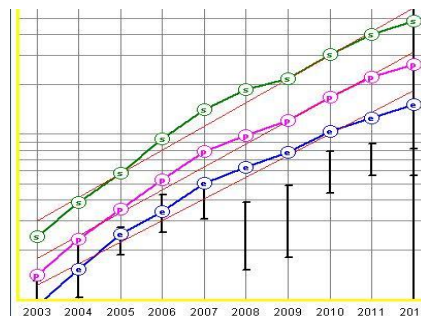




FIRST QUARTER (JANUARY - MARCH) 2016 eNEWSLETTER

UPCOMING EVENTS AND CLASSES (all times are MT):

- Winter - Spring 2016
 - Introduction to Investing (Free), January 9, 9am – 12:30pm, CCUM
 - Stock Selection Guide (SSG), January 16, 9am – 3pm, CCUM
 - SmallTalk Stock Study, January 19, 7pm -- 8pm via Webinar
 - Judgment on the SSG, February 6, 9am – 2:30pm, CCUM
 - Mutual Funds and ETFs, February 10, TBD, CFU
 - SmallTalk Stock Study, February 16, 7pm – 8pm via Webinar
 - Portfolio Management, March 12, 9am – 12:30pm, CCUM
 - SmallTalk Stock Study, March 15, 7pm – 8pm via Webinar
 - Mutual Funds and ETFs, March 20, TBA, CFU
 - Why Invest in Stocks, April ???, 7pm to 8pm, Smoky Hill Library, Room B
 - Why Invest in Stocks, April ???, 6:30pm – 7:30pm, Eloise May Library, Room B
 - SmallTalk Stock Study, April 19, 7pm – 8pm via Webinar



Class and Event Location Addresses

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

EQUITY ANALYSIS

How Small Is Small?

By Doug Gerlach

Defining Size by Market Cap

There are three primary ways of determining the size of a public company. The first, and perhaps the most common, is by the **market capitalization** of the company, determined by multiplying the number of shares of stock that are outstanding by the price of those shares of stock.

One problem with measuring company size using market cap is that it incorporates a large measure of investor sentiment into the calculation. Companies that are liked by investors will have higher market caps than companies that are unloved (all other things being equal).

For instance, the list of the largest companies in the U.S. and Canada ranked by capitalization includes Twitter Inc. (TWTR) at around position #350. With a market cap of \$24.0 billion, one could assume that this company is a big, established operation that's making plenty of money for shareholders. In reality, Twitter had revenues of \$665 million in fiscal 2013 and lost money to the tune of \$1.79 per share.

Yes, Twitter is an emerging business, and yes, it has significant "mind share" in the social media space, but the company has not yet figured out how to build an ongoing enterprise. Some investors are obviously betting that the company will start making money in the not-so-distant future, driving up the valuation of the business.

But when compared by market cap, Twitter's next closest peer, just up one position on the list cited above, is a pretty well-known global business called Sony Corp. (SNE), which has a market cap of \$24.2 billion and 2013 sales of \$77.5 billion. Yes, Sony hasn't been a "growth stock" in a decade, and yes, Sony also lost money in 2013 in the neighborhood of \$1.2 billion, but the Twitter/Sony comparison illustrates the problem with market cap. Companies are pegged by a value that doesn't tell investors whether a company might be in the ascendency or in the descendancy.

Move another twenty or so places down the list of largest companies and you'll find Dollar General (DG) with a market cap of \$21.2 billion. Unlike Twitter and Sony, Dollar General actually makes money consistently; on 2013 sales of \$14.5 billion, the company earned \$1.0 billion in net income, or \$3.17 a share for stockholders. By market cap, though, the company is valued lower than the value of Sony or Twitter.

For all the negatives of using market capitalization as a method of defining company size, it's the de facto standard on Wall Street, perhaps because it's an easy number to calculate, but perhaps as well because Wall Street doesn't care much about fundamentals, so measuring a company by its popularity is good enough for them.

The generally accepted definition of company size by capitalization is that *small-cap* stocks have market caps below \$2 billion. (Companies currently tracked by the **SmallCap Informer** max out at a market cap of about \$2.5 billion.)

