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Investment Philosophy and Strategies.

Investment Philosophy and Strategies - Damodaran.

- Your investment philosophy is your set of core beliefs about how investors behave and the extent to which you consider the market to be efficient.

- Your investment strategy should be designed to take advantage of pricing errors – e.g. price momentum resulting from the herd mentality; market over-reaction to news; mis-pricing due to lack of financial coverage. Basing a strategy on market over-reaction to news is a short-term strategy whereas buying neglected companies is longer term. Strategies become less successful the more they are publicised.

- Consideration of your strengths and weaknesses is important e.g. your attitude to risk. Also your time horizons.

- Firm specific risk can be diversified away. The Capital Asset Pricing Model (CAPM) measures market risk – this is measured by the Beta of an asset. A riskless asset has a Beta = 0; a riskier asset > 1.

Use of Financial Ratios:

- **Current Ratio** – traditional analysis suggests 2 or greater but a very high number may reflect an inability to reduce inventory.

- **Operating Cash Flow** = EBITDA.

- **Tobin's Q** is a ratio of the value of the firm to replacement cost and some think it a better measure than Book Value.

Multiples should be used along with their companion variable: PE with Earnings Growth; PBV with ROE; PSR with Net Margin; EV/Sales with Operating Margin. Each multiple should be compared with the average for the sector. If the difference cannot be explained by the fundamentals then the firm can be classed as undervalued. Firms in the same sector are presumed to have similar risk, growth, and cash flow profiles. PE/EPS Growth rate = Growth adjusted PE Ratio; PBV/ROE = Value Ratio; PSR/Net Margin = Margin adjusted PSR. Comparing with firms outside the sector can be done as follows: PE = Actual + EPS Growth + Payout Ratio (cash flow) + Risk (Beta); PBV = Actual + EPS Growth + Payout Ratio (cash flow) + Risk (Beta) + ROE; PSR = Actual + EPS Growth + Payout Ratio (cash flow) + Risk (Beta) + Net Margin.

Price Momentum.

- Over a time period of up to 8 months, stocks that have gone up in the last 6 months tend to continue and vice versa. Over a period of years, there is a negative correlation suggesting that markets reverse themselves over long periods.

- Stocks go up more on Mondays and do better in January esp. small firms; Returns on Monday are likely to be negative if the previous Friday was negative and vice versa. Days following trading holidays are usually positive.

- Strong volume helps price momentum. TA could be used to augment returns on a primary FA strategy e.g. using RS with Rising EPS growth.

Market Psychology:

- Investors over-react to new information so buy when others are selling and vice versa; market participants are slow learners so there may still be an opportunity to trade after an announcement; investors change their mind frequently and irrationally; tendency for investors to be swayed by the crowd; tendency for investors to hold on to losers too long and sell winners too soon. Keynes compared playing the stock market to guessing the winner of a beauty contest – the winner will be the one who best gauges who the judges will pick.

Value:

- A low **PBV** may be a measure of risk and justified if a low ROE is expected; a firm expected to earn an ROE less than the Cost of Equity should trade at a discount to Book Value. Therefore, look for low PBV, a high ROE and low default risk (Debt ratios). Tobin's Q provides an alternative to PBV – a low Tobin's Q firm is more likely to be taken over.

- Low **PE** stocks may have high-risk earnings or low growth. You could modify earnings e.g. a) P/Normalised Earnings b) P/Adjusted Earnings or c) P/Cash Earnings [=P/Cash Earnings + Depreciation + Amortisation]. Then check for Risk using Beta or Debt to Equity Ratio. Assess growth and eliminate declining Earnings or Earnings Growth lower than the sector.

- **EBITDA multiples**. EV/EBITDA = Market Value of Equity + Market Value of Debt – Cash & Marketable securities. If using this multiple, screen for low Investment Needs and high ROC.

- **PSR**. A low PSR is a useful measure for smaller firms. Look for low Risk, good Margins and low Debt (or EV/Sales).

- **High Yield**. Need to check Dividend Cover and Reinvestment needs.

- Overall, Value investing needs a long time horizon and reasonable diversification.

- **Contrarian**. Markets tend to over-react and stocks doing well/badly tend to reverse over time. For example, buy stocks that have gone down the most over the last 5 years. Need to hold for long periods.

- **Vulture Investing** = betting on a restructuring or a recovery. Avoid sectors in long-term decline; buy a poorly performing company in a positive sector; bad managers can be removed. Bad companies will often get worse before they get better. Companies take long periods to recover. Diversification is crucial with this strategy. Need to be of independent mind and not easily swayed. Some investors lack patience and bail out early. Need to be able to cope with short-term volatility. If the company divests assets the market usually responds positively to the news – operating performance tends to improve after the divestitures. With a Spin-off the parent company's share price tends to increase on the announcement. Debt is often the problem – some believe no debt is best; Damodaran believes in an optimal debt ratio e.g. a firm with stable and large cash flows and a high tax rate can gain value from the use of debt. Evidence suggests changes in management are generally viewed as good news. Managers tend to be stubborn and resilient.

Small Cap:

- Small Caps tend to do better when the Yield Curve is downward sloping and inflation is high. Small Caps tend to do well in January.

- To be successful here, you need a long time horizon, good diversification, and reliance on one's own research. Small-Cap and Value go well together. See Pradhuman on Small Cap Investing.

Growth:

- Past Earnings Growth is not a reliable indicator of future growth. Companies growing fast will see their growth rates decline towards the market average. Revenue Growth seems to be more predictable than Earnings Growth. Some investors go for accelerating Earnings Growth.

- Better to look to expected growth and Analysts' Estimates. However, analysts have a tendency to overestimate growth. Markets also tend to over-price growth. Growth investing seems to do better when the Yield Curve is flat or down sloping. Low PEGs may be high risk. The PEG can be modified to include the Dividend Yield e.g. PEGY = PE/ (Expected Growth Rate + Dividend Yield).

- Growth investing has done best when Earnings Growth is low and investors are pessimistic.

Trading on News:

- Best if you can follow the trades of top executives. N.B. Insider trading using derivatives to hedge increases following price run-ups and prior to poor earnings announcements. Stock prices tend to go down after insiders take hedging positions.

- Most announcements are preceded by price run-ups on good news and vice versa, due to insider information. Increased trading volume in the stock and derivatives are also indications.

- You can track illegal insider trading by looking at trading volume and bid-ask spreads.

Analyst Forecasts:

- Information showing the economy grower at a faster rate than forecast will result in analysts increasing their growth forecasts for cyclical firms. Analysts may also adjust their estimates based on information revealed by competitors. Analysts are generally over-optimistic about future growth; they over-estimate growth at the peak of a recovery and under-estimate growth in the midst of a recession.

- An earnings momentum strategy is to buy stocks when analysts revise forecasts upwards (short-term strategy with limited returns); the weakness is that the strategy is depending on weak links – company reports and analyst forecasts. Some analysts may be too close to the firm. It is best to identify the most influential analysts rather than following consensus forecasts.

Analyst Recommendations:

- Any downgrade is a Sell signal. Analysts tend to follow the lead of others in herd-like fashion. Sell recommendations affect prices much more than Buy recommendations. Prices tend to trend down on sells whereas the price impact with Buys is immediate (usually 3% on Buys and 4% on Sells in the first three days, followed in the next 6 months by an additional 5% for Sells and levelling off for Buys).

Announcements on Earnings:

- The major question is how it fares in relation to expectations; returns on the three days around the announcements tend to be more positive for Value and Small Cap stocks. Announcements on Fridays are more likely to contain negative information – also announcements that are delayed, esp. more than 6 days.

- Markets are more efficient about assessing good news; an investor needs to move quickly if he is to benefit. Best if you can forecast the likely firms based on historical earnings and trading volume. 'Buy on the rumour, Sell on the News' means that most of the benefit comes in the run-up with only a small advance after the announcement.

Takeovers:

- Price movements occur around the announcement date and not when consummated. Target firms are the clear winners. Half the premium is usually incorporated by the time of the announcement due to leakage – then, a jump on the date. Cash-based acquisitions are best. If a takeover attempt fails, there is a price fall but 60% of firms are taken over within 60 days of the first failure. Bidding firms tend to fall in price because it is felt they usually fail to deliver on promises of efficiency and synergy plus the fact that they often over-pay. Best if you can invest before they become targets.

- A typical target firm is i) under performing in its sector and market ii) less profitable iii) lower stock holding by insiders iv) low Tobin's Q v) smaller Market Cap. Therefore, screen for a) low Market Cap b) low insider holdings c) low PTBV d) low ROE.

Stock Splits:

- Prices tend to go up on the announcement. Companies that expect their stock prices to go up in the future are more likely to announce stock splits.

Dividends:

- Any increase is seen as a positive signal. There is usually a more pronounced reaction on a decrease e.g. 5% compared to 1%. Prices tend to drift up/ down for long periods after dividend changes.

[Information based strategies need instant information and instant execution.]

Market Timing:

- You need to be right 70%+ of the time to break even. Market timing skills are vastly over-stated. Various indicators may tell you that the market is over-valued but it does not tell you when the correction will occur.

- You can always find under-valued stocks in an over-priced market. PEs tend to revert to 16 but lower interest rates allow for much higher PEs. There is a positive relationship between GDP growth and stock returns in any single year but it does not predict returns for the following year.

- Increases in Interest rates leads to higher Cost of Equity and lower PEs. Greater willingness to take risk leads to a higher Risk Premium for equity and higher PEs. An increase in expected Earnings Growth leads to a higher Market PE.

- If markets are over-valued, you could switch from Growth to Value. If a market increase based on real economic growth is expected, then you might switch into cyclicals. If interest rates go up causing the market to drop, switch out of financials into consumer products. N.B. The market will bottom out and peak before the economy e.g. invest in cyclicals when the economy enters a recession, then shift into industrials and energy as the economy improves. Contrarians may invest in sectors that delivered the worst performance in previous periods.

- Professional attempts at market timing have generally failed.

Indexing:

- Pick funds with the lowest expenses and the highest R Squared.

- Small Cap funds outperform Large Cap. Younger funds do better than older ones. Also younger managers.

- The highest rated funds do not do any better – they tend to increase their management fees. Active funds tend to stay in cash too long. They sometimes suffer from lack of consistency in investing style. There is a tendency to herd behaviour. Window dressing takes place in December. Avoid funds with high turnover ratio.

- EFTs have advantages, being liquid and can be sold short.

Buying and Selling Approaches.

Structuring a Portfolio for Long-term Growth – Siegel.

Source: Stocks for the Long Run by Jeremy Siegel ISBN 0-07-058084-7
http://www.amazon.co.uk/exec/obidos/ASIN/007058043X/qid=1068164151/sr=1-6/ref=sr_1_0_6/026-2297028-0123661

- Shares should constitute the overwhelming proportion of all long-term portfolios. A reduced exposure to equities can be achieved through inflation-indexed government bonds.

- Invest the largest percentage in a highly diversified range of low-cost funds, esp. index funds.

- Place up to a quarter of your shares in mid- and small-sized stock funds.

- Allocate about one-quarter of your portfolio to international equities, approximately equally between the USA, Europe, Far East, and emerging markets.

- Use contrarian strategies of increasing stock exposure when most investors are bearish and vice-versa.

- Invest when short-term interest rates are being eased.

- Follow calendar anomalies. Small caps do better in January. Superior returns occur at the very end of the month and the beginning of the next month. September is the worst month of the year. Mondays are worst, Fridays best.

- Use the 200-day Moving Average to time entry and exit from the market.

Value Buying and Selling.

Source: The Motley Fool www.fool.co.uk/

Invest in good companies on the dip.

1. Do not down average.

2. Buy when market is pessimistic.

3. Sell when:
    - Fundamentals change for the worse
    - Grossly over-valued
    - Better investment opportunity exists
    - Stock falls 10% below purchase price or when 50 day Moving Average falls below the Price line.

4. TMF Pyad Sell:
    - PBV is usually the first to break. That is, it will go over 1. It breaks first in most cases because the discount to 1 is usually fairly modest to start with. Shares bought on a PBV of 0.9 need only rise by 11% for the discount to be erased. But if the PE on purchase was 8 and the Yield 5%, when PBV hits 1, the shares would only be at a still attractive 8.9 and 4.5% respectively. Do not sell just because PBV<1 ceases to exist.

    - Sell on a strongly rising PE and falling Yield, unless there is an indication that these would come back down to value levels by the release of very good figures. Thus if historical PE had risen to 16 and Yield to 2.5% and an announcement showed doubled EPS and Dividend, that immediately puts the shares back on to a PE of 8 and yield of 5% on a historical basis.

    - If you wait for the announcement, review the net Cash, PBV and, especially, EPS forecasts. If these still make sense stay in because the share had reinstated deep value status. This situation is quite rare.

    - In most cases, announcements merely confirm that the share has performed in line with expectations, rather than greatly exceeded them, and has lost super value status. Therefore, after a good rise, where most of the deep value has gone, sell shortly before announcements, rather than after, because shares frequently fall back following the figures, unless those figures are much better than anticipated. That does not happen often.

Technical Analysis Indicators.

- Establish the existence of a trend when the 20, 50 and 200-day Moving Averages go up together.

- If the Price Line penetrates the Trend Line upwards this gives a Buy signal and vice versa.

- If Volume is up on an upward breakout, this authenticates the Buy Signal.

- Moving Average. Buy when the share price rises above its Moving Average and vice versa.

- 10 and 20-day Exponential Moving Averages. Buy when the shorter average goes above the longer Moving Average.

- Relative Strength Indicator 21. Buy when above 50 and Sell below 50.

Moving Average Charts:

Buy Signals

- If the average line flattens out or advances following a decline, and the price of the stock penetrates that average line on the upside, this constitutes a major buying signal.
- If the 50-day Moving Average, moving up, goes above the 200-day Moving Average this is a Buy signal.
- If the price of the stock falls below the Moving Average line while the Moving Average line is still rising, this also is a Buy signal.
- If the stock price is above the Moving Average line and declines toward it, but fails to go through and instead turns up again, this is a Buy signal.
- If the stock price falls too fast and far below a declining Moving Average line, a short-term rebound toward the line may be expected.

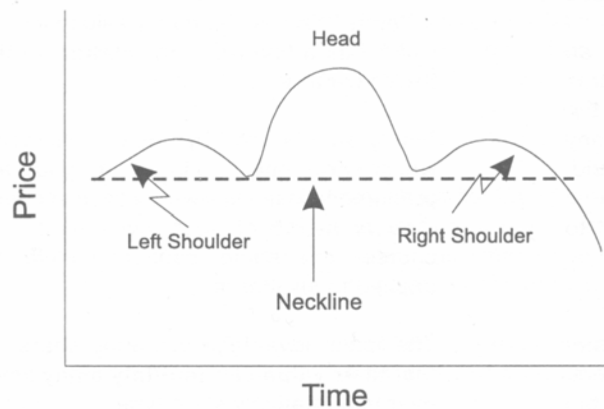
Sell Signals

- If the Moving Average line flattens out or declines following a rise, and the stock price penetrates that line on the downside, this constitutes a major Sell signal.
- If the 50-day Moving Average moves down through the 200-day Moving Average this is a Sell signal
- If the price of the stock rises above the Moving Average line while the M A line is still falling, this also is a Sell signal.
- If the stock price is below the Moving Average line and rises toward it, but fails to go through and instead turns down again, this is a Sell signal.
- If the stock price rises too fast above a rising Moving Average line, a short-term reaction may be expected.

