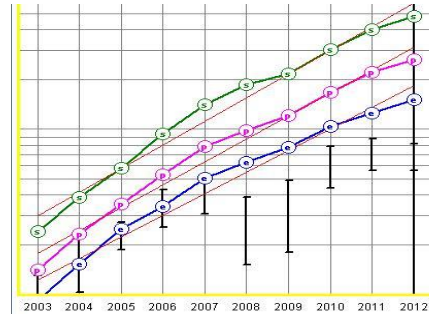
BETTERINVESTING™
Rocky Mountain Chapter



THIRD QUARTER (JULY - SEPTEMBER) 2015 eNEWSLETTER

UPCOMING EVENTS AND CLASSES:

- Fall 2015
  - **Annual Meeting with Educational Program presented by popular educator Cy Lynch (free),** Thursday, September 10 via **Webinar**
  - Introduction to Investing, CCUM, September 12
  - SmallTalk Stock Study, September 22
  - Stock Selection Guide, CCUM, September 26
  - Judgment on the SSG, CCUM, October 3
  - Starting an Investment Club, CFU, October 6
  - Mutual Funds and Exchange Traded Funds (ETF), CFU, October 7
  - **Investors' Education Day at CCU with guest speakers Avi Horwitz and Don Cassidy, Saturday, October 17**
  - SmallTalk Stock Study, Monday, October 26
  - Mutual Funds and Exchange Traded Funds (ETF), CFU, November 7
  - Starting an Investment Club, CFU, November 12
  - SmallTalk Stock Study, Tuesday, November 17

Class and Event Location Addresses

Christ Church United Methodist (CCUM) 690 Colorado Blvd, Denver Co 80206 SmallTalk Seminars via Webinar at 7pm MT	Colorado Christian University (CCU) 8787 W Alameda Lakewood, CO 80226 Colorado Free University (CFU) 7653 E. 1st Place, Denver, CO 80230

ANNUAL MEETING

Not confident about the overall quality and potential return of your portfolio? Can't decide which stock to buy more of? Not sure when you should sell a stock? In this class offered for free as part of the Rocky Mountain Chapter's annual meeting, Cy Lynch explains why it's best to make portfolio management decisions by focusing on the potential impact on your overall portfolio, rather than just looking at a stock in isolation. He'll then use practical examples to demonstrate how portfolio-centered decision-making can simplify your investment decisions and take emotion out of portfolio management, especially the dreaded decision to sell.

Cy is a respected and experienced long-term investor and contributor to educational efforts of BetterInvesting (BI) and is a sought after presenter for investing seminars throughout the country. Cy is a registered investment advisor and writes columns for BetterInvesting magazine.

INVESTORS EDUCATION DAY

The **Investor Education Day** features two long time investors, Avi Horwitz and Don Cassidy. Avi will be presenting three sessions: *The Simplified Income Statement: Preferred Procedure, Hidden in Plain Sight: Potential Company Problems, and Challenging Weak Stocks in Your Portfolio.*

Don Cassidy, author "It's When You Sell That Counts", will help us get more comfortable with selling, and recognize when it is time to sell. We may find that the real barrier to our wise and timely selling is our own emotions.

Directors from the Rocky Mountain Chapter Board will have a session discussing some of their current companies of interest.

EQUITY ANALYSIS

TAKING A CLOSER LOOK AT THE P/E RATIO

by John Rogers

The P/E ratio appears in Section 3 and 4 of the SSG because it plays two unique roles:

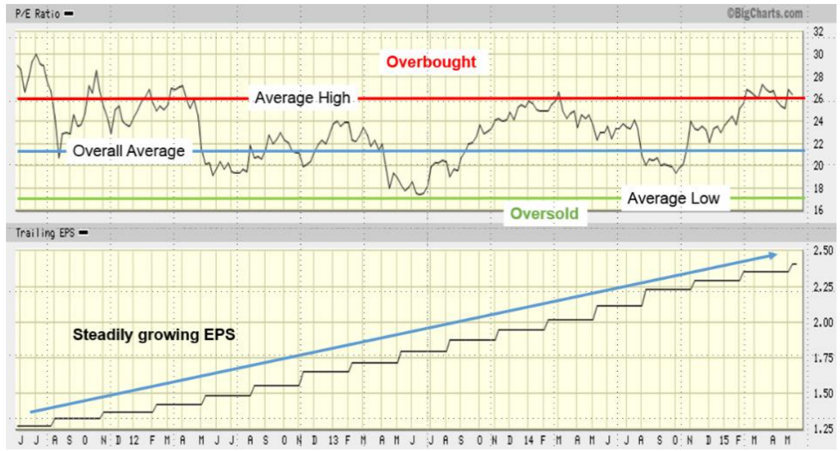
1. helping determine if the stock is currently overbought or oversold, and
2. projecting the high and low stock price over the next five years to see if it is in the buy or sell range.

