BETTERINVESTING™
Rocky Mountain Chapter

MARCH 2013 e-NEWSLETTER

COMING EVENTS

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

> SmallTalk focuses on smaller companies, *FREE*, March 18th via the internet using Webinar.

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

> Also, check out the new **Recordings** section of the chapter website. Lots of interesting videos of classes and events.

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HOW TO ESTABLISH A SELL PRICE

By Bill Cook with John Rogers

When looking to purchase the stock of a great company, the normal objective is to make the most accurate prediction of company performance over five years, i.e., the normal SSG. One determines the buy and sell prices by making a reasonable, balanced earnings growth estimate and looking at the history of the company (and its counterparts) to figure out what reasonable high and low average PE ratios are for the long term, occasionally eliminating obvious “outliers”. Nevertheless, there is always residual uncertainty in these choices incurring some attendant risk.

On an SSG used for a buy consideration (the buy-side SSG), former “Portfolio Workshop” columnist Ralph Seeger advised being more conservative than the normal SSG for extra safety. The market may be range bound (trendless price movement but with increasing earnings) or an outright bear (declining prices and earnings), both with PEs trending lower. Or it may be a bull market with generally higher PEs. Also, the individual sector may be in or out of favor. Such conditions may persist for many years. Choose the high and low average PEs conservatively on a buy-side SSG. Seeger suggested removing the two highest high and highest low PEs of the most recent five years in Section 3 of the SSG and many people do so regularly when considering a buy. Where reasonable, they choose lower earnings growth rates as well.

If a well-managed, thriving, growing company has performed well, and has reasonable trends on earnings and revenues, one should think about determining at **what price you think the company is so overvalued that it should be sold**. In other words, at what point has an overenthusiastic market pushed the stock price so high that you aren’t likely to make a minimum acceptable rate of return and need to lock-in your cap gain?

Already, this becomes a judgment as to what is that minimum acceptable rate of return for you (apart from the general BI philosophy of wanting to double your investment in five years from that point forward).

When considering a sell price, one should use a more **optimistic** or “sell-side SSG”. This is just the opposite of the buy-side SSG discussed above. For a good company that is performing well and which has been rewarded with higher stock prices (such as Chipotle, Roper, Fastenal, or Panera), **making a sell decision on either a normal or buy-side SSG will frequently result in selling a stock far too soon.**

In preparing a sell-side SSG for a good company, you should pick more "optimistic" growth rates than on a normal or buy-side SSG. For instance, if you used a lower Value Line earnings estimate as compared to the higher analysts' consensus estimate in the buy-side SSG that justified buying the stock in the first place, you might use the analysts' consensus estimate in the sell-side SSG. Further, you should restore any high PEs that may have been removed in the normal or buy-side SSG to make a sell-side SSG.

One source for looking at how realistic one's PEs are - look at the projected five years out average PE on Value Line (about the 8th line of data), the average of the annual high and low PEs, and space the difference between the high and low about what the typical difference is for that company).

Sometimes there is very high upside potential coupled with high uncertainty (such as Chipotle). Then one might even do a third "very optimistic" SSG. (Hint: if you are doing multiple SSGs on a stock that you want to save in Toolkit, change the company name under the data such as adding "optimistic" and change the company symbol such as adding "op" to it so that you won't write over the original.)

Here is where the acceptable rate of return comes in (and where you need to make that judgment for yourself). My sell point is when my buy SSG's rate of return (ROR) is about 7-8.5%, the ROR on my sell-side SSG is about 10-11.5%, and if I do a very optimistic SSG, the ROR is 13-14.5%. With this approach the last few years, my SSGs will generally stay consistent from one type to another (if my normal SSG is down into the sell range, then my optimistic one will also be down into the sell range with the above guidelines). Within the range, I make subjective judgments on how well I like the company, the confidence in the numbers I used, and other opportunities. Another aspect that always should be considered is what alternative investments are available and what are their RORs (challenge tree concept). A critical part of this is that your sell-side SSGs need to be updated any time your expectations change and <u>every</u> time that earnings are reported. Otherwise, you may sell before you want to (example: I updated Roper after the 4th Q report came in recently and upped my sell price).