Reversal Patterns.

Source: All About Shares by Net-Works www.net-works.co.uk/

Head and Shoulders Top & Bottom.



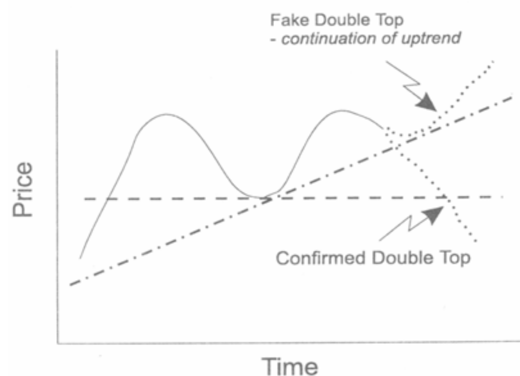
Head and Shoulders Top:

- The lowest point on the right shoulder must be lower than the highest point on the left shoulder.
- A Sell signal is registered once the Price falls from the right shoulder and breaks through the neckline.
- The price can pull back towards the neckline before declining sharply.
- Watch for a Bull Trap during this initial period.

Head and Shoulders Bottom:

- Reverse of the top.
- Be sceptical of a break through the neckline on low volume.

Double Top Formation.



Prediction is more difficult than with a Head and Shoulders Formation because it may only be a continuation of an uptrend, as is the case 90% of the time. It is important to wait for the confirmation.

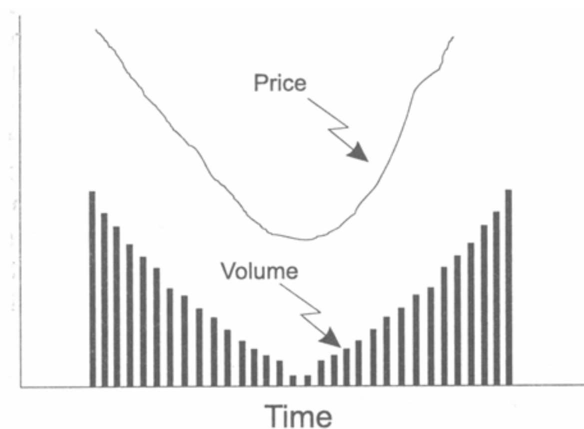
Double Bottom.

Look for increased volume on the rally up from the second bottom. If the volume is less or equal to the rally from the first bottom then it is probably a continuing downtrend.

Triple Tops and Bottoms.

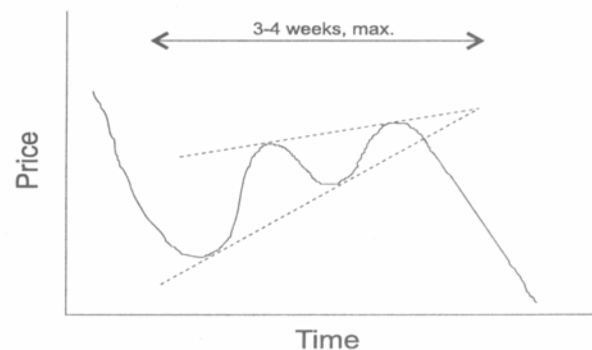
Fairly rare. The volumes at each stage need to be progressive.
Beware of an apparent Double Top not dropping sharply but going on to forming a Triple Top.

Rounding Tops and Bottoms.



In a true rounded bottom formation, the volume decreases as the Price decreases.

Wedge Formations.



- If the triangle is pointing upwards, a fall in price can be expected when the price curve penetrates the lower line.
- A triangle pointing downwards is a falling wedge and a penetration of the upper line anticipates a rise in price.
- A triangle pointing level suggests consolidation of the trend.

Weinstein's Stage Analysis Strategy.

Source: Stan Weinstein's secrets for Profit in Bull and Bear Markets
http://www.amazon.co.uk/exec/obidos/search-handle-form/026-2297028-0123661

Stage Analysis:

Stage One - base formation where price fluctuates in a narrow range, moving back and forth over the 200-day Moving Average (or 150-day MA).

Stage Two - advancing phase where price advances over the 50-day and 200-day MA.

Stage Three - top area where the price peaks. It may drop below the 200-day MA which begins to slope downwards. This is a Sell signal.

Stage Four - declining phase where the price drops below the 50-day and 200-day MA. It continues to decline until a new Stage One starts.

Stock Selection and Entry:

1. Positive Market trend.
2. Bullish sector. Sector analysis is the same as Stock analysis.
3. Select best Chart Patterns in the sector. With shares in a Trading Range record the Price at which breakout should occur.
4. Identify where the next area of Resistance is. It is best if there is no overhead resistance. Resistance, which is 1.5 to 2 years old, is not very potent.
5. When share first breaks out of Stage One or after a pullback to the breakout point, which is safer.
6. Volume should be up on the breakout and down on the pullback.
7. Buy half on the breakout and half on the pullback.
8. Do not buy on a breakout if the price line is below the 200-day MA.
9. Relative Strength (Price/Price of Market Average) should be positive.
10. Look for useful patterns. Head and Shoulders Bottom is bullish if it breaks out above the Neckline. Double Bottom is more common.
11. Look for Triple Confirmation Pattern: i) price above 200-day MA ii) RS positive at breakout iii) big price move up to 40-50% before the breakout.

12. Do **not** buy when:
    - market bearish
    - negative sector
    - price below 200-day MA
    - declining 200-day MA
    - too late in Stage Two advance
    - poor volume on breakout
    - poor Relative Strength
    - heavy recent overhead Resistance
    - below a breakout.

Exit:

- Set Stop just below the floor of Support. Raise the stop to the 200-day MA as the price advances.

- The objective is 20% within two months. Sell.

Bear and Bull Market Indicators:

- Stage Analysis. A break below the 200-day MA is a strong Stage Four Sell signal.

- Advance/Decline Line. A/D Line and the Index going up is a positive. If both break down from a top formation, a new bear market is about to occur. Prior to this, there should be a widening gap between the two lines, as the A/D Line loses momentum. On a bottom, the Index line will stop and the A/D Line will continue down. This indicates the start of a bull market.

- New Highs/New Lows Indicator. Divergence between the two gives an early warning of a reversal. Use only with other indicators.

- General Motors. If GM does not make a new high or a new low within 4 months, the trend is reversing. Compare with GM Stage Analysis - if contradictory, go with the Stage Analysis.

- Price/Dividend Ratio = Index / (Index*Yield in decimal form). 14-17 is over-sold and 26-30 is over-bought. Use only with other indicators.

FA and TA Investment Protocol.

1. Use selection filters to identify potential buys.

2. For each share identified by the filters do a very quick visual check. Exclude shares that are not trending up or showing signs of beginning to (breakout).

3. Look at the chart characteristics for 10, 5 and 1 year using a line chart. Take note of the trend, patterns and gaps. Exclude unsuitable candidates.

4. Look at the weekly and daily candlestick charts, noting any significant patterns and exclude unsuitable shares.

5. Move to the chart to determine support and resistance levels and to look for patterns.

6. Identify possible buys using the following characteristics:

7. OBV- Moving gently upwards, not flat or falling and with room to rise.

8. RSI above 50 and rising, not flat or falling and with room to rise

9. Shorter term MA above long term MA. (10 and 20-day).

10. Using the Support and Resistance levels already determined is the risk reward ratio 1:3 or better?

11. Can I currently buy close to support? If not put it on the watch list.

12. If it is a buy, look at the intra-day charts to find a buying point.

13. On purchase set stops and initial sell levels. Set alarm levels at the same time.

14. Monitor daily using candlesticks RSI and OBV. Once a week look at weekly candlesticks and chart patterns in the P&F chart.

Cohen Investment Approach.

Source: The Armchair Investor by Bernice Cohen
http://www.amazon.co.uk/exec/obidos/ASIN/0752811738/qid=1068160373/sr=1-2/ref=sr_1_0_2/026-2297028-0123661

Criteria:

- Check the fundamentals using Company REFS or Investors Chronicle.
- EPS should be growing by 20% or more.
- A small Market Capitalisation with strong demand favours a rising share price.
- Use technical analysis to help with buy and sell decisions. Buy on a breakout with high volume after a base-building phase. Look for the 20-day moving average cutting above the 50-day moving average; both averages moving up and the 200-day moving average starting to turn up. Wait for the price to close above the breakout price on two consecutive days before buying. A gap is a positive signal.
- Look for efficient management.
- No Debt and Cash rich is preferable.
- EPS Growth should double over 5 years.
- Consider selling on a profits warning.
- A little institutional support is helpful.
- Look for something new - products, management, or new high.
- Invest when the stock market is moving in a positive direction.
- Sell poor performers quickly.

Market Indicators:

- Look for all indices rising strongly – over 20 points.
- Record each day's total volume of shares.
- Find the average size of each trade by dividing the total number of shares by the number of trades done. 17,000+ is busy on the part of private investors. 25,000+ indicates strong institutional activity.
- A sharp setback on low volume suggests that fund managers are not selling.

- Record daily the number of shares making new highs, the numbers making new lows and the difference between the two. A strong bull market is suggested if there are over 200 shares making new highs.

- Use the 10-day Test to record the number of days up and the number of days down in the index e.g. 6/4.

Announcements:

- Check the date for the announcement of results before buying. Check for buying in the 8-week run-up to the results. Watch out for profit taking before results are announced.

- Waiting for the results to be announced is a safer course of action.

Price Action Momentum Trading.

Source: How I Trade for a Living by Gary Smith
http://www.amazon.co.uk/exec/obidos/ASIN/0471355143/qid=1068160540/026-2297028-0123661

Patterns:

- V Bottom Upside Reversals - downtrend or previous day down followed by a down day with a late upward surge.
- Late Day Upside Price Surge - previous day down followed by a down day with a late upward surge in the last 2 hours closing ½% up on previous close.
- Extreme Momentum Days - a big forward movement can presage continued momentum.
- Friday–Monday Momentum – stronger than average strength on the Friday often leads to continuing strength on the Monday.
- 1% True Selling Day – 2 weeks+ of a rising trend followed by a 1% drop on most of the indices.
- Divergence Patterns – in the indices.

Indicators:

1. Sentiment.

2. Technical:
    - Increased percentage of new 52-week Highs.
    - Advance/Decline Line where Index decreases but A/D Line rises.
    - Triple Witching Weeks can lead to price increases. Stock options, stock index options and stock index futures expire on the third Friday of March, June, September and December. If these traders have been bearish (e.g. heavy put buying in the weeks leading up to expiry), the unwinding of their positions tends to lead prices up.

Rivalland Swing Trading.

Source: Mark Rivalland on Swing Trading
http://www.amazon.co.uk/exec/obidos/ASIN/1897597193/qid=1068160783/026-2297028-0123661

- Establish the long-term trend using the FTSE Swing chart, Coppock Indicators etc. Avoid taking positions between 7 and 31 December, or if the 5-week RSI is overbought.
- Determine the short-term trend using both Swing and P & F charts. The Swing chart has primacy.
- Individual stocks – use the FTSE Swing chart as a filter for entering the market. Do not trade against the trend.
- Concentrate on the largest 50 FTSE companies.
- Do not take a position if the weekly RSI is overbought.
- Trade on the first day after a 3-day+ counter-trend has ended.
- Be flexible on the requirement for 3 consecutive days, as long as the time span is relatively short.
- P & F charts – use Box sizes of 1.2 to 2.5% and a 3 Box Reversal.

Best signals:

- Triple Top esp. TT with Rising Lows
- Long Tail Down (for bottom fishing)
- Bearish/Bullish Shake-out
- Whipsaw.

Take profits using 5-day RSI:

- 80-84 consider profit taking
- 84-88 ½ profits
- 88+ full profits.

Forensic Accounting.

Source – Bear Essentials by Simon Cawkwell

1. A change in accounting policy is usually bad.

2. Directors. Avoid companies whose directors have disproportionate salaries and large expense accounts. Look for directors who have a significant equity exposure.

3. Options. Share options should be treated as a cost. Option purchases are not tax-deductible and dilute Shareholders' Equity. Watch out for cancellation of existing options and the award of new ones on more favourable terms.

4. Cash. Watch out for switching money in at year end. Check the cash over two year-ends; if there is a lot of cash there should be a matching amount of interest; be suspicious if the interest is not there.

5. Capitalising Costs boosts profits in the short term, flattering the P & L and the Balance Sheet. The usual justification is that an asset is being built up, but it is not a good practice. Check the P & L, Cashflow Statement and Notes to see if any interest has been capitalised.

6. Goodwill Amortisation. Evil would write it off immediately to Shareholders' Funds.

7. Depreciation over a lengthy period flatters profits. Need to check if the company is generating enough cash to replenish its capital reserves (replace machinery etc).

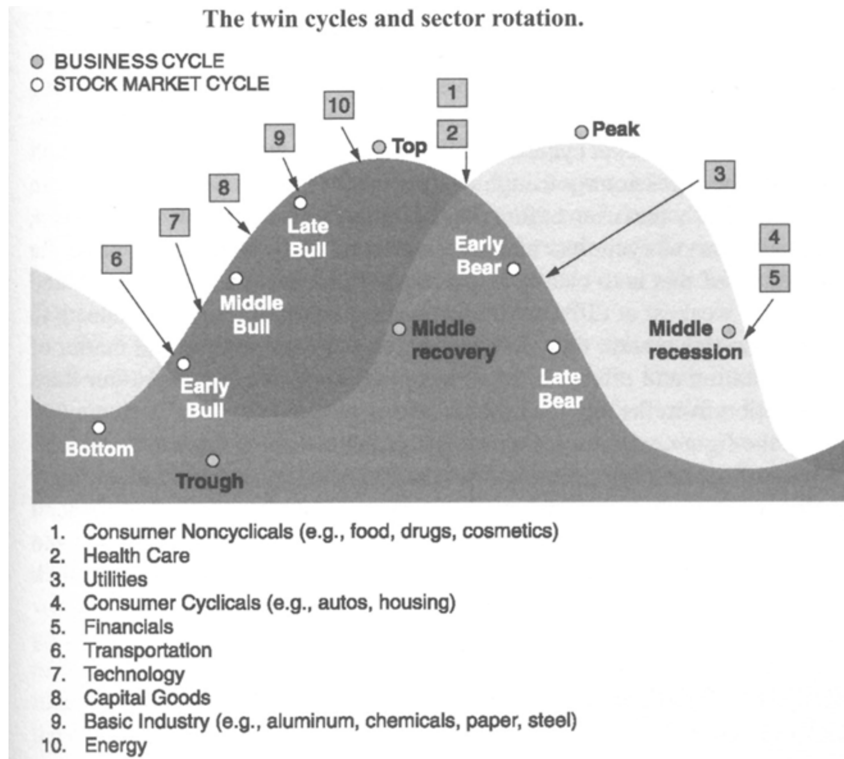
8. Debt. Check out the cost of servicing debt. View Preference Shares as debt; dividends are really interest costs. Divide Total Net Debt by Free Cash Flow to get an idea of the number of years needed to clear the debt. Companies are in difficulty if their long-term finance comes from an overdraft facility.