As commonly defined, the P/E ratio is the current stock price divided by a year's worth of recent company earnings. The stock price changes during the trading day while the EPS changes only four times a year. So short term variations in P/E are due to price volatility.

Let's take a closer look at this key ratio and get a better understanding of the important role it plays using Cognizant Technologies (CTSH) as an example. We'll use today's (6/10/2015) data including a stock price of $64.85.

In Section 3 we see the average high and low annual P/Es of the past five years. We will use the average annual P/Es to reduce the effect of the highly variable stock price and to get a better picture of the typical P/E range for a particular company. We then average the high and low annual P/Es to obtain the average P/E over the time period of a business cycle. These are sometimes referred to as the typical or "signature" P/Es for the company. The average high and low P/Es are used to estimate a range of stock prices expected over the next five years. Averaging the high and low average P/Es yields an overall average. In this example, the overall average P/E is the sum of 26.4 (the five year average high P/E) and 17 (the five year average low P/E) divided by 2 which gives us 21.7. The average P/E can play an important role in determining a buy, hold, or sell.

High P/E	Low P/E
31.5	17.7
29.3	18.8
22.7	15.7
25.1	15.1
23.4	17.7
26.4	17.0



In these graphs, we see the P/Es of CTSH swing above and below the overall average P/E of 21.7 staying mostly within the bounds of the average high P/E and average low P/E. If the price moves outside the high/low bounds, we have a <u>grossly</u> overbought or oversold condition. Note that the steadily increasing EPS indicates a strong company. However, investors' mood can vary despite the company being sound. That volatility is just noise and it can be to our advantage. We can buy this company when oversold and avoid buying when overbought reducing risk and improving returns. Right now, CTSH appears to be overbought and very pricey.

Since the P/E ratio is simply price divided by EPS, if we multiply the P/E by the EPS, we're left with price. If you tell me the P/E and the EPS, I can tell you the price of the stock. Tell me the P/E and the lowest the EPS will ever go and I'll tell you the lowest the price the stock will ever go. Similarly for the high price. Our problem here is deciding which EPS to use as it can be defined in four somewhat different ways.

We can adopt any of the following four definitions:

1. EPS of the last full fiscal year which is the default choice and is hard data, not some nebulous future projection. Or we can use the
2. trailing twelve month (TTM) EPS which is just the sum of the quarterly EPS over the most recent four quarters and it too is hard data. The TTM EPS is generally thought appropriate for a company growing at a rate of 14% or greater. Then there is the
3. forward twelve months (FTM) EPS which is your projected EPS over the coming four quarters which may or may not come about. Some like this definition because traders typically value a stock based on what they think it is going to do in the coming year. Finally, there is the
4. Value Line "fence straddling" compromise which sums the EPS of the most recent two quarters (hard data) and the coming two quarters (projected data) for a total of four quarters.

The P/E ratio that is calculated, can also depend on the definition of the EPS that is used in its calculation. If the TTM EPS is used to calculate the P/E, we call it the "trailing P/E", TTM P/E, or just plain P/E. This definition is most commonly used by everyone and is used in our SSGs. If you calculate the P/E using the FTM EPS, you have the "projected" P/E used by ToolKit, "next year's" P/E or the "forward P/E" which you sometimes hear analysts and commentators use. Since the EPS may be expected to grow next year, the forward P/E will be less that the trailing P/E and that makes the stock look cheaper and more attractive to buy. That's the reason you hear commentators sometimes refer to the "next year's" P/E, simply because it sounds better.

Based on the projected EPS growth rate in Section 1 and the average high P/E or the overall average P/E, we can calculate two possible high stock prices in five years.

