JANUARY 2013 e-NEWSLETTER

COMING EVENTS

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

>**Introduction to Investing,** January 12th, 9am to 12:30, ***NO CHARGE***, Christ Church United Methodist

>**Stock Selection Guide (SSG) – Learning the Basics,** February 2nd, 9am to 3:30pm, $37.50, Christ Church United Methodist

>**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

>**Research Resources on the Internet,** February 23rd, 1pm to 3pm, $10, Colorado Christian University Computer Lab (included with Advanced ToolKit)

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

>**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

>**Spring Investors Forum,** April 20th, 9am to 4:30pm, $69 early and $79 late registration, Christ Church United Methodist

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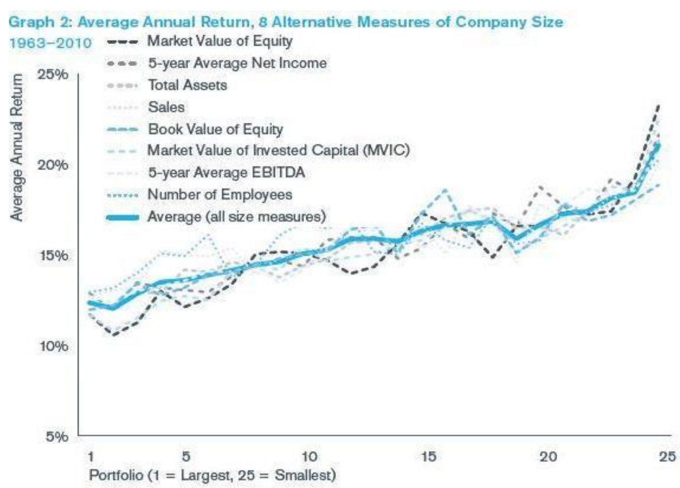
>**ALL NEW: SmallTalk (see description below), *FREE***, January 16th, February 13th, March 18th, and April 17th via the internet using GoToMeeting. **25 registrant limit. Sign-up Now!**

NEWS FLASH: *The Louisville Public Library now takes Morningstar*

COMPANY SIZE

Your Rocky Mountain Chapter is launching a new online discussion series focused on smaller, faster growing companies as covered in last month's newsletter. But what exactly is a small company? Do we classify it according to sales or capitalization (total current value of its stock) or earnings or something else?

A recent study of ways to measure a company's size shows that while there may be a number of ways, they all come down to pretty much the same thing as seen in the graph. No



matter how the company size is measured, the larger have a lesser return on average than the smaller. Remember that just because a company is small doesn't mean it is automatically a fast grower. But fast growers are more common among the smaller compared to the larger. So the smaller companies are fertile ground for finding outsized growth and return.

SMALL-CAP RISK

Smaller companies tend to be more risky than larger ones. We deal with this increased risk through judicious stock selection, requiring rates of return greater than 15%, and diversification. Of course, market risk can never be diversified away, only the risk in holding an individual stock.

As company size decreases and risk increases, it takes proportionately more holdings for proper diversification. But how many large, medium, and small holdings will we need to diversify away our specific company risk assuming we've already minimized it as much as we can by careful selection?

To illustrate, let's consider a club with 10 members who want to restrict the number of stocks each member must monitor to two. That means they can handle no more than 20 stocks in their portfolio. They will also follow the BI guide of investing 25% of their cash in large, 50% in medium, and 25% in small companies. Small might be considered 67% more risky and medium 33% more risky than large companies. We know how our cash is distributed among the size categories, but how many individual stocks do we need to hold in each to reduce risk by diversifying? No, the answer is not putting equal numbers of stock in each category or, heaven forbid, buying only one or two small companies because they are harder to research.

To answer this question, we need to do a little algebra. Let x be the number of large, y the number of medium, and z the number of small companies. Then $x + y + z = 20$

Medium may be considered 33% more risky and small 67% more risky than large companies. So $y = 1.33*x$ and $z = 1.67*x$ and our equation becomes: $x + 1.33*x + 1.67*x = 20$

Solving for x, we get $x = 20/4 = 5$. So we can have 5 large companies in our diversified portfolio of 20 stocks. Then $y = 1.33*5 = 6.65$ which rounds to 7and $z = 1.67*5 = 8.35$ which rounds to 8. This breakdown is just an illustration of how you will need proportionately more small compared to large companies to keep your portfolio diversified.

Assuming $100,000 in cash to invest, one would invest $25,000 in five large, $50,000 in seven medium, and $25,000 in eight small companies.

Is all of this extra work? Yes, but you will get an enhanced rate of return from your portfolio in exchange.

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. More details will be presented at the January SmallTalk.

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

"When we took over Berkshire, gold was at $20, and Berkshire was at $15. Gold is now at $1,680 and Berkshire is $140,000." – Warren Buffett