9. Exceptional Items. Check to see if they have been recurring. Usually a credit is established on the books, which provides a pot to be drawn on; done in acquisition accounting.

10. Tax Rates. Be suspicious of a low tax rate, which probably means that profits are lower than stated.

11. Working Capital should move roughly in line with the growth of the business e.g. if Turnover is up 10%, so should Working Capital.

12. Assets. Look for a strong NAV. ROCE is a key figure. Dividend Cover should be 2*.



The twin cycles and sector rotation.

Top-Down Investing.

Market Indicators.

Advance-Decline Line.
It tends to signal the end of a trend before the Moving Averages. The theory is that the knowledgeable investors are the first to invest in a rising market and the first to get out when a market stops rising

FTSE	Advance-Decline Line	Prediction
Rising Prices	Falling	Falling
Near Previous Top	Below Corresponding Top	Falling
Near Previous Top	Above Corresponding Top	Still Rising
Falling	Rising	Rising
Near Previous Bottom	Above Previous Bottom	Rising
Near Previous Bottom	Below Previous Bottom	Falling

Unchanged Share Index.
The theory dictates that when more stocks than normal remain unchanged in price the market is at a top or a bottom and about to change direction. To calculate the index divide the number of unchanged shares by the total number of traded shares. The percentage is usually between 5 and 25%. If it is near to 5% this is considered bullish, if near to 25% bearish.

Odd Lot Purchases.
A large volume of odd lot buying by the general public is a sign that the market is about to fall. Moreover, odd lot selling is an indication that the market is about to rise. It is based on the belief that the general public always get it wrong.

Bull/Bear Ratio.
High readings are bearish and low, bullish. Over 60% suggests extreme optimism and the onset of a bear market; below 40%, extreme pessimism and time for a bull market.

Put/Call Ratio.
Purchasers of Puts expect the market to decline and purchasers of Calls expect the market to rise. The balance between the two gives an indication of bearish or bullish expectations among sophisticated options traders. As traders become bullish, the Put/Call Ratio will increase; as they become bearish, it will decline.

Sentiment Analysis.
When stock market advisers display extremes of either optimism or pessimism, the trend is probably about to reverse.

Money Supply.
The greater the increase in M1 Money Supply the greater the chance of an upturn.

Net Free Reserves.
If banks have lots of excess cash in their reserves, this usually goes to business loans with consequent expansion of the economy.

Interest Rates.
A fall in base rates is a bullish indicator, and an increase bearish.

Vintcent Strategy.

Source: The Investor's Guide – Be Your Own Stockbroker by Charles Vintcent
http://www.amazon.co.uk/exec/obidos/ASIN/027364467X/qid=1068164380/sr=1-3/ref=sr_1_0_3/026-2297028-0123661

1. Establish the overall direction of the market. Consider interest rates, inflation, exchange rates, and political stability.

2. Carry out sector analysis:
    - Is the sector creating demand for products?
    - Are prices falling? Is it getting hard to sell?
    - What are current market conditions?
    - Is the sector likely to grow?
    - Measure the share performance against it – share price and PE.

3. Carry out a company analysis:
    - What are its key products? Is it achieving 10%+ growth?
    - How can the company sustain growth? What is its market position?
    - Are the managers credible? Are they liked in the City?
    - Is the share's valuation reasonable?
    - What risks does it face?

4. Organic Earnings Growth should be 30% yearly, with growth rate of 50%+.

5. Note the High and Low of the share over the last 12 months. Calculate how far off its high it is today.

6. Note the latest movement in the price since yesterday.

7. Check Market Capitalisation. Avoid companies of less than £150m.

8. Study share price graph over 3 years using the 30-day and 200-day MAs.

9. Check the Extel report showing the accounts over the last 5 years.

10. Check the Dividend Cover over the last 5 years.

11. Calculate the Dividends over the last 5 years. Look for an upward trend.

12. Look for a positive net Cash Flow record.

13. A share on an upward trend but near the bottom of its trading range is a buy. A share that has broken through the upper level of its trading range is a definite and immediate buy. A share on a downward trend in its trading range can be bought when it begins to turn upwards.

14. For Investment Trusts choose one whose Gross Yield is 5% or more, or whose price is at a discount to NAV.

Sector Analysis.

Source: Investors Chronicle

A Top-Down strategy identifies the promising sectors and selects the best stocks within the sector using the chosen criteria.

Automobiles

- Unemployment and interest rates have a negative impact on car sales.
- Like Utilities, Automobiles is good for Dividend Yield. Sell on Dividend cuts.
- Some value stocks are available at a 60-80% discount to market PE. Sell when they fall back to the 20-40% discount range.
- Growth opportunities exist in increased content per vehicle – electronics and new technologies.
- Invest in companies with high Margins since they are better protected against cyclical downturns.
- Avoid companies with low liquidity since institutional money pushes the share price.

Chemicals

- Avoid a ‘buy and hold’ strategy.
- Good management is crucial in this sector.
- Chemicals is capital intensive so look beyond EPS.
- Avoid cheap stocks, which usually means bad in this sector.

Luxury Goods

- Strongly linked to good macro-economic environment and equity markets.
- It is a fragmented market with pressure for consolidation.
- Control over distribution gives a competitive advantage.
- Japanese are the single biggest buyers of luxury goods.

Transport

- Airline stocks with low PEs are a sell. High airline PEs are caused by lower earnings, which exist around the bottom of a cycle. Therefore, good time to buy.
- Americans stop travelling abroad at the slightest excuse.
- Transport companies are very sensitive to GDP growth.
- Pay particular attention to a company’s net cash position.

Banking

- Look for strong CEO leadership.
- Check out ROE, Cost/Income Ratio and the success of expansion moves.
- Problem banks are usually worse off than the figures indicate.
- In an environment of consolidation, look for a well-positioned bank.

Leisure

- Leisure spending is one of the first to go in an economic downturn.
- Cost of refurbishment is an important factor.
- Rising property values can be a benefit.
- Legislative changes can affect the sector.

Biotechnology

- Management is the key. The product is only half the story.
- Keep an eye on the news flow, which contributes to the volatility.
- Ensure a large enough Market Capitalisation and adequate liquidity.

Innovative Therapeutics

- Invest for the long term.
- Invest only between the first confirmation of the product's potential and its market approval.
- Astute management is needed.

Energy

- Cyclical sector.
- A contrarian position can be useful.
- Disciplined management is essential.
- Avoid being seduced by alternative sources of energy.

Utilities

- Utilities usually have spare cash. Watch how they spend it. Best if it is invested in the core business.
- Equally good if they return cash to shareholders through special dividends or share buybacks.
- Invest in utilities that are restructuring.

Enterprise Software

- A shortfall in revenue targets is usually disastrous and can mean a 50% correction.
- One profits warning tends to lead to another. However, buying an established company on a 50% correction can be a winning strategy.
- Beware if the story sounds too good.
- News flow impacts significantly on prices.
- It has a strong correlation with movements in the Tech sector.

Tobacco

- Usually provides a strong and predictable cash flow.
- Litigation has introduced volatility.
- Profits warnings are rare. When they occur, the problem could be serious.
- Select multi-national producers with strong brands.
- Demographics are important e.g. a younger population.

Biotechs

- Phase II or Phase III is potentially more lucrative and the risk is lower than at Phase I.
- Are there any issues with safety or efficacy that could hold up the drug's route to market?
- The trials should meet the requirements of the US Food and Drug Administration as well as European medical regulations.
- FDA Orphan Drug status can speed up the development process if there is no existing treatment in the market.
- Interest from big pharmaceutical companies gives more credence to the company's technology and offers the potential for revenue from milestone or

upfront payments. The further along the clinical trial process the drug is, the bigger the payments because more of the risk is taken out of the equation.

- It is no good having a great product, but no cash to pay for the development.
- Check for cash burn and overheads. Find out if the company is living beyond its means or has it attempted to cut costs.
- Some biotechs sprang from academia and are headed by scientists who may be too close to the research and unable to judge the commercial potential. Management experience is desirable.
- Having experience in dealing with big pharma helps in seeking to clinch lucrative licensing deals.
- Select companies with existing revenue streams and a range of drugs or products in its pipeline.

Defensive Stocks tend to hold up in a bear market.
The sectors are:

- Pharmaceuticals
- Food and Drink
- Supermarkets
- Tobacco
- Utilities

Shares like Tesco and GlaxoSmithKline should be long-term core holdings.
Some defensives should be retained for their good dividend yields.

Cyclical/Recovery Stocks tend to outperform when the economy recovers from recession.
The sectors include:

- Engineering
- Chemicals
- Mining
- Media
- Transport
- Retailers

Highly Cyclical.	**Non-Cyclical.**
Automobiles	Beverage
Chemicals	Electricity
Construction	Food Producers
Electronic Equipment	Food and Drug Retailers
Forestry and Paper	Gas
General Retailers	Healthcare
Information Technology	Household Goods
Insurance	Pharmaceuticals
Leisure and Entertainment	Telecommunications
Media and Photography	Tobacco
Oil and Gas	Water
Restaurants and Pubs	
Software Services	
Support Services	
Transport	

Sector basics

1. It's the economy, stupid

- Over the long run, economic growth and stock market returns have actually been negatively correlated. What really matter are turning points.
- Over time, the economy moves through stages where it expands and contracts at changing speeds. Financial experts commonly refer to this as the 'economic cycle', and typically switch between different sectors according to which stage of the 'cycle' it is. As the economy picks up, the idea is to move into economically sensitive industries. When it falters, investors move into those that are less sensitive.
- Talking about a 'cycle' makes it sound as though the economy follows a smooth and predictable pattern. While contractions and expansions do happen in turn, the intervals are seldom, if ever, regular. And supposed sub-phases of this 'cycle' often repeat themselves or get missed out altogether.
- Financial markets aren't concerned with what is going on today, but with what is likely to happen tomorrow. It is all about anticipating economic developments. Waiting for confirmation that recovery has taken place is another way of saying 'missed opportunity'.
- Leading indicators of economic activity provide clues to turning points in the economy before they happen, as well as the strength or weakness of tomorrow's growth e.g. the OECD's leading indicator. Sectors often do react to changing economic conditions as expected. Shares in 'cyclical' industries such as mining and chemicals do indeed perform better when the leading indicator points to an improving economy. Likewise, 'defensive' sectors - tobacco and food producers, for example - have recorded their best results when the indicator was signalling a slowdown.
- However, not everything follows the textbook. For example, sectors that are supposed to fare better during the later stages of an economic 'cycle' often performed well during its early stages, too. The same is equally true of so-called 'earlier cyclicals' during the latter stages of an expansion. Now and again, certain defensive sectors thrive in upswings, while particular cyclical ones do badly during downswings.
- Identifying sectors' behaviour is one thing, explaining it is more difficult. The conventional story is based on profits. In this view, cyclical firms have cyclical earnings. When those earnings peak, it is best to switch into defensive sectors, where earnings are much steadier. Thanks to cyclical companies' high operational and financial gearing, they subsequently enjoy a strong profits recovery, and investors should exploit this early.
- In reality, there's no need to complicate the situation by introducing earnings. Investors' attitudes to risk provide a neater explanation. During hard times, sensible investors want to hold assets that are uncorrelated with their own incomes or their homes. This could well involve selling volatile shares, such as those in cyclical sectors. During a recovery, they regain confidence and enter risky areas, which may well have been oversold in the downturn.

2. Pack animal or lone wolf?

- While looking at sectors is an efficient way to seek out potential investments, individual shares should not be ignored. A share I in a certain sector will not necessarily move the same way as that sector. Therefore, you need to know how a sector's members behave in relation to the group as a whole.
- When a sector consists of very similar companies, the behaviour of the individual shares tends to be more predictable. For example, the three members of the UK tobacco sector - whose businesses are almost identical - have all been around 90 per cent correlated with the overall sector in the past 10 years.
- On the other hand, the leisure sector shows little such conformity. Three of the four hoteliers are fairly highly correlated with the sector as a whole. A number of its pub members are somewhat less correlated, while First Choice Holidays, a tour operator, has only a weak relationship with the group as a whole.
- The situation is even less coherent within support services. This ragbag of a sector comprises numerous firms, many of which have no obvious link to the others. Three of its members have been negatively correlated with the sector.
- This diversity has obvious implications for investors wanting to mimic exposure to an entire sector using 'bellwether' stocks. Based on historical trends, ICI's shares would replicate the chemicals sector. But Rexam would be inappropriate in the support services sector.
- Watch out for cases where a company is more highly correlated with a sector than its members. Life assurer Aviva enjoys a stronger relationship with the food retail sector than does Wm Morrison a supermarket chain. Likewise, British Airways moves more closely with the engineering sector than its constituent members.

3. Club versus country

- As an investment style, allocating money to different industries is steadily advancing at the expense of doing so across different countries. Economic globalisation is the most likely reason behind this shift. As economic policies internationally follow a similar course and economies become more synchronised, individual industry issues matter more than country ones.
- Academic studies of several stock markets have confirmed that correlations between countries' returns have slightly increased in recent times, whereas those between sectors have declined strongly.
- However, other approaches still matter. Even though cross-country investing has lost ground to sector strategies, researchers stress that countries can play a useful role in diversifying a portfolio. In addition, there are important choices to be made between growth and value, as well as between large and small companies.

4. Where to find out about sectors

- The Financial Times' Companies & Markets section carries a daily FTSE sectors table containing price, dividend and earnings information.
- Yahoo's finance pages are easy to use and have some nifty features. As well as breaking down each sector into its constituent companies, the pages also enable users to plot charts, including technical analysis graphs. Go to: http://uk.biz.yahoo.com/sectors/
- A similar package is offered on the sector pages of Selftrade, including advanced technical analysis and Japanese candlestick graphs.

The main sector drivers

According to the capital asset pricing model, the only systematic risk affecting sector returns was market risk. Here are some of the other risks:

Real interest rates

- Many sectors are sensitive to changes in real interest rates, as measured by index-linked gilt yields. This is especially true for telecoms. A one percentage point rise in index-linked yields is associated with a 49 per cent fall in the sector. Changes in index-linked yields alone can explain two-fifths of the variation in telecoms' annual returns since 1990. Such a rise is also associated with 20 per cent-plus falls in the insurance and IT sectors. However, rising real interest rates are associated with good returns on mining, chemicals and paper stocks.
- There's a simple reason for these links. Telecoms and IT stocks are supposed to offer plenty of cash flows in the distant future, being 'growth stocks'. A rise in real interest rates increases the rate at which investors discount future cash flows, which impacts negatively.

