10 Year Treasury is yielding 1.9%. Which do you think is the better investment? MCD at 5.7% or the Treasury at 1.9%? It looks to be a no brainer. But wait! The stock is riskier than the bond. So we need to include a "risk premium" in our calculations. For a "steady Eddie" like McDonalds, a risk premium of 3% is usually believed adequate. So let's subtract the risk premium from the earnings yield to get a risk adjusted earnings yield of only 2.7%. Now McDonalds is still a better investment even though the choice isn't quite as obvious.

What about Apple (AAPL)? Apple's TTM EPS is $44.10 and the current stock price is $540. Going through the calculations, we find the earnings yield for AAPL is 9.8%. But it is a much riskier "high flyer" and gets a risk premium of 6%, twice the risk premium for MCD. So AAPL ends up with a risk adjusted earnings yield of 3.8%, still way ahead of the Treasury's yield of a meager 1.9%. Now do you see why Louis Rukeyser always advised to buy bonds when the 10 Year Treasury yields over 6% and sell under 3%? Otherwise, unless short term volatility keeps you awake at night, stocks can't be beat.

HOW SMALLTALK WORKS

Each month a small company stock will be presented and discussed. It will be evaluated objectively by a strict set of criteria including a projected rate of return of 15% or greater. Then the group will provide consensus judgment as we complete an SSG together. Next conference is Wednesday, February 13th.

Here are some of the sources we will be using, most of which may be unfamiliar to you.

- SmallCap Informer
- IAS Newsletter
- AAII Shadow Stocks
- MyStockProspector
- Morningstar Stock Screener
- ToolKit6 "Roster of Quality"

WORDS OF WISDOM

"The trait most common among successful investors is not intelligence, experience or intuition. It's discipline." – Scott O'Neil