To determine what the price will be for certain RORs, I will take my saved SSG in Toolkit and try various higher prices and see what the calculated ROR is. For instance, if my buy-side SSG on Fastenal at $46.50 gives a ROR of 11.9% and my sell-side 16.2%, I might try several values in my Toolkit SSG and determine that my sell price might be $58 which gives my buy-side SSG a ROR of 7.1% and my sell-side SSG a ROR of 11.2% (this is for an example and isn't a thoroughly researched number). A word of caution: if your Toolkit comes back and asks you if you want to save the SSG when you close it, say no - you want to keep the actual data, not the higher prices you were testing (that is why you saved the actual data earlier). I don't use the Online Tools SSG and so I don't know if you can do it this way. However, you can always take the calculated high price and the price you are testing, then determine the gain percentage and use your calculator to determine the ROR by trial and error. (Hint: if the calculated high price is 50% above the test or actual price, the ROR is 7.5%/year over five years.)

If you are looking at a company that is not a "good company", i.e. has shown poor earnings or revenues trends, has failed to meet expectations, has demonstrated poor management or treated stockholders poorly, then that is a different story - one should be looking at what you can get out of the stock with as much of your investment as possible, and you shouldn't be giving management the benefit of the doubt. If you are looking at a company that has a history of performing well and being well managed, but has done poorly for a couple of quarters apart from the economic cycle, and shows promise that they may return to performing well, that is a more difficult decision. In my experience, differentiating between a company that is impaired long term and one that has done poorly for a couple of quarters but will return to performing well is frequently the toughest decision in analyzing stocks.

As an illustration of the simpler of these ideas, consider club favorite Cognizant Technology Solutions (CTSH). This table shows the range of EPS growth rates you will find in your research. Note the wide range of values. You might choose the median value for your normal SSG (18.95%), Value Line (20.5%) for your sell-side SSG and the 15% sales growth Preferred Procedure calculated value (14.7%) for your buy-side SSG.

COGNIZANT TECH SOLN (CTSH)	
Source (5 Yr EPS Growth)	EPS Growth
Analyst Consensus	18.20%
Implied Growth Rate	26.40%
Preferred Procendue (15%)	14.70%
Preferred Procendue (20%)	19.70%
Value Line	20.50%
Yahoo Finance	17.85%
AVERAGE	19.56%
MEDIAN	18.95%
HIGH	26.40%
LOW	14.70%
RANGE	11.70%

Looking at the P/E values over the past five years, the high and low P/E ratios have varied widely. You might accept all of them for your sell-side and normal SSGs but eliminate the two highest values in each column for your buy-side SSG for an extra margin of safety.

	High P/E	Low P/E
2008	25.8	10
2009	26.2	9.7
2010	31.6	17.8
2011	29.3	18.8
2012	22.7	15.7
AVERAGE	27.12	14.4

	High P/E	Low P/E
2008	25.8	10
2009	26.2	9.7
2010	31.6	17.8
2011	29.3	18.8
2012	22.7	15.7
AVERAGE	24.9	11.8

Comparing the buy point for your normal and buy-side SSGs shows the difference. The buy point on the normal SSG is $92.80 while the buy point on the more cautious buy-side SSG is $73. Obviously, the buy-side SSG is giving you a greater margin of safety. On the other hand, the normal SSG shows a “sell” price of $179.20 while the sell-side SSG shows a sell price of $190.10, thus making it less likely you will sell too soon. Just remember that if company performance becomes suspect for any reason, you must consider a possible sell regardless of current price.

WORDS OF WISDOM

“It’s tough to remember in uncertain times like these that wealth building in stocks is a marathon, not a sprint. And the secret to superior returns – whether you’re an ultra-conservative dividend seeker or focused on aggressive growth – is methodically investing in quality companies that will grow.” - Roger Conrad, editor *PersonalFinance*.