Retail sales and house prices

- General retailing stocks are not badly hit by slower retail sales. Since 1990, the correlation between retail sales volumes and general retailers has been slightly negative.
- Instead, falling retail sales matter for real estate (a 1 per cent drop in retail sales is associated with a 4.1 per cent fall), pharmaceuticals and telecoms stocks (where a 1 per cent fall in sales is associated with 5 per cent higher returns for both sectors). For most sectors, however, the impact is insignificant.
- The same is true for house prices. There's not a single FTSE sector that moves by more than 2 per cent (up or down) with a 1 per cent drop in house prices. Even the construction sector, on average, falls only 4 per cent when house prices drop 10 per cent.

Leading indicators

- The OECD's index of leading indicators for the world economy matters. A 1 per cent rise in this over 12 months is associated with returns of 3.5 per cent or more on the general industrials, media, software and leisure sectors. For these sectors, moves in the OECD's lead indicator alone can explain more than one-fifth of the variance in annual returns. The reason is signs of better economic times to come are good news for many sectors.

Oil prices

- The oil sector does not benefit most from rising oil prices; mining, media and IT sectors have all been more sensitive to oil prices. The oil sector is dominated by the diversified giants, BP and Royal Dutch Shell, whose prices do not move much. A strong oil price is usually a sign of a strong global economy, which benefits cyclical stocks.
- The main message is that sectors are not very sensitive to oil. Even a 50 per cent rise in oil prices is associated, on average, with only a 15 per cent rise in the mining sector, a 6.5 per cent rise in the oil sector and a 14 per cent drop in tobacco, which is usually the hardest-hit sector.

Short-term interest rates

- A one percentage point rise in short-term rates is associated, on average, with falls of 3-5 per cent in the general retailing, banks, mining and tobacco sectors, but rises of just over 2 per cent in the pharmaceuticals, food retailing and software sectors.

Sector behaviour

Sector reputations stem from their supposed relationships with the wider economy and the stock market. They are typically labelled either 'defensive' or 'cyclical', depending on how they are meant to behave under certain economic conditions and in response to movements in the market.

Aerospace & defence: capital spending by firms on expensive equipment, such as aircraft, generally waits until the economy has clearly taken off. Consequently, investors have branded the sector a 'later' or 'industrial' cyclical. Its poor showing during the early 1990s' recovery supports this notion.

Banks: the banks sector, despite its low beta, is not considered defensive. However, the sector has frequently outperformed in anticipation of both improving and worsening economic conditions. Interestingly, it has tended to beat the market more often and more strongly as leading indicators deteriorate.

Beverages: a favourite defensive refuge in harder economic times. History bears this out, with fairly consistent performance during downswings, matched by poor showings during upswings. Rather insensitive to stock market gyrations, it also offers low variation compared with its level of returns.

Chemicals: the chemicals sector is definitely considered cyclical and has performed consistently well during upswings and poorly in weaker periods. Often spoken of as an early cyclical, the sector did indeed achieve its greatest out-performance during the recovery that followed the last UK recession.

Construction & building materials: this sector, cyclical by reputation, has had mixed showings in both periods of economic strength and weakness. Although known as an earlier cyclical, the pattern of its returns doesn't really bear this out. Property market trends may have greater influence than international economic indicators.

Electricity: this is one sector that really does deserve its defensive tag, given its excellent record during harder economic times. Oddly, it hasn't slumped back during anticipated cyclical recoveries, as have many of its defensive peers.

Electronics: an obvious play on a strongly rising stock market, the high-beta electronics sector supposedly does better once an economic recovery has really developed. Its best recent showing actually occurred in the later stages of the 1990s' boom, while the sector tends to do worse in downturns.

Engineering & machinery: the engineering and machinery sector is counted as a later cyclical play, owing to its dependence on capital spending. Nevertheless, it did well enough in the early stages of the last economic recovery. It is also a consistent loser during downswings as investors' appetite for risk diminishes.

Food & drug retailers: unlike general retailers, food and drug sellers are seen as a solid defensive sector. Consistently robust showings during cyclical downturns support this, while the opposite is true when the economic outlook brightens.

Food producers: belief that 'everyone always needs to eat' underpins the sector's reputation for defensiveness. When the economy moves from boom to bust food shares prosper. Recently, they've been the worst performers when strength is forecast.

Forestry & paper: along with other basic materials, paper is classed as early cyclical. It lived up to this tag coming out of the 1991 recession, but prospered towards the end of the last stock market upswing. To be avoided when economic slowdown looms.

General retailing: as a consumer-dependent sector, general retail is reputed to prosper some way into an economic recovery, as consumers benefit from employment and wage growth. In truth, the sector has an inconsistent record.

Health: increasing demand for health-related products and services means the health sector is known for combining the qualities of defensiveness and growth. In reality, however, health has a poor record during harder times, when other defensives have done well. Indeed, its performances during upswings are much better, which suggests it has cyclical features.

Insurance: although insurance is not typically included in either cyclicals or defensives, the sector has a definite tendency to beat the market in times of sliding confidence and lag behind it when good times are forecast. This makes the sector look relatively defensive, along with life assurance.

IT hardware: since businesses tend to invest in new technology after an upswing has got well under way, investors count IT hardware as a later cyclical. During the 1990s, this was broadly so, with weakness in the early recovery contrasted with strength in its latter stages. The biggest loser of all, however, when leading indicators deteriorate.

Leisure and hotels: a beta close to the market and a moderately low coefficient of variation do not immediately suggest a 'late cyclical' sector. In fact, leisure and hotels has prospered during almost as many downturns as upturns. That said, its overall performances have been stronger during the good times.

Life assurance: because they hold large amounts of equities, life assurers are considered by investors to be a geared play on the stock market. In terms of the economy, though, the sector has often done much better during expected slowdowns than it has during forecast pick-ups, much as a defensive industry might behave.

Media: considered a cyclical, and deservedly so. Since advertising tends to pick up some way into an economic recovery, investors rightly believe media to be a late cyclical. But it can perform early on, as during the upswing at the start of the 1990s.

Mining: more so than any other sector, mining has outperformed the market strongly during upswings. But its historic performance during periods of weakness is not as bad as one might expect. Despite a sharp economic slowdown recently, mining has belied its 'cyclical' tag by continuing to boom, suggesting every 'cycle' is different.

Oil and gas: the sector is widely considered cyclical, and it does outperform more often and more strongly when leading indicators head up. But the sector has outperformed just as many times during downturns over recent years, albeit not by the same degree. The low beta is also untypical of a cyclical sector. It could be that the combined weight of BP and Royal Dutch Shell makes up such a large part of the FTSE that outperforming the market is mathematically more unlikely.

Personal care: while notably strong when the economic omens are poor, personal care, surprisingly, has the capability to beat the market even when things are looking up - although much of this is based on the sector's largest company, Reckitt Benckiser, which has undergone a successful restructuring over the past six years.

Pharmaceuticals and biotech: a very low beta and a marked tendency to do well following peaks in the cyclical leading indicator have earned the sector a rightful reputation for defensiveness. Conversely, pharmaceuticals tend to disappoint during times of rising optimism about the economy.

Real estate: its relatively low sensitivity to the stock market smacks of defensiveness, but this is contradicted by the real estate sector's unspectacular performances during hard times. This is partly offset by its tendency to do better when economic prospects improve, making it a cyclical sector of sorts.

Software: since companies tend to invest in new software when their balance sheets are healthy, software has a 'later cycle' label. A disastrous showing at the beginning of the 1990s' recovery would tend to support this idea, followed by its strength later in the decade. Although not a consistent winner during the good times, when it does do well, it does so spectacularly.

Speciality finance: a collection of firms that are not easily categorised with other financials such as banks, speciality finance does not have an obvious reputation among investors. It has cyclical qualities, though, having done markedly well when economic growth is on the horizon.

Support services: given the highly differing characteristics of the companies making up this sector, there is confusion among investors as to its identity. Experience shows it to be strongly 'cyclical', gaining and losing alongside the leading indicator.

Steel: the sector is rightly considered cyclical, although the 'early' tag is unhelpful. That said, steel has not always outperformed during periods when the leading indicator has gained. When it has, though, it has often done so impressively. In true cyclical fashion, it almost always loses during the downswings.

Telecom services: the advent of mobile telephony meant that the perception of the telecom services sector changed from that of a utility to that of a growth sector. Although it did disastrously during the bursting of the technology bubble, the sector's longer-term success during such times merits its defensive tag. Still, it shows that sectors' reputations are liable to sudden change.

Tobacco: known as the classic defensive sector, tobacco has indeed done exceptionally well during every one of the past seven major declines in the leading indicator. It is important not to confuse the late maturity of the industry with its investment potential, though, as the excellent sector share price growth in recent years emphasises.

Transport: both people and goods move around most when the economy is in full swing, which may account for transport's 'late cyclical' badge. In fact, it achieved one of its best showings during the early 1990s' recovery. Overall, however, it has actually disappointed during cyclical upturns, doing slightly less badly in downturns.

Utilities (other): with their steadily flowing businesses, water companies are regarded as defensives. The excellent performance of other utilities when the leading indicator has turned down supports this, while they have done poorly during the good times.

Sector recommendations - late 2005

Aerospace & defence: airlines continue to struggle with bloated costs and rocketing fuel prices but the high oil price has proved good news for the UK's aerospace sector. New planes have generated orders on the promise of greater fuel efficiencies. The soaring oil price means that cash-rich Middle Eastern flag-carriers have been ordering new planes. Boeing and Airbus expect to increase aircraft deliveries by around 10% this year, and analysts predict an extended super-cycle. Meanwhile, defence markets are also offering solid prospects, with new military aircraft and a wider shift to technology-led warfare prompting huge increases in budgets. **Buy**.

Banks: an uncertain housing market and a massive consumer debt pile do not make for an ideal banking backdrop. But given that it would take an economic recession of early 1990s proportions to seriously hit the banking sector, the outlook is not so bad. However, some banks are better placed than others. Two camps at present: slow growth, costly players such as Lloyds TSB, which are overly focused on slow-moving UK retail business; and those with efficient structures and more diversified earnings bases, such as HBOS or RBS. Yet, despite the quality differences, there's not much difference in bank share price ratings, making the sector **good value** overall.

Beverages: consolidation hopes should help support shares prices over the coming year. The two international brewers - Scottish & Newcastle and SABMiller - are the most likely participants in any takeover action. Given their solid reputation, beverages companies could benefit if investors' appetite for economically sensitive industries wanes. But slowing consumption of alcohol - particularly of expensive spirits - is always a risk during harder times. The possibility of further value-creating deals, combined with modest valuations, make the sector **worth buying**.

Chemicals: the sector is groaning under rising costs and potentially onerous new European legislation. Record oil prices mean many raw material prices are rapidly increasing, and companies have also had to absorb energy price hikes of around 40 % in the past year, with more to come. Fortunately, so far most companies have passed on these costs to customers. But new draft European legislation, known as REACH, could increase the amount of testing required before new chemicals are introduced into the marketplace and add to costs. For now, the sector looks **fairly priced**.

Construction & building materials: spending on schools, hospitals, utilities and transport is keeping construction companies busy, with several boasting record order books. The house builders have had to start providing lower-cost units to help first-time buyers reach the first rung of the housing ladder. Some profit margin erosion has obviously occurred, but nothing to warrant the rather lowly rating on which the builders trade. With house-price inflation levelling off, builders and builders' merchants should see demand starting to accelerate, while there is little sign of any slowdown in infrastructure spending. Against this background, **good value.**

Electricity: surging power prices are certainly proving beneficial for share prices in the electricity sector - since the start of the year, they have gained a whopping 26 per cent on average. It's true that the cost of producing electricity has also risen due to higher fossil fuel prices and new carbon emission targets, but those electricity generators that have extensive and flexible generating assets are powering ahead. The

outlook for electricity prices remains buoyant, underpinned by the tight margin between generating capacity and demand. What's more, US electricity prices are showing signs of recovery after several dull years, making the sector **worth buying.**

Electronic & electrical equipment: a quick glance at valuations across the electronic and electrical equipment sector suggests there is little short-term value to be found here. Share prices have climbed sharply over the past 12 months on the back of burgeoning demand, driven by the US and China, and the average sector multiple is now a whopping 17 times this year's forecast earnings. This fails to discount the risk of an economic slowdown in these key markets. Although, so far, there are few signs that demand is abating, there is little room for error. But, like the engineering sector, electricals consists of a number of high-quality, high-margin niche businesses that may be attractive as takeover targets for global engineers. **Good value.**

Engineering & machinery: the UK engineering sector is a ragbag collection of highly focused niche businesses, so searching for common threads is almost a fruitless task. But, as the takeovers of Kidde and Domnick Hunter highlight, global engineering conglomerates are prepared to pay a premium for these high profit margin-making specialists. Some analysts believe there may be further consolidation in the coming months, although they largely shy away from picking potential takeover candidates. But this likelihood is already reflected in shares prices across the sector, which trades at a premium to the stock market. And although there could still be value to be found in companies with exposure to late-cycle capital expenditure-reliant markets, such as oil & gas and utilities, against a mixed economic backdrop, the sector is **fairly priced**.

Food & drug retailers: the battle for market share will remain the main game in the food retail sector. While Tesco is likely to dominate the industry for some time, the ongoing challenge for the two other main listed players is to achieve consistent positive underlying sales growth. And they will have to do so against a tough background of deflation in selling prices. For Sainsburys, this involves continuing to improve its competitiveness against its cheaper rivals, but without sacrificing quality. For Morrison, the test is to complete the messy integration of Safeway. The combination of defensiveness and individual recovery stories means **buy**.

Food processors: while food processors should always be able to count on steady demand for their produce, the sector faces great uncertainties. The big supermarket chains will continue to demand better terms from these companies. Makers of bog-standard items - such as milk and supermarket own-label products - are most at risk here. Owners of top food brands - such as ABF, RHM and Premier Foods - are best-placed to deal with the pressure. Buying new brands or consolidation is a distinct possibility. Spikes in energy, packaging and raw material costs also threaten to choke profitability. But food processing's robust credentials and reasonable rating make it **worth buying**.

Forestry & paper: high energy costs and low selling prices for paper products will continue to dog the forestry & paper sector, otherwise known as DS Smith. Unlike other basic materials industries, such as mining and steel, paper hasn't benefited from Chinese economic growth. Having just issued a profit warning induced by the harsh conditions, Smith has few fans among investors. Self-help measures - such as closing

less efficient mills - could boost the UK sector. Also, a forecast reduction in European capacity may be on the cards. Ultimately, though, paper needs a recovery in demand to restore its profits. Based on its low valuation, the sector is nonetheless a **buy**.