If we use the analysts' EPS growth rate of 16.6% for CTSH, we can project an EPS of $5.18 in five years. Using the average high P/E of 26.4 we will get a projected future high price of $136.75 (26.4 times $5.18) which implies a compound annualized rate of return of 16.1% assuming a current price of $64.85. This high price is used to calculate the projected price range and U/D ratio.

If we use the more conservative overall average P/E of 21.7 we'll get a price of $112.41 (21.7 times $5.18) and a projected average rate of return (PAR) of 11.6%. The latter projection reflects EPS growth alone while the former, larger number reflects both EPS growth and P/E expansion. The difference in projected high price of $24.34 ($136.75 – $112.41) is due to P/E expansion alone. P/E expansion increased our projected high price by an incredible 21.7% and our rates of return by an even more incredible 38.8%.

Note that in calculating a projected high stock price, we use a single EPS (the projected EPS in five years) but two different P/Es (the average high P/E and the average P/E).

Unlike the projected high price, SSG Section 4B(a) calculation of the low anticipated price uses one P/E (the average low P/E) but gives us options (see above) on which EPS to use. This choice of EPS is important as it determines the price range. Because options 1 and 2 are historical data, they are the ones almost universally recommended with option 1 considered the default. ToolKit6 does give you the choice of overriding the default and using the TTM EPS, the FTM EPS or the average of the two which is similar to the "fence straddling" Value Line option. The online SSGPlus gives you the choice of option 1(the default) or option 2.

Option	EPS
1. Fiscal Yr	$2.35
2. TTM	$2.41
3. Avg TTM + FTM	$2.60
4. FTM	$2.80

Returning to our example company, the default EPS is $2.35 since that was the EPS for the last full fiscal year 2014. The TTM EPS is $2.41 which is generally preferred when analyzing a strong growth company like CTSH. However, another choice that Ralph Seeger, the former host of Better Investing magazine's "Repair Shop", recommended is using the FTM EPS. He believed, with good reason, that professional investors tend to value stock on next year's earnings. They focus on what the company <u>will</u> do, not what it has done.

Let's examine the effect of our EPS choice on the predicted low price. We've used a projected high price of $136.75 representing both P/E expansion and EPS growth. Recall that the U/D ratio depends upon our projected high and low price and on the current price. As you can see in this table, depending upon our choice of EPS, the U/D can vary between a low of 2.89 (hold) to a high of 4.17 (buy). At $64.85 (P/E 27), the stock is in the buy range when using the TTM EPS since the U/D is greater than 3. But note that the stock is selling at a P/E of 27 which is above the overall average of 21.7 and even slightly higher than the average high P/E of 26.4. This presents us with a conundrum we'll discuss later.

Average low PE = 17 & Current Price of $64.85						
EPS TYPE	EPS	Projected Low Price	Projected High Price	U/D Ratio	Buy Below	Buy PE
Last Fiscal Year	2.35	$39.95	$136.75	2.89	$64.15	26.62
TTM EPS	2.41	$40.97	$136.75	3.01	$64.92	26.94
AVG TTM + FTM EPS	2.60	$44.20	$136.75	3.48	$67.34	27.94
FTM EPS	2.80	$47.60	$136.75	4.17	$69.89	29.00

What if we used the alternate high price of $112.41 calculated using the overall average P/E of 21.7? Without the P/E expansion and depending on EPS growth alone, the stock is overpriced at $64.85 no matter which EPS we choose. Neglecting P/E expansion forces you to take a much more conservative attitude with your investments. Note how the U/D ratios, buy prices, and buy P/E ratios have all come down. Both ToolKit6 and SSGPlus assume a projected high price including both P/E expansion and EPS growth, but you can override the defaults and enter your own high price projection based on earning growth alone if you wish.