Large-cap stocks have market caps above \$10 billion, with mid-caps falling in between small and large. *Micro-caps* have market caps between \$50 million and \$300 million, with *nano-caps* coming in below \$50 million. On the other end of the scale, *mega-caps* have market caps above \$200 billion. (A reminder: these definitions are general in nature and are frequently modified by mutual funds, indexes, financial advisors, and data services according to their own methodologies.)

If you look at companies in the Russell 2000 stock market index, however, you'll see companies that have much higher market caps than \$2.0 billion. This is because the Russell 2000 Index includes the smallest 2000 companies of the 3000 largest companies in the US markets. You might need to read that sentence twice to grasp its

full meaning; the Russell 2000 does not include the 2000 smallest companies in the U.S., or even the 2000 smallest according to some fixed definition.

This method of determining stocks for the Russell 2000 Index is why Russell's definition "small-cap stocks" is actually growing over time. According to The Royce Funds, in 1995 the largest company in the Russell 2000 Index had a market cap of \$750 million. At the end of May 2012, when the Index was reconstituted, its largest stock had a market cap of \$2.6 billion. That's quite a difference in size.

Today, the weighted average market cap of the Russell 2000 is \$1.1 billion. By comparison, the smallest company in 2012 in Morningstar's Small-Cap category had a capitalization of \$712 million while the largest was \$2.4 billion.

Defining Size by Revenues

In an attempt to overcome the limitations of defining company size by market capitalization, another method has been used and popularized by BetterInvesting (formerly the National Association of Investors Corp., NAIC, which is also the parent of the **SmallCap Informer's** publisher).

BetterInvesting teaches its members that diversifying a portfolio of stocks by company size is one way to help improve the reward-to-risk potential of an investor's holdings. Large company stocks grow more slowly but are more stable than smaller stocks, while smaller company stocks grow more quickly but are more volatile than larger stocks. Combining them both in a portfolio helps balance out returns over time. Midsized companies are in the sweet spot, offering both growth and a measure of stability and should make up the largest part of the portfolio of an investor seeking long-term capital appreciation.

BetterInvesting's method of defining companies is to look at the level of their revenues, either in the last fiscal year or the trailing twelve months. In their instructional manuals beginning in the early 1990s, midsized companies were defined as having annual revenues between \$400 million and \$4 billion (with small and large defined accordingly). By the mid-90s, these breakpoints had grown to \$500 million and \$5 billion, where they have remained for the past twenty years.

In the mid-2000s, some of ICLUBcentral's club and stock analysis tools, such as myICLUB.com, StockCentral.com, and Toolkit 6 for Windows, used the above definitions and also added categories for micro stocks (revenues below \$100 million) and mega stocks (revenues above \$15 billion), in an effort to help steer investors away from these more speculative (on the lower end) and more slow-growing (on the upper end) companies.

The problem with a static definition of company size is that \$500 million today just doesn't go as far as it did twenty years ago. Many long-term oriented, growth stock investors find it hard to discover smaller companies that have the right growth and value attributes but are within the \$500 million sales limit.

In fact, according to the U.S. Bureau of Labor, \$500 million in 1995 has the same buying power as \$782 million in 2014. It's become clear that a revision to this definition is in order, and that small companies should probably be defined as those that have annual revenues below \$750 or \$800 million, with large companies having annual revenues above \$7.5 or \$8.0 billion. These new definitions are being rolled out in many of ICLUBcentral's software and web-based tools.

Defining Size by EPS Growth Rate

A third possible definition of company size is to consider the long-term or projected EPS growth rate of a company. As far back as 1971, BetterInvesting (then NAIC) published a recommendation that defined large companies as having 5-7% EPS growth a year, smaller companies growing EPS 12% and up annual, and midsized companies showing EPS growth in between at 7-12%.

This method has the advantage of focusing on the key consideration of a growth stock portfolio—*the growth of earnings of the component companies*. Some large companies when defined by revenues or market cap may have outsized EPS growth rates; likewise, some smaller companies may be growing at puny rates that won't serve an investor's overall total return goals as they should.

Over the long-term, a stock's minimum rate of capital appreciation will approximate the growth of its profit. Dividends will add another boost to returns, as will smart purchases at lower P/E ratios that are typical for a company. (This is how you can invest in a large-cap company that is growing at 7% a year and still achieve a double-digit return over time.)

But it's the earnings power that is the largest part of a stock's potential return. By focusing on the expected overall growth rates of the stocks in a portfolio an investor can improve his or her return.