General retail: a disposable income-sapping combination of faltering house prices, rising interest rates and dwindling remortgaging activity has already triggered underperformance by the general retail sector in recent months. This pressure hasn't gone away by any means, so it's hard not to see this gloomy picture continuing to darken. Furthermore, general retailers continue to increase their number of outlets precisely at a time when underlying sales are falling. Overall, then, they are expanding into a weak market, and investors should **sell** the sector.

Health: changes afoot in the structure of government funding will challenge the business models of healthcare companies that service the NHS. From next April, NHS hospitals will no longer be paid upfront, but by results or how many patients they treat. This means already stingy NHS managers will be counting their pennies even more carefully. Capital equipment suppliers, such as mattress manufacturer Huntleigh, are already feeling the effects. But industry experts say the new regime, an attempt to make the NHS more commercial, should be beneficial for the sector, although it may take time to implement. Therefore, the sector offers **good value**.

Insurance: the soaring premium rates achieved following the attacks on the World Trade Center (WTC) are now a distant memory, but the insurance market refuses to weaken substantially. Granted, premium rates in plenty of business lines are falling. But plenty more sectors are still delivering rate increases and, overall, the market looks stable and next year is likely to see solid underwriting profits. That rating stability largely reflects a need to rebuild reserves following a stream of costly post-WTC disasters. These included last year's hurricanes, while August's Hurricane Katrina should also help keep rates higher for longer than they otherwise would have been. The sector is **fairly priced**.

IT hardware: the exponential growth of consumer electronics should be great news for the companies in the UK's IT hardware sector. Many of its constituents design the semiconductors that power these devices, which range from mobile phones to MP3 players and, in 2004, the industry sold more chips than ever. But an inventory glut curtailed sales throughout the first quarter of the year and sent shivers through the market, which saw shares drop to 12-month lows. The industry has demonstrated new-found resilience, though, working through the excess stock in just three months. And the industry's forecasting body, the Semiconductor Industry Association, has revised its delivery forecasts upwards on evidence that the consumer-led boom shows no signs of letting up. **Good value**.

Leisure & hotels: legal changes are to pose opportunities and threats to the gambling and drinking parts of the leisure sector. Relaxation of entry rules and an increase in the number of jackpot machines should boost casinos from this autumn. The introduction of a smoking ban in Scotland's pubs next spring could hurt their owner's earnings, though, and will guide investors as to the effects of a future English ban. International travel patterns - particularly business trips - will determine the fortunes of major hoteliers. But the likely further shift away from property ownership towards management and franchising could support valuations. Overall, the sector is a **sell**.

Life assurance: UK life assurers are beginning to reap the benefits of an upturn in demand for pensions and other savings products. Further government incentives are expected next April when a big change in pension rules comes in. The position at the moment is simple: the number of people drawing a pension is growing all the time as life expectancy improves, and the state pension alone will not be enough for a comfortable retirement. Consumers are also starting to regain confidence and their appetite for equity and bond-based investments after a torrid time of falling equities and product mis-selling. The sector is **worth buying**.

Media: the advertising downturn will remain the dominant theme, with almost all stocks affected. There is no sign of a recovery, particularly in the badly performing employment advertising market. Mainstream players are also dealing with the threat that internet sites pose to their advertising revenue, which is even starting to affect local newspaper publishers. To combat that, there are likely to be more acquisitions of internet businesses by traditional operators and new website launches. Investors should avoid the sector in the short term, but start looking for value in beaten-down media stocks when signs of an advertising recovery emerge. **Sell**.

Mining: few would dispute that, over the long term, commodity prices tend to mirror the marginal cost of production. But, from time to time, prices can remain high for extended periods, because it takes so long to bring new capacity on stream. Mining bulls argue that, courtesy of Chinese demand, we are in just such a 'stronger for longer' phase now. Bears point out that a supply-side response is already building, especially in base metals. If some commodity prices start to weaken, diversified miners, such as Rio and BHP Billiton are more defensive than single-commodity plays, such as Antofagasta and Lonmin. As with oils, cash-generation is impressive across the sector. Some select opportunities but overall is **high enough**.

Oil & gas: cash is what it's about. High oil prices mean major producers are drowning in money and, even after heavy capital spending, there is plenty left for shareholders. Mergers and acquisitions would appear unlikely at current valuations but, if heavy exploration spending does not start to yield results, that could change. Smaller exploration and production companies have driven the oil price higher, but their recent record at finding hydrocarbons has been patchy. The market could start to fret about this should oil prices weaken. The service companies are making the most of higher spending, but share prices have raced ahead and the sector is richly rated. **Fairly priced.**

Personal care: with demand for personal care and household cleaning products growing at a modest rate in developed markets, further innovation will remain the name of the game in the sector. As far and away the biggest player in the UK sector, Reckitt Benckiser is well-placed to achieve such innovation, especially given its excellent track record of creativity. However, high ingredient and packaging costs will continue to threaten profit margins. Following the Procter & Gamble takeover of Gillette, further industry consolidation could boost the sector's outlook. **Fairly priced.**

Pharmaceuticals & biotech: the future of this sector depends on how the industry and regulators respond to the fallout from the Vioxx scandal. US company Merck's painkiller was withdrawn last year after it was linked with heart attacks, and the company is now embroiled in class-action lawsuits, the first of which Merck lost to

the tune of £140m in damages. GlaxoSmithKline and AstraZeneca have come in for criticism, too, with both companies now posting clinical trial data on the internet to increase transparency. And analysts fear there may be fewer drug approvals in the future and increased regulation. But the bad news is well-known and the reaction has been overdone. **Good value**.

Real estate: commercial property is showing signs of strain. Share prices in commercial property groups are linked to the value of their property portfolios. These values have been rising, driven by huge investor appetite for this asset class. But prices are now so high that rental yields, according to the Investment Property Databank's July data, are at record lows of 4.1 per cent. Also, commercial property has underperformed equities by around 5 per cent this year. The quoted sector is being buoyed up by the prospect of UK real estate investment trusts (Reits). But Reits may not be introduced until 2007. The property Bull Run is reversing, so **sell**.

Software: in the absence of any real recovery in corporate IT investment, public-sector spending looks to remain a vital component of the software sector's growth prospects for some time. Companies such as Xansa, Northgate IS and iSOFT should continue to produce steady cashflows from long-term government contracts, while more commercially facing companies, such as Computacenter, face difficult markets as product replacement cycles lengthen and IT services become a commodity. Technology's reputation as a growth sector has been battered in recent years, and many are turning to acquisitions to boost flagging growth. So, with the sector trading at a massive premium to the market, it looks **fairly priced** at best.

Speciality & other finance: speciality and other finance covers investment managers and stockbrokers to buy-to-let lenders and inter-dealer brokers. Those companies with exposure to mortgage and sub-prime lending have seen some slowdown as a result of high debt levels and a weaker housing market, but bad debt levels have yet to create problems. Stockbrokers are experiencing more favourable trading conditions, helped by an increase in discretionary fund management. The recent cut in interest rates has provided psychological support across the sector, and a steadily improving equity market is underpinning investment performance, making the sector **good value**.

Steel: after decades of inept management, Frenchman Philippe Varin has put the UK's only volume steel maker - Corus - back on a firm footing, cutting costs and rationalising production. He was helped last year by a strong recovery in steel prices, on the back of rampant demand from China. The steel industry is a lot better at managing output these days, but the long-term issue for Corus - and all its OECD peers - is whether they can compete with lower-cost economies. Innovation - such as coloured steels for the construction industry - is one option. Vertical integration is another, although now is hardly the time to be buying iron ore assets. Overall, though, the steel sector represents **good value**.

Support services: support services, which contains recruiters, private finance initiative (PFI) contractors, equipment hire firms and even an undertaker, is a real hotchpotch of a sector. Continuing skill shortages in this country and expansion opportunities in the rest of Europe make the recruiters worth buying. And heavy government spending should keep supporting many contractors, making them worth buying, too. But high oil prices and US airline trauma mean investors should sell

airline services. The 2012 Olympics will boost many in the sector, from plant-hire groups to catering outsourcers to those who make money from public-sector construction projects. Overall, the sector is a **buy**.

Telecom services: consolidation chatter has resounded in the telecommunications industry since the implosion of the dot-com bubble. Now it is officially under way with Cable & Wireless buying Energis, and Spanish national champion Telefonica looking at 02. The prospect of further merger and acquisition activity will continue to drive prices. Investors are also appreciating telecoms' stable cash flows, with the added bonus of growing markets, including mobiles, broadband and data. That should shrink the sector's discount, as the likes of private-equity investors and rivals look to take out telecoms operators. The attractive combination of strong cash flow, undervaluation and consolidation make the sector a **buy**.

Tobacco: with European governments on an anti-smoking crusade, the trading environment in the UK tobacco companies' most lucrative markets is going to remain demanding. However, from the experience to date, they should handle this well. Cost-cutting will continue to offer a way to maintain and even boost profitability in developed markets. Meanwhile, expansion into China represents a growth opportunity - although BAT, Imperial Tobacco and Gallaher are all some way from making real money there. Further consolidation is inevitable, but may not happen in the immediate future, owing to the industry's high current valuations. A renewed bout of stock market weakness could boost the sector's appeal but, otherwise, it is no more than **fairly priced**.

Transport: although passenger growth trends are positive, record-busting oil prices have been stalling growth prospects across the sector from airlines to bus operators. So, with no respite from rocketing oil prices in sight, the only real excitement is likely to come from takeover activity. For example, easyJet's shares have doubled in value during the past year on bid rumours, while logistics companies are also ripe for consolidation as they struggle to eke out decent margins. But aside from pockets of bid action, the oil price will continue to be a drag on earnings. Consequently, the sector's rating of 13 times forward earnings looks too high. **Sell**.

Utilities (other): having sailed through the recent regulatory review, the UK's water companies are now looking forward to five years of agreed price rises. This transparency of earnings is a major plus point for the sector, as is its chunky 5 per cent average dividend yield. Merger mania has also recently hit the sector with a series of takeover bids - water companies' reliable cash flows are a major draw for bidders. But, following a long period of out performance, the sector is trading on a punchy 19 times forward earnings, leaving it worth holding for income. **Fairly priced**.

Mining Sector.

Mining Cycle

The current mining super cycle (high and rising use of metals) is driven by China and India. As of early 2005, it is at the peak of a normal 8-year cycle (signs of peaking are ease of speculative new companies to raise cash and Australian interest in the London market) but 3 or 4 cycles make up a super cycle. The fundamentals for growth remain – growth in demand and tight supply. Prices have fallen since April but they would need to fall 15% to become value again.

Criteria:

- Profits but more particularly Cash Flow
- Growth profile
- Current earnings and Dividends – avoid 'blue sky'
- Tried and tested management with a good track record
- Independent corroboration e.g. consultants SRK
- Avoid – most cash shells, Director selling, exploration companies valuing assets in the ground at market prices

Tips

- Long-term: Consolidated Minerals, Peter Hambro Mining, First Quantum.
- Brokers: Monterrico, Asia Energy, Western Canada Coal, Petra Diamonds, firestone Diamonds, Rambler, Peter Hambro Mining, African Eagle, Albidon, Frontier Mining, Vane Minerals, Jubilee Platinum, Consolidated Minerals, First Quantum, Van Dieman Mines.
- Emerging Markets: European Nickel, Golden Prospect, Monterrico, Mano River, African Eagle, Zambesi.
- Avoid: Zari Resources, Zareba Resources, Churchill Mining, Highland

Valuation:

A. Producers

- Sector PE Ratios. Be careful of a single mine company with low PE and high Yield – the life of a mine may be very short.

- Discounted Cash Flow/Net Present Value. This gives a calculated value for the shares that can be compared to the market value. Take taxed Earnings over, say 10 years, discounted back to Present Value using a discount rate of 5-10%.

- Net Assets per Share.

- Metal Value per Share. Market Cap. per oz. for Production, reserves and Resources is calculated by dividing Market Cap. into each of the three categories. Similarly, Metal Value per Share can be calculated by first dividing the Number of Shares in Issue into each of the three categories Oz. per Share. Then calculate the value of that oz. /share figure. Compare with the share price.

- ROCE/WACC. ROCE needs to be greater than WACC if the share is to have value.

- EV. EV = Market Cap. + Market Value of all non-equity finance (debt, convertibles, and warrants) minus any cash. EV/EBITDA is a useful multiple – the higher the multiple, the more expensive.
  Economic Value Added. EV = NOP – Adjusted Tax – Return on Invested Capital (using WACC%)

B. Exploration Plays

- Calculating Mineral Value. Determine i) cubic metres ii) tonnes per cubic metre iii) grade% iv) metal price.
- Net Present Value. Use metal prices below current market price especially if in a bull market.

Oil and Gas Exploration & Production Sector.

Production Companies.
Valuation: multiply the barrels of oil or equivalent production per day (boepd) by the current Spot Price times 365 days. Deduct Tax of 50% plus Costs of approx. 25% to give a Profit after Tax figure. Divide the Market Cap by Profit after Tax to give a forward PE.

Exploration Companies.
Booked reserves relate to oil in the ground which are booked in the Annual Report and have a Declaration of Commerciality, implying viable production in the short to medium term. There is a long process of verification before actual reserves are booked and this can create an anomoly in valuation. Oil in the ground tends to be priced at the $3-5 level, which relates to a Spot Price of $20-30. The implication of this is that E&P Sector valuations are not driven by the Spot Price and are, therefore, undervalued. This creates scope for M&A activity.
Valuation of an oil field is done by multiplying the 2P figure by $3-5. Multiply by the Risk Percentage e.g. 10% initially rising to 50% on the drilling report. Divide by the ownership percentage. Divide by the number of shares to determine how much the share price should rise on the announcement. The combined 2P reserves of a company comprise its NAV (i.e. the NPV of the cash flows from its oilfields)

1P is Proven; 2P is Proven and Probable; 3P is Proven, Probable and Possible.
(Proven = Reserves which on the available evidence are virtually certain to be technically and commercially producible, i.e. have a better than 90% chance of being produced.
Probable =Reserves which are not yet proven, but which are estimated to have a better than 50% chance of being technically and commercially producible.
Possible =Reserves which at present cannot be regarded as probable, but which are estimated to have a significant but less than 50% chance of being technically and commercially producible.)

Reserves/Production Ratio is computed by dividing the company’s Proved Reserves by the amount of annual production.

New Economy Investment Areas.

Source: Investors Chronicle

Asset Management	Biotechnology	Broadband
Content Management	E-learning	Internet Infrastructure
Logistics	Media	Outsourcing
Optical Components	Semiconductor equipment	

New technologies:

Smart dust
Tiny airborne devices—individually called 'motes' — containing sensors and communications capabilities. These devices will be around the size of a grain of sand and will contain sensors, computational ability, bi-directional wireless communications, and a power supply, while being inexpensive enough to deploy by the hundreds.