Average low PE = 17 & Current Price of $64.85						
EPS TYPE	EPS	Projected Low Price	Projected High Price	U/D Ratio	Buy Below	Buy PE
Last Fiscal Year	2.35	$39.95	$112.41	1.91	$58.07	24.09
TTM EPS	2.41	$40.97	$112.41	1.99	$58.83	24.41
AVG TTM + FTM EPS	2.60	$44.20	$112.41	2.30	$61.25	25.42
FTM EPS	2.80	$47.60	$112.41	2.76	$63.80	26.47

Many investors will require the buy price to meet not only the 3:1 U/D criteria but also that the current price P/E be at or below the overall average P/E. Using the current price of $64.85 and the TTM EPS of $2.41, we get a current P/E of 27 which is far above our overall average P/E of 21.7. What price would a buyer entertain using this new criteria? Well, using the TTM EPS and the overall average P/E, we get a buy price of only $52.30 ($2.41 times 21.7). This is a very conservative approach, but it is in common use.

In ToolKit6, we keep a portfolio of stocks presented in the chapter's "Small Talk" webinar series. One of those is Air Lease (AL) which has a current U/D of 6.3 and a Total Return of 25.5% which should make it a screaming buy. But it isn't awarded a "buy recommendation" in ToolKit's "Portfolio Summary" because the current P/E is 18.6 which is higher than the long term average P/E of 16.7. Now 18.6 is only 11% greater than the average P/E of 16.7. It all depends upon your risk tolerance. Can you take on a bit more risk to own a stock promising a return of over 25%? It's your choice and a very personal one at that.

It does pay to be cautious but remember that if you're too cautious, you may miss some great opportunities. Better Investing's "1 in 5 rule" states that of five stocks acquired using the BI method, one will a noticeable outperformer, one an underperformer, while the others roughly match the projections. But that one winner makes the whole portfolio. The trouble is that you never know which of the five the winning one is. And that's why we invest in a diversified portfolio of stocks.

DID YOU KNOW THAT… Winning with Dividend Growth

According to Ned Davis Research, publicly traded companies paying a dividend returned 10.1% compared with just 4.1% for non-dividend companies between 1972 and 2006.

What's more, during periods when the market declined between 1970 and 2000, dividend stocks outperformed non-dividend-paying stocks by a 1.5% margin *every month*.

"Dividends aren't about Wall Street. Dividends are about you, the actual shareholder. They do provide a practical source of cash to fund portfolio withdrawals during retirement, but they also drive total returns for investors of all ages and goals. Bypassing the ups and downs of the stock market, dividends provide a tangible link between the shareholder and the profits of the actual businesses he or she partly owns. Dividends provide a reflection of the quality of a company, its management, and the value of its shares. No dividend is guaranteed, but the best dividends—those that are large, reliable, and grow over time—create a powerful core for anyone's portfolio." – **Josh Peters, Morningstar analyst and editor of *DividendInvestor*.**

WORKING TOGETHER

The Rocky Mountain Chapter board of directors see their main duties as 1) supporting clubs and individuals, and 2) providing quality education for everyone. All directors are unpaid volunteers who want to "give back" for the support they've received in the past. The board meets monthly over the internet using GoToMeeting. But the chapter has the special challenge of providing for a membership spread across Colorado, Utah, Wyoming, and the northern 2/3 of New Mexico. If you live in one of these areas, please volunteer to become a contact for those in your area. For more info email our chapter president.

BRINGING MEMBERS AND CLUBS TOGETHER

The Find-A-Club program has been in place since 2008. Its goal is to match people looking for clubs with clubs looking for people. Over time we came to realize that the specific objective of matching people with clubs for the purpose of expanding club membership was a problem. Generally, it's an activity that the SEC does not condone because of the potential for abuse. Even though it is highly unlikely that the SEC would ever prosecute an investment club, we were overly cautious regarding program design and operation, which made the program difficult to use. The Find-A-Club needed to be replaced.

BetterInvesting teaches people how to become successful long term investors. That's our mission. So it is totally acceptable (and desirable) for clubs to publicize that guests who want to learn about investing and investment clubs are welcome to attend club meetings to learn more. So, a new program, **Visit-A-Club,** was born.

The Rocky Mountain Chapter will rollout the Visit-a-Club program this summer. To participate in Visit-A-Club, contact j.loken@rmchapter .org. More information as it becomes available.

WORDS OF WISDOM

"Investments that are denominated in a given currency include money-market funds, bonds, mortgages, bank deposits, and other instruments. Most of these currency-based investments are thought of as “safe. In truth they are among the most dangerous of assets. Their beta [i.e., volatility] may be zero, but their risk is huge." – **Warren Buffett**