In the investment club portfolio clinics that I conduct around the country, I suggest that clubs calculate the *average weighted growth rate of their entire portfolio*. This provides a thumbnail for the expected rate of return that it is reasonable to expect from the club's holdings.

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WORKING TOGETHER

The Rocky Mountain Chapter 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.

Relative Value: Current and Projected

By Shirley Pfister

Relative Value is defined as a measure of value and risk, and it is a ratio. It is found at the bottom of Part 3 of the Toolkit6 SSG.

AVERAGE P/E RATIO	21.7	PROJECTED P/E RATIO	20.8	TTM EPS	2.55
CURRENT P/E RATIO	24.1	PEG RATIO	1.3	FTM EPS	2.96
RELATIVE VALUE	111.1%	PROJ. RELATIVE VALUE	95.7%	AVG TTM + FTM EPS	2.75

The actual calculation of the **current Relative Value** is the **Current PE** divided by the **Average PE (Signature PE)**. The signature PE is simply another term for the average PE. Average PE will be used in the rest of this column. It is usually calculated for the last 5 years. A second method of calculating RV is to calculate the average PEs using the average high and average low PEs from ALL of the years which are available (less the real outliers). The more data used, the less effect variations will have on the average, and the more valid the average PEs will be!

The average PE is the “normal” relationship between the company’s stock price and its earnings. Perception can drive the short term price: what goes up, will go down and what goes down, will come up! It is almost sure that any deviation in PE NOT cause by earnings is only temporary! Since most agree with this, whatever the PE of a stock is at the minute, it will eventually return to the average PE if it’s not there now. The average PE is relatively constant and predictable. The average PE of a company is based on the industry and the company’s performance. The average PE is used to evaluate the price of the company stock!

A Relative Value between 85-110% is an indication the company is probably reasonably priced. The range may vary slightly depending on the reference used, but most agree on values in this area.

When the RV is below 85, this can indicate something is amiss. Something may not be known. Recheck the company as it may not be a *bargain!* Ask yourself, “Why would an investor pay less for a stock than it usually sells for?” Has something happened recently that research did not pick up? Maybe some new announcement about earnings has just been made.

When Relative Value is more than 110%, the company might be overvalued: a bit pricy. Others might interpret this to indicate the company is a high quality company and are willing to pay a high price for the company! A second consideration is maybe everyone is willing to pay too high a price for the company! How the number is evaluated can be influenced by the amount of research and knowledge known about the company. Just remember the usual range, and be cautious when the value is outside this range! If a stock is purchased when the PE is too far above the average PE, when it later returns to

the average PE (and believe that it will return to the average PE), this can greatly decrease any gains that may have initially been appreciated!

Projected Relative Value is another measure/ratio similar to Relative Value. Some think the current PE should be calculated using the earnings of the next 12 months instead of the trailing 12 months. The thought is stocks are bought for their future performance and with the expectation of those future earnings. Toolkit calculates the PROJECTED Relative Value using the estimated earnings for the next twelve months. Using the selected estimated growth rate on page one of the SSG, Toolkit then calculates the Projected RV.

The Projected RV range is 80-100%. This is a lower range than the Relative Value range. The reason for this is a result of calculating with a higher earnings number. A favorable appearing RV or Projected RV figure can be made up of an unrealistic current PE being divided by an unrealistic average PE! The MOST important factors to “keep your eyes on” are those affecting the Company EARNINGS! Remember, interest rate, inflation, competition, and trends in the Industry all can affect EARNINGS! Always keep in mind what PEs were selected to calculate the RV and Projected RV. This bring to mind just how import the PEs are in determining if the “Price is Right”.

References:

- ▣ **Stock Talk** by Ellis Traub (2010)
- ▣ **Stock Selection Handbook**, BI Educational Series (2003)
- ▣ **The Five Rules for Successful Stock Investing** by Pat Dorsey (2004)
- ▣ **Toolkit 6** by I-Club (2011)

WORDS OF WISDOM

“The one thing I will tell you is the worst investment you can have is cash. Everybody is talking about cash being king and all that sort of thing. Cash is going to become worth less over time. But good businesses are going to become worth more over time.” –

Warren Buffett

Successful Investing
Better Investing, Rocky Mountain Chapter