Smart Sensors
These devices have embedded intelligence and micro-controllers and have been developed for a variety of utility applications. Smart sensors can monitor parameters such as voltage, radiation, temperature, humidity, etc., and process this information within the sensor itself. The sensor can identify threshold limits, or process data, activate alarms, etc.

Virbots
A virbot (virtual robot) is a computer program that uses artificial intelligence to simulate intelligent conversations with users. Virbots are also expected to play a big role in the classroom as education moves to the Web. They can help keep students engaged and their (students') minds from wandering.

Moletronics
A new kind of molecular-scale electronics that they hope will one day surpass the power and capacity of the silicon-based technology in today's computers. Switches, gates, transistors and other electronic devices built on a molecular scale.

Customised medicine
Scientists who helped to sequence all the genes in the body have devised a method to produce a more detailed map of the million or more variations in human DNA that make people unique. The variations are called SNPs, single nucleotide polymorphisms. They hold the key to why people are susceptible to diseases such as cancer, diabetes, and heart disease and the best way to diagnose and treat them. The ultimate goal of SNP technology is the development of customised medicine and prevention strategies tailored to an individual's genetic profile.

Electronic Paper
Electronic paper is a thin, flexible plastic sheet that can be used to download information. It operates as a reusable computer display. Gyricon Media. E Ink.

Nanotechnology
The science of making tiny mechanical devices for use in e.g. computer chip design or healthcare devices implanted in the body. SkyePharma and Elan are exploring its potential in drug delivery.

Fuel Cells
They generate electricity by reacting oxygen in the air with nitrogen. Use in cars and mobile phone batteries. Ballard Power. Morgan Crucible. Johnson Matthey. Porvair.

Smart Cards
They use an embedded microprocessor chip to store lots more information than a traditional magnetic stripe card. Can be used to pay bills, access medical records, make phone calls and conduct online transactions. Used in mobile phones as SIM cards. Bank smart cards will be next. National ID cards. Gemplus. Oberthur. Activcard.

3G
Third generation mobile phones. Hardware designers like ARM, Parthus, ARC, TTP, Imagination Technologies. Software companies like Psion and Symbian.
Content for 3G phones like Indigovision and iTouch.

Bluetooth
This short wave radio technology allows everyday appliances to communicate with each other without wires. Cambridge Silicon Radio is a pure Bluetooth play but its float has been delayed indefinitely. Densitron is developing a product to locate men overboard. Parthus has a Bluestream product. TTP is involved in software design.

Biometrics
The development of devices that can accurately recognize individuals from their bodily characteristics - eye scans, voice recognition, facial thermograms and hand geometry. Vocalis. NXT has a joint venture with QinetiQ. Ensigma is a subsidiary of Imagination Technologies.

Stem Cells
Stem cells make up an embryo immediately after fertilisation. They can be used to replace dying cells. Uses for Parkinson's and Alzheimer's diseases, and diabetes. Reneuron is the leading UK company. It could take 20 years for stem cells to become practical therapies. Problem of the anti-abortion lobby.

Telematics
The application of advanced IT to motor vehicles to help drivers navigate roads. Trafficmaster and Toad are developing applications for individual motorists. CybIT and Minorplanet deal with fleet management which will be first to take off. Delphi, Visteon, Bosch and Siemens.

Missile Defence Shield
Missile interceptors and missile destroying lasers. Boeing.

Bears and Bulls.

Source: Hargreaves Lansdown Knowledge Centre
http://www.hargreaveslansdown.co.uk/siteredesign/stockbrokers/frameset.asp?url=15

Bear Market:

1. Choose shares with low Betas less than 1.

2. Select high yield shares with a safe dividend:
    - Dividend Cover>1.8
    - Gross Dividend Yield above 10-year UK Gilt yield
    - Stable Profits record extending into the future
    - Sizeable Market Capitalisation and well-known name

3. Choose Sectors that historically do well in bear markets:
    - Soft drinks companies
    - Major pharmaceutical companies
    - Food producers
    - Major oil companies
    - Basic household products companies
    - Telephone companies
    - Electric utilities

4. Avoid companies with:
    - High PE Ratios
    - No tangible assets
    - No profits
    - High levels of Debt
    - Non-essential products

5. Avoid sectors with:
    - House builders
    - Motor vehicles
    - Industrial materials/machinery
    - Advertising
    - Stock market businesses.

6. Select stocks with a good Margin of Safety associated with these Key ratios:
    - Market Cap/Sales (PSR) less than 1
    - Market Cap/Free Cash Flow less than 5. FCF=Operating Cash Flow less tax, interest and capital spending.
    - Operating Cash Flow greater than Operating Profits
    - Enterprise Value/Profit before Interest less than 10. EV=Market cap plus Debt and minus Cash.
    - Market Cap/Tangible Book Value (PTBV) less than 1.
    - Gearing less than 25% or net Cash in the bank.

7. Use pound cost averaging.

8. Look out for the bear market bottom:
    - The market will have been trending down on light volume for a year or more.
    - There may have been a dramatic event that produced a final bout of selling
    - Investing in shares will have been unfashionable for some time.
    - Sound companies may face absurd rumours
    - PE Ratios will be in single figures
    - PTBV of the market will be less than the long-term average of 0.65.

9. Signs of a Bear Market:
    - Cash is regarded as an undesirable asset
    - Value is hard to find. Average PEG will be 1.5+ and few stocks will be trading at a discount to assets
    - Average Dividend Yield will be historically low
    - Interest rates will usually be about to rise. Chances of further fall will be minimal
    - Bullish consensus
    - Lots of IPOs, and of poor quality
    - Ratio of Director buying to selling will have fallen to historically low levels
    - Shares will be failing to respond to good results, implying market exhaustion
    - Exuberance
    - When 75%+ of all stocks have been above their long-term averages and the number of stocks falls below 75%, this is a bearish technical signal
    - About 14 months will have elapsed since the last Coppock Indicator buying signal, during which time the average gain would have been 30%+
    - Broad money supply will usually be contracting
    - Cyclicals usually do well near the top of bull markets.

10. Stages:
    - At the start of a bear market, there is a sharp fall but economic conditions remain positive.
    - Economic conditions deteriorate but the market becomes over-sold.
    - This is followed by a sucker's rally, people believing that the bottom has been hit
    - Economy deteriorates, followed by panic selling
    - This phase ends ready for the next bull market when investors abandon all hope for the future
    - The first positive sign is when shares no longer fall on bad news.
    - Many new bull markets have started with a major double bottom formation.

Bull Market:

Signals that lead to a Bull Market are:

1. Capitulation - This refers to the point at which people give-up. True capitulation involves extremely high volume and sharp declines (oversold stocks). It usually indicates panic selling. After capitulation, selling takes place. Great bargains exist because everyone who wanted to get out of a stock for any reason (including forced selling due to margin calls) has done so. As a result the price reverses or bounces off the lows.

2. Interest rates - Before the bull, rates should be low or at least decreasing. There is usually an inverse relationship between markets and interest rates. Lower interest rates spur the borrowing market because companies get money at a cheaper rate. The borrowed money typically finances expansion, which ultimately leads to higher profits.

3. Realism - Warren Buffet once said, "Investors should be fearful when others are greedy, and greedy when others are fearful." The final stage of a bull market is ruled by greed and incredibly high expectations. At the end of a bear market, investors start to become more rational and realistic, forgetting about the unsustainable high returns to which they were once accustomed.

4. Inflation - This is the rate at which the general price for goods and services is rising, so purchasing power is subsequently falling. If inflation is high, the Federal Reserve will typically battle it by increasing interest rates, which slows spending. Most bull markets build during periods of low or decreasing inflation.

5. Volume - Watching the number of shares traded on the stock market can be a good indicator of shifting sentiment. During a bear market, many pensions, funds and other institutional buyers have large amounts of money sitting as cash on the sidelines. This money is waiting for an opportunity to get back into the markets.

6. IPO Market - When a bear market is at its worst, very few new companies go public. IPOs are used to raise money and finance expansion. When companies that have profitability begin to emerge into the IPO market, it signals improvement in the market.

7. Chartist Signal – the bear market is over when the Indices stay above the 200-day Moving Average for at least 10 days.

The Financial Year.

January Investors buy shares. Institutional buyers will put last year's performance, good or bad, behind them and come back to work full of fresh ideas and new money. There is a saying if the market goes up in January, it goes up for the year.

February No complaints; shares do tend to rise. UK earnings season is underway.

March Another good month for shares prices, on average. Final dividends begin to flow in from companies that report a calendar year-end, and are reinvested.

April The new tax year begins on the 6th, bringing with it fresh capital gains tax and ISA allowances. Shares tend to do reasonably well in April, but this is not the best time to make new investments as poorer months are close on the horizon.

May 'Sell in May and go away,' so goes the famous stock market rhyme, and it really works. While many investors will not want to sell up completely, stock market history does show that this is not a good time to make fresh investments.

June A good time to hit the beach, as not too much happens in the markets. One of the poorer months for shares, but not too bad a time to take profits.

July Half-year results provide the only interest here. Though a new quarter starts in July, it can be one of the poorer ones for institutional cash inflow.

August August is an anomaly, the second best performing month of the year. No one knows why, but we do know that the gains are short lived.

September The second line of 'Sell in May and go away' is 'Come back again on Leger Day'. In fact, September is a poor month, so it does no harm to keep out of the market. Stock market historian David Schwartz has shown that the stock market averages a rise of 13% from Nov. to April and only 1% from May to Oct.

October October is a frightening time for the risk averse, but a great time for those investors who are brave enough to dive in at the lows. Once October's volatility is past, there is the best six-month stretch the year has to offer.

November Investors hoping to catch the January rise have begun to get in earlier. November is a strong month, with everyone watching spending in the Xmas run up. Retailers and leisure firms are often uppermost in investors' minds.

December Get out the spreadsheet and see how you did. Benchmarking your portfolio against indices is the best way of seeing how you shape up as an investor. Look over any mistakes and work out how to do better next year.

Other Calendar Influences

Presidency. 1st year of US Presidency tends to be a bear market. 2nd year tends to produce a bottom about mid-year. 3rd year tends to be the best of the cycle. 4th year tends to be weak in the first half and strong in the second. Days. Monday is the worst and Friday the strongest. Holidays. The day preceding a holiday is bullish.

Trends and Anomolies in the Stock Market.

Source: Simon Thompson IC

1; **Clock Adjustments.** When the clocks go back on the last Sunday in October, the stock market tends to go up on the following Monday. When the clocks go forward on the last Sunday in March, the markets tend to fall.

2. **Santa Claus Rally.** The market tends to rise in the month of December around 3%.

3. **Most Profitable Quarter**. The fourth quarter rising over 4.5%, followed by the first quarter rising over 4%.

4. **Falling Third Quarter.** The third quarter is usually the worst-performing quarter. When the market falls in the third quarter, the fourth quarter usually produces a strong rally of the order of 10%.

5. **Changes to Index Constituent Members.** Companies falling out of an index have to be sold by tracker funds, producing an over-sold situation. The best day to buy is when they fall out of the index (i.e. third Monday of March, June, September and December).

6. **Effect of Interest Rate Cuts.** The FTSE All-Share Index tends to do well in the 12 months following the first interest rate cut. The best performing sector is banking, followed by IT Hardware, Steel, Mining, Construction and Building Materials, Forestry and Paper, Automobiles, Specialty Finance, Real Estate, and Leisure. Cyclicals tend to do well while Defensives tend to underperform the market.

7. **Housebuilding Play.** The housebuilding sector tends to take off in the first quarter, rising over 10%. This coincides with their reporting season in late-February and March and the start of the spring selling season. Investors should buy large housebuilders like persimmon, Wimpey, Barratts, Berkeley, and Bellway.

8. **S&P 500 Dog Effect.** The 10 worst-performing shares tend to bounce back in the fourth quarter, making an average return of 25%. This is due to the fiscal year-end in the US at the end of September.

9. **The Most Profitable Day to buy the FTSE Index**. The ninth trading day of August is best, with the nineteenth trading day of September a close second.

10. **FTSE All-Share Dog Effect.** The time to buy the worst performers is at the end of December to capture the January bounce in excess of 5%.

11. **FTSE 100 Level by March 2008.** History suggests the market could double, five years after the end of the bear market. Therefore, 6837.

12. **FTSE Falls, Three Years in a Row.** Only four times in the last 135 years.

13. **Index-linked Yields.** Telecoms tend to out-perform the market following the three-month period when index-linked yields have fallen.

14. **Summer Effects.** July and August tend to be poor historically. However, when the market rises during the summer, it tends to rally strongly. If the market rises in the third quarter, it also tends to rally in the fourth quarter.

15. **Best-performing Sector.** High-yielding stocks tend to out-perform e.g. tobacco and, especially, banks.

Main Investing Styles.

The 5 Keys to Value Investing.

http://www.amazon.co.uk/Five-Keys-Value-Investing/dp/0071402314/ref=sr_1_12/202-7523631-9877467?ie=UTF8&s=books&qid=1178998814&sr=1-12

Rationale of book:

1. You will have a specific value framework to help you make investment decisions.

2. You will know how to find the balance between price and value, and how to "buy right."

3. You will know how to identify events that move stock prices.

4. You will be able to generate your own value investment targets and build your own portfolio.

Goal of the Value Investor:

Good Business + Excellent Price = Adequate Return over Time

Emotional Discipline:

With an established framework, value investors are more likely to avoid getting caught up with the moods of the market or their own emotional feelings of the day.

Characteristics of Value Investors:

1) They exude emotional discipline,

2) They possess a robust framework for making investment decisions,

3) They apply original research and independent thinking.

The Seven Fundamental Beliefs:

Belief No. 1: The world is not coming to an end, despite how the stock market is reacting.

Belief No. 2: Investors will always be driven by fear and greed, and the overall market and stocks will react accordingly. This volatility is simply the cost of doing business.

Belief No. 3: Inflation is the only true enemy. Trying to predict economic variables and the direction of the market or the economy is a waste of time—focus on businesses and their values, and remember Belief #1.

Belief No. 4: Good ideas are hard to find, but there are always good ideas out there, even in bear markets.

Belief No. 5: The primary purpose of a publicly traded company is to convert all of the company's available resources into shareholder value. As shareowners, your job is to make sure that this happens.

Belief No. 6: Ninety percent of successful investing is buying right. Selling at the optimal price is the hard part. As a result, value investors tend to buy early and sell early. *[Buying early allows the investor to use dollar cost averaging. Dollar cost averaging is buying more shares of a particular company as the share price trades lower in the market place.]*

Belief No. 7: Volatility is not risk; it is opportunity. Real risk is an and permanent change in the intrinsic value of the company.

Five key questions in considering investment opportunities:

1. Is this a good business run by smart people?

This may include items such as quality of earnings, product lines, market sizes, management teams, and the sustainability of competitive positioning within the industry.

2. What is this company worth?

Value investors perform fair value assessments that allow them to establish a range of prices that would determine the fair value of the company, based on measures such as normalized free cash flow, break-up, takeout, and/or asset values. Exit valuation assessment provides a rational "fair value" target price, and indicates the upside opportunity from the current stock price.

3. How attractive is the price for this company, and what should I pay for it?

Price assessment allows the individual to understand fully the price at which the stock market is currently valuing the company. In this analysis, the investor takes several factors into account by essentially answering the question: Why is the company afforded its current low valuation? For example, a company with an attractive valuation at first glance may not prove to be so appealing after a proper assessment of its accounting strategy or its competitive position relative to its peers.

4. How realistic is the most effective catalyst?

Catalyst identification and effectiveness bridges the gap between the current asking price and what value investors think the company is worth based on their exit valuation assessment. The key here lies in making sure that the catalyst identified to "unlock" value in the company is very likely to occur. Potential effective catalysts may include the breakup of the company, a divestiture, new management, or an ongoing internal catalyst, such as a company's culture.

5. What is my margin of safety at my purchase price?

Buying shares with a margin of safety is essentially owning shares cheap enough that the price paid is heavily supported by the underlying economics of the business, asset values, and cash on the balance sheet. If a company's stock trades below this "margin of safety" price level for a length of time, it would be reasonable to believe that the company is

more likely to be sold to a strategic or financial buyer, broken up, or liquidated to realize its true intrinsic value—thus making such shares safer to own.

Example Valuation Approach:

1. Sum-of-the-parts valuation (using three different multiples EV/EBITDA, EV/FCF, and PE).

2. Historical valuation (using the same multiples to see how the market valued the company historically).

3. Transaction deal basis (comparison with similar deals using EV to Cash Flow and EV to Revenue).

Take an average to give an idea of Fair Value. The need is then to establish a Purchase Price at a discount to Fair Value and with a margin of safety. For example, 5.5 times Enterprise Value to pre-tax and interest cash flow could be used.

Analyzing Financial Statements:

1. *Income Statement*. The income statement reports revenues and expenses incurred over a specific time period. The income statement is important because it provides value investors with information that allows them to gauge the prospects of a company's future earnings. Generally speaking, the more income noted, the stronger the earnings power.

2. *Cash Flow Statement.* It provides: a) the sources of cash during a period, b) uses of cash during a period, and c) change in cash balance during a period.

There are three sections to the statement of cash flows:

i) Operating activities include the daily transactions involving the sale of products, and the results from providing services to customers. This could include the cash receipts from the sale of goods or services and the cash payments to suppliers to purchase inventory.

ii) Investing activities include lending money, collecting on those loans, or buying and selling assets.

iii) Financial activities include obtaining cash from creditors, repaying the amounts, and providing them with dividends.

The most important, however, is the cash flow from operating activities, as it involves the sale of goods and services—the viability of the company. If it is clear that the cash flow from operations is not the primary source of cash, the company may be headed for trouble.

3. The Balance Sheet. Essentially, the balance sheet summarizes what the company owns and compares it to what the company owes to outsiders and investors. The balance sheet always balances between assets and liabilities plus equity. The assets in a balance sheet are the economic resources that are expected to generate future benefits to the

company.The balance sheet provides the independent value investor with the tools with which to make sound judgments on the financial health of the company.

Three Approaches to Understanding the economics of a business:

1. Vertical Assessment Approach. There are six specific tools the value investor uses for a typical non-service-oriented company. They include the 1) industry analysis, 2) competitive position analysis, 3) manufacturing, 4) operating, 5) tax strategy assessment, and 6) debt analysis.

The use of a common-size statement is the most popular way of performing a vertical analysis. A common-size statement is an income statement that shows all items as a percentage of sales as well as in sterling form.

One of the industry tools that has been well received among investors is the industry framework developed by Professor Michael E. Porter. What makes the Porter framework particularly useful is that it is widely used among a variety of investors of different styles. His framework assesses five different "forces" that drive industry profitability. The forces include the threat of new entrants, the threat of substitute products, the bar-gaining power of buyers, the bargaining power of suppliers, and the degree of rivalry among competitors.

Operating cost control: Assessing a company's operating cost controls includes looking at the trend of expenses as a percent of sales over time.

A certain amount of debt on a company's balance sheet is good, because it can prevent management from making costly mistakes e.g. implementing a diworseification strategy. Academics refer to this benefit as "the discipline of debt." There is a "right" amount of debt that a company can have to avoid financial distress, operate under ample disciplinary constraints, and maximize its returns. When considering debt analysis of a company, the value investor uses two primary tools: Interest Cover and Debt-to-total-capitalization ratios.

2. ROE Decomposition Approach. The ROE approach, better known as the "du Pont Model," highlights how profitably management has been able to allocate the firm's resources. Return on sales (ROS) indicates the amount of profits a company is able to keep for each dollar that the company takes in from the sale of goods and services. Asset turnover shows the amount of revenues the company is able to generate for each dollar of assets committed. Return on sales multiplied by asset turnover generates return on assets (ROA).

ROS (Net Income/Sales) * Asset Turnover (Sales/Assets) * Financial Leverage (Assets/Equity) = ROE.

Good businesses consistently produce ROEs greater than their equity cost of capital.

3. Cash-Flow-Based Approach. There are three common definitions: net cash flows, cash flows from operating activities, and discounted cash flows. Net cash flows are calculated by taking a company's net income and adding or subtracting non-cash items. This is sometimes referred to as cash earnings. The intent of net cash flow is to show the cash that the company generates. This calculation is well liked among investors, with one caveat, however. The problem is that it assumes that a business's working capital

accounts do not change over time. As a result of this failure, many investors look to cash flow from operating activities, which includes the change in assets and liabilities, as well as net cash flows. The final type of cash flow is the discounted cash flows method (DCF), which is the sum of future cash flows discounted to the present. DCF is used—among other reasons—because it takes into account the time value of money. The discounted cash flows method is generally used as a valuation tool, and less as a business "assessment" tool.

Business Quality red flags:

There are several key red flags that value investors look for when evaluating the earnings quality of a company. The following are the 15 common red flags; and, if identified, should warrant a closer look:

1. There is a difference between the company's accounting policy with other companies in the same industry such as how revenue is recognized. Check the footnotes.

2. Management's incentive package is purely based on increasing earnings per share and has the discretion over accounting treatment.

3. There are unjustified changes in estimates, accounting, or financial policies.

4. There are special business arrangements and deal structures to achieve accounting objectives, such as earnings growth.

5. The Letter to Shareholders does not adequately disclose the company's business strategy and its economic consequences. The Letter to Shareholders can be found in the company's annual report.

6. The management was not complete in addressing the prior year's poor performance in the MD&A. The Management's Discussion and Analysis (MD&A) can be found in the annual report.

7**.** There are changes in accounting. Look at the footnotes.

8. There are unexplained transactions that helped earnings. Scrutinize the footnotes to uncover uncertainties.

9. There is an abnormally high increase in inventory relative to sales growth. Review the latest income statement, as well as the balance sheet.

10. There is an abnormally high increase in accounts receivable relative to sales. Take a look at the income statement and balance sheet.

11. Net income is growing faster than cash flow from operations. Take a look at the most recent statements of cash flow and income.

12. There is an unexpected and large write-off or charge-off. See most recent news on the company.

13. There is a large fourth-quarter adjustment. Take a look at the annual report.

14. The company is lending money to customers or has a significant equity stake in its customers.

15. The company changes expense calculations or any other material items that can enhance earnings. See the footnotes in the annual report.

Assessing management:

Buffett's advice is to read the annual reports of the company and compare them from one year to the next. Go back as far as possible to determine whether management lived up to the promises made. Buffett also suggests that investors compare a company's annual reports to its competitors' reports. Management credibility is extremely important. And the best way that managers can earn credibility over time is to deliver on their promises. Value investors typically assess past promises by reviewing management's past letters to shareholders and analyzing the financial statements.

In analyzing the financial statements, some investors employ an economic value added (EVA) approach to assign management's ability to make decisions. EVA simply assesses if current management was able to generate excess returns with the capital they invested above the cost of their capital. EVA is a company's after-tax operating income minus its cost of capital. The formula is as follows: EVA = Net Operating Profit After taxes - (cost of capital * capital employed). Economic value added is appealing because it takes into account management's ability to make prudent capital allocation decisions. Look to see if the company links its management incentive schemes to it.

Price and Value Assessments:

The objective in the game of investing is to buy low and sell high. To properly assess the price of a company's stock, one has to be willing to uncover the necessary data points in order to understand fully the business and the value metrics that a rational buyer of the enterprise would be using in valuations.

Some investors spend time trying to estimate what the next three to four years will look like for a particular company. There are a variety of news services and research companies that publish the future earnings predictions of analysts. Investment analysts use these estimates to value companies. Value-minded investors, on the other hand, focus not on earnings that are too distant; rather, they concentrate on what earnings and cash flows are today.

To get to a company's fair value, the value investor triangulates a valuation. Triangulation involves using three of the best valuation tools for that particular business. There are three broad categories of tools that a value investor uses to value a company. They are comparison based, asset based, and transaction based. In each of these approaches, using "multiples" is the most common tool that investors use to value companies.

There are different types of valuation tools. Some are comparison based, whereby the value of the enterprise is based on the valuation of other similar companies. There is an asset-based valuation, which focuses on the intrinsic value of the enterprise. Transaction-based valuation tools assess the worth of a business based on what other companies have been sold for in the market place.

1) Comparison-based tools: Comparison-based tools compare one company to another company of similar likeness. In the comparison-based valuation toolbox, value investors possess many different valuation tools that they can call upon to determine the value of an enterprise. The most common tools are price-to-earnings (P/E); price-to-book (P/B); enterprise value to earnings before interest, tax depreciation and amortization (EV/EBITDA); and price to sales (P/S) or enterprise value to revenues (EV/R).

a) Price-to-Earnings: The most common way to use P/E ratios is to find a few companies that are very similar to the particular company in question. These similar companies are often called comparable or "twin" companies. The objective is to get a relative sense of the value of the enterprise based on the current value of the company's peers. Finding good twins may be a problem because no two companies are completely alike. They may have a different product mix, financial leverage, etc.

The relative P/E ratios are used to assess the P/E ratio of a company in relation to the market. One can compute relative P/E by taking the company's current P/E and the current P/E of the stock market. The relative P/E metric is used two different ways. Some use the firms' relative P/E and compare it to the historical trends. For example, if a company's stock has had historically a 10-percent discount to the overall market P/E, and now it is trading at a 25-percent discount, the stock would presumably be cheap. The other way that investors use this metric is to compute a relative P/E ratio as it relates to its sector-average P/E. One shortcoming with using the P/E ratio is that it cannot be used to value firms with negative earnings.

There are four primary concerns that relate to the use of earnings. First, the accounting used can have too much of an impact on earnings among similar firms. Another concern with using earnings is the fact that it excludes both business and financial risks. One may have too much leverage, and the other may not generate enough cash to finance its operations. The earnings number is not a "cash" number. This fact leads to the third concern: earnings exclude required investments to keep the business operating and growing. Investments such as capital investments are excluded in the earnings calculation. Capital expenditures are critical because significant outlays should be taken into account when assessing the economic value of an enterprise. While depreciation expenses are included in the earnings number, they are a noncash item; they thereby reduce the economic value of the enterprise. Value investors often add back depreciation and deduct capital expenditures as an ingredient to obtain a firm's economic pulse.

The P/E ratio is best used among investors when evaluating financially sound companies with no near-term (in one to three years) capital expenditure requirements on the horizon. The stock market on a long-term basis focuses on management's impact on the cash flow growth rather than pure accounting earnings.

b) Price-to-Book: This valuation tool gives investors a sound measure of value, which can be compared to the market value. Book value, net worth, and shareowners' equity value are essentially the same. P/B is also attractive to some investors because one can value companies with negative earnings—a feature that the well-liked P/E ratio fails to deliver.

The critical failing here is that P/B is useless if legitimate treatment of depreciation is different among firms in an industry. Therefore, investors using P/B without taking a very close look at items such as depreciation would be misled. The other critical failing is that as the economy becomes more technology and service oriented, the less P/B becomes valuable as a tool. Specifically, the tangible assets of companies in the technology and

service sectors are insignificant. Ideas and human capital, while difficult to quantify, are much more important assets for these market sectors.

Companies with various amounts of options outstanding can be wrongly assessed as being undervalued or overvalued. In some cases, companies with a great number of options outstanding can appear to be undervalued, since the market value in the numerator appears lower due to the unrealized level of options in the company. The value investor typically adds the market value of the options to the market value of the equity before calculating the P/B ratio. When comparing book values across firms, the value investor also takes into account stock buyback programs and recent acquisitions the company may have had, in order to assess it properly. When companies buy back their own stock, the book value of the equity declines by the amount of the repurchase. This is what happens when a company pays a cash dividend. In fact, some regard stock buybacks as just another form of a dividend. However, buybacks have historically been larger in dollar amount than dividends, and therefore have had a larger impact on a firm's book equity.

A drop in ROE typically has an indirect, adverse impact on P/B ratios as the book value falls. Some investors believe that the strong relationship between ROE and price-to-book value gives some of the best clues to uncover undervalued companies. Companies with high ROE should trade at high price-to-book value multiples and vice versa. Companies in which value investors are most interested are those with a high ROE, and are valued in the marketplace with low P/B value ratios.

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c) EV/EBITDA: Value investors also try to gauge the intrinsic worth of a company by examining the entire firm—the company's enterprise value. This is done by taking the company's market value, adding its total debt, and then subtracting the cash. Including a control premium, this is the value that a private or strategic buyer of the enterprise would pay for the company.

The treatment of cash is what often confuses new users of this tool. There are two simple reasons why cash is excluded. First, the value of a firm is the value of its equity and its debt. By taking out the cash, the formula is essentially using a "net" debt number—debt less the cash, or absolute debt. The other reason is more complex. Interest income is not included in the EBITDA number. Often, this interest income involves returns from idle cash. Therefore, since this interest income is not included in the EBITDA calculation in the denominator, then it should be taken out of the numerator as well.

This multiple can be used across a wide variety of firms with negative or depressed earnings. Second, given the differences in depreciation among companies, EBITDA adds back the depreciation to compare the operating-cash-generating strength of similar companies.

EBITDA has many shortcomings and Buffett does not like it. With the proper perspective on the failings of EBITDA on hand, the investor can begin to apply the EV/EBITDA tool

with the proper level of caution. The best way is to focus on three variables: tax rate, depreciation and amortization, and capital expenditures. Regarding the tax rate, value investors often regard companies with lower tax rates as companies who deserve a higher EV/EBITDA multiple, as opposed to those with higher tax rates. Likewise, they view companies who derive a greater portion of the EBITDA from depreciation and amortization as companies of a lesser quality and believe that these companies should warrant a lower multiple. Finally, the value investor focuses on capital expenditures and concludes that companies using a greater portion of EBITDA for capital expenditures deserve a lower multiple. In addition, that investment in capital expenditures has to generate a return above the company's cost of capital.

d) EV/Revenue and Price/Sales: Enterprise value to revenue is calculated by taking the firm value, which includes the firm's debt and equity, and dividing it by revenues. The current equity market value, which is the stock price multiplied by the shares outstanding divided by the revenues, gives us the price-to-sales ratio, or P/S.

In the very rare occasion when value investors use revenue-based multiples, they prefer using EV/R because it values the entire firm. Price to sales values the equity portion of a company. In general, the reason why most daring investors like to use revenue multiples is that they are not influenced by accounting decisions that can plague other valuation tools such as the P/E or EV/EBITDA multiples. When using P/S, a company is seen as being undervalued despite the fact that it may have too much debt on its balance sheet. Therefore, when comparing one company to another, P/S ignores the amount of debt a company has on its balance sheet—which is an important element in determining firm value.

The disadvantages of EV/R and P/S are their heavy emphasis on future top-line growth. For example, investors often pay a high multiple for a company that is showing strong sales growth despite the fact that it is losing money or going into lower-margin businesses. If an investor decides to use EV/R or P/S, it is done in concert with an assessment of the firm's industry growth dynamics, the company's competitive positioning, and profit margins.

e) Other Enterprise Value metrics: There is EV/EBIT, EV/EBITDA-Capital expenditures, and EV/Cash Flow. These multiplies have the same characteristics as EV/EBITDA, but with more variables included in the denominator like EBITDA-CAPEX, free cash flow, EBIT, with the exception of the EV/EBIT ratio, which does not add back depreciation. EV/EBIT is often used in industries where capital expenditures are typically for maintenance purposes and are close to depreciation and amortization expenses.

f) PEG Ratio: Most value investors do not use PEG ratios.

Some practitioners of PEG use forward-looking PE ratios. When investors use the PEG ratio this way, they are double counting the growth of the company.

Several investors on Wall Street compare PEG ratios among industry groups. If a company has a high ratio relative to the group, it is deemed overvalued, and vice versa. If two companies have the same growth rate with one paying out a large part of its earnings in the form of dividends, the dividend-paying company would have a more desirable growth characteristic than the one with 100% of earnings reinvested in the company. Comparing PEG ratios works only when companies have the same growth characteristic

and risks associated with that growth. At a minimum, it should be used with other tools—and with extreme caution. The best way to use PEG—if at all—is to find the absolute perfect twin company with similar earnings risk, growth prospects and type, and retained earnings characteristics.

2) Asset-based Tools: Asset-based valuation tools are not based on the valuation of twin companies. They are based on the value that a particular company generates—its intrinsic value.

a) Discounted Cash Flows. Discounted cash flow becomes a very useful tool for valuing the assets of a firm. At its core, it values companies without using market price quotations, and incorporates the time value of money. The value of a firm is the discounted value of a company's free cash flow.

Net Income + Depreciation + Amortization - Capital Expenditures = Free Cash Flow

Buffett uses the long-term Treasury rate as his discount rate. Other investors use a weighted average cost of capital (WACC) as their discount rate because it is the overall expected return from the entire enterprise.

DCF does not work well in very common situations, such as when analyzing cyclical companies, companies who are acquisitive, companies undergoing a corporate restructuring, and companies with hidden or underutilized assets. For example, assets such as idle but valuable land or unutilized licensing agreements would be valued at nothing under DCF. Value investors use DCF when the cash flows of the enterprise are not too cyclical, and it can be assumed that they will have relatively the same risk profile in the forecasted future of five to seven years.

b) Sum-of-the-parts: The sum-of-the-parts method is essential for carving the business in different parts, which may require different tools to evaluate each.

3) Transaction-based Tool: The transaction-based tool relies on the values that the acquired company places on a firm's assets. The applications of the tools are less rigid, essentially using the same valuation metrics that buyers of business have used in the general market. These metrics can include EV/cash flow, P/S, DCF, etc. It all depends on the data that is available. The only requirement is that the value investor searches aggressively for prior transactions of similar businesses.

Catalyst Identification and Effectiveness

While buying assets at a discount from underlying value is the defining characteristic of value investing, the partial or total realization f underlying value through a catalyst is an important means of generating profits. Furthermore, the presence of a catalyst serves to reduce risk.

Firm value catalysts include such business transactions as a company merger or acquisition. There are a number of forces that help bring security prices into line with underlying value. Management prerogatives such as share issuance or repurchases, subsidiary spin-offs, recapitalizations, and, as a last resort, liquidation or sale of the business all can serve to narrow the gap between price and value.

Internal catalysts:

New management can be installed.

The company can employ a new corporate strategy. Investors often look at a sales-to-capital ratio as a tool to help analyze such revenue growth prospects. The investor calculates this ratio by taking the sales figure, available on the income statement, and dividing by the firm's capital, found on the balance sheet. A higher sales/capital ratio limits the need for the company to plow back cash to finance growth, thereby increasing cash flows and ultimately the value of the enterprise. Many investors often focus first on the impact that investment decisions have had on a company's overall cost of capital, in order to gauge their potential returns. The objective is to identify capital that is being allocated to more profitable areas of the firm, which are not likely to increase the company's cost of capital or the risk profile of the enterprise.

Companies can also implement new product strategies. Value investors watch for potential catalysts that will reduce operating risk by making the company's products and services stickier (i.e. drawing in repeat customers). Advertising is often a company's method of choice to accomplish this goal.

Improved operational efficiencies can also be a catalyst. If a company can increase its operating margins relative to its peers, it can generate greater value for its shareholders. Investors often target companies with low margins relative to their industry counterparts, because these companies will benefit most from this type of catalyst.

Cutting costs is one of management's favorites. Often, companies reduce costs by cutting back on research and training, even though this may be sacrificing their future growth potential. Such cost cutting is not prudent, and will often be a detriment to the company in the long term. Cutting costs as a sole means to drive firm value can be a dangerous game. In fact, cost cutting is often promised as a means to justify value-destroying decisions by management. Take acquisitions for example. Companies often overpay for companies and offer cost cutting opportunities to pacify shareholders. Unfortunately, rarely are such promises delivered.

Investors often view a new financial strategy as a potential catalyst. The value of a firm is often determined by the cash flows generated by the company, discounted back to the present at a cost of capital. Typically, a reduction in a company's cost of capital will increase the value of a firm. To reduce a firm's cost of capital, management will often change the levels of debt and equity on the balance sheet. Debt is much cheaper than equity, as the lender bears less risk than the equity holders. However, too much debt could cripple a company and push it into financial distress. As the cost of capital decreases, the value of the enterprise will only increase if the higher debt levels do not affect the cash flows of the firm. This is a delicate balance that value investors must assess carefully.

A sustained tax rate reduction can be a potent catalyst. There are certain initiatives that can be implemented to help reduce the tax burden. These include multinational companies moving income around to take advantage of optimal tax environments, acquiring operating losses from other companies so they can use them to shield future income, or using complex risk management procedures to reduce the company's average tax rate. Value investors, in general, are skeptical of tax strategies to increase firm value.

Reducing working capital can free up cash. The non-cash working capital in a company is the difference between the non-cash current assets and the non-debt portion of current liabilities. This typically includes inventory and accounts receivable less accounts payable. Any setbacks making improvements in working capital could affect the company's future growth and operating income. This is due to the fact that companies often maintain inventory and provide credit to their customers as encouragement to buy more goods and services. When considering the potency level of working capital as a potential catalyst, the value investor assesses the potential risk that the company may lose sales in an attempt to reduce investments in working capital.

Reducing capital investments to create value is very tricky. The net capital investments made by companies—the difference between the company's capital expenditures and depreciation—is cash coming out of the company that reduces the cash flow to the firm. This cash is typically used to fund future growth opportunities, while maintaining other assets in the company. While a company might generate cash inflows by reducing investments in existing assets, which can generate value for shareholders, it also risks reducing the life span of these assets. Conversely, if a company invests all of its capital on existing assets, there may be no free cash flow—a move that may impair firm value.

Share buybacks are one of investors' favourite catalysts. It is when a company's stock price trades at a significant discount to a firm's fair value that value investors mostly search for catalysts. The most common catalyst, and certainly less complicated in terms of execution, is the stock repurchase.

There are six primary reasons why companies buy back their own stock: 1) to reduce the company's dividend cash outflow without reducing the dividend itself; 2) to signal to the stock market that the company's stock is undervalued; 3) to increase earnings per share; 4) to change the company's capital structure; 5) to buy the shares of a big seller of the stock; and 6) to give current shareholders a tax-friendly cash distribution.

Value investors view a buyback as an acquisition made by the company; the price has to be right. Increasing earnings per share is many times best achieved when the company uses new debt to finance the repurchase. This action increases not only earnings, but may also increase a firm's ROE. Return on equity could increase due to the change in the firm's capital structure.

Spin-offs and equity carve-outs can be a good way to spur a company's share price. For example, a slow-growth, low-margin conglomerate that has a fast-growing, high-margin division, may be a good candidate for a spin-off, due to the potential valuation differences. In addition, companies with several divisions and complex structures are hard to value, and are often valued at a significant discount to the values of their parts. Spinning off divisions is often a remedy that eliminates this conglomerate discount.

Split-offs. A split-off is similar to a spin-off. The difference is that in a split-off, investors must choose which company they would like to own, the parent or the new company, but not both. Value investors focus on the quality of the two businesses, their values, and the price at which these investors would own the shares—factoring in any incentive from the parent company.

Asset Sale: An asset sale is only part of the value creation. The other half is the use of the proceeds. Typically, if these assets generate investment returns less than the company's cost of capital, or what they could potentially generate, then they are the most potential

candidates for sale. The use of the cash received from the sale of assets can also be a catalyst. There are typically three uses for the cash received. First, the company can invest the cash in the stock market. Secondly, the company can invest the cash in other areas of the company, which might produce a higher return for the company. Finally, as a less risky alternative, the company might share the proceeds of the asset sale with shareholders by repurchasing stock or issuing a dividend.

Worth more dead than alive: full or partial liquidations are often a potent catalyst. Liquidating would be a catalyst if the stock price of the company trades well below its liquidating value—a value that is computed as the net worth of tangible assets to the firm.

External Catalysts:

The presence of shareholder activists.

Industry merger activity can also be effective. A good acquisition target might be a firm that is doing a poor job managing its assets or one that has assets that are too complicated to be properly valued by the general market. For example, companies that have several business units often trade at a deep discount to their after-tax sum-of-the-parts valuation. Exploiting a target's debt capacity, for example, is a viable reason for acquisition. An under-levered company with unused debt capacity is often a target because of the borrowing capabilities available to help finance the acquisition. Also, an increase in the debt capacity will help lower the combined company's cost of capital, and in turn, will boost firm value. The value investor is particularly interested in the benefits relating to net operating loss carry forwards and the handling of depreciation. Both of these items have a positive impact on the cash flow of the buyer, since they can potentially lower one's tax rate. After-tax free cash flows increase, and obviously, so does the firm's value.

Time: the silent external catalyst. The end of a temporary, negative catalyst—an adverse event or series of events, such as high resin costs for packaging companies or low oil prices for oil-related companies—can also prompt value enhancement.

The Margin of Safety Principle.

Graham's definition of margin of safety is essentially the gap between price and value. All else being equal, the wider the gap between the two, the greater the safety level. Graham also explains that the margin of safety is important because it can absorb mistakes in assessing the business or the fair value of the enterprise.

Some value investors use a variety of measures in determining a firm's safety levels. They are as keen on asset values as is on earnings and cash flow. Value investors look for several other different measures, such as break-up value, favorable dividend yield, and price-to-cash flow, as supporting casts to Graham's margin of safety concept.

Graham sought to prevent excessive losses by buying companies at "net-net values"—a price equal to the firm's current assets less all liabilities, giving very little value to property, plant, and equipment. His focus was almost purely quantitative.

Quantitative:

Liquidation value: If the company in question operates in a declining industry, the investor might use a liquidation value of the assets, given the fact that such assets would

often prove to be of little or no use to others, especially if they are specific to a particular business. In calculating liquidation value, some value investors first calculate the asset value then subtract the liabilities. In calculating this number, some value investors take the value of cash and marketable securities. Marketable securities, assuming that they are short term, are valued at the face value at the time, which is essentially how the stock market values them. Then they would give a discount to other assets like plant, property and equipment, and inventory. Depending on the industry and the usefulness of the asset, discounts can range from 20 percent on generic goods, which can be used in other industries, to 80 percent for highly specific goods that are useful to a particular industry. Such a high discount is essentially scrap value for such assets. Items such as goodwill and other intangibles are excluded in the valuation process.

Replacement value: If the company in question is in a normal and stable industry, the value investor might choose to value the assets at replacement cost. The rationale is that if a competitor wanted to enter the industry, the suitor would either buy its way in or build its operations from the bottom up. Like the liquidation method, cash and marketable securities are taken at book value. After cash and these marketable securities, the value investor looks at a company's receivables. The receivables on the balance sheet are the first area requiring an adjustment, as they include provisions should customers become delinquent. If a company entering the industry wanted to build a similar level of receivables, that company would most likely have to incur higher debts in order to reach similar levels to a firm already operating in that market. Value investors tend to look closely at the cost of inventory. There would be an increase in replacement costs in situations where the inventory on a company's books had the benefit of lower raw material costs. Other items under current assets, like prepaid expenses and deferred taxes, remain relatively at face value. Property, plant, and equipment (PP&E) are often the largest non-current assets on the balance sheet. The value investor assesses each part of the PP&E to arrive at the best replacement value. The "property" part of the PP&E is often stated below replacement value given the fact that property, such as land and real estate, typically appreciates in value over time. Moving on to goodwill, one can justify valuing it at zero, since it represents the mark-up for overpaid assets. The problem with tacking a zero value to goodwill is that it fails to give the complete picture of the financial environment. The fact that only tangible assets are calculated understates the value of an enterprise. As a back-of-the-envelope way for assessing goodwill, some value investors often use a portion of goodwill, which can range from 10 percent to 60 percent of the value reported on the balance sheet. This is then adjusted again for the degree to which this intangible asset contributes to the value of the firm. A company with strong brand value, allowing it to sustain a strong market position with increasingly loyal customers, could garner a higher value for its goodwill than a firm that has lesser characteristics. As a rule of thumb, some value investors take a critical look at a company's debt, particularly if the financial strength is rated a B or less. It is critical to assess the past obligations, long-term debt, and ongoing obligations of the firm in question. These obligations are often listed under current liabilities and are due within one year. Value investors deduct these liabilities from the replacement asset value to get the replacement value of net assets. Using the replacement value of net assets, the value investor deducts from this number the next two categories of liabilities: any past obligations, and long-term debt.

Interpreting the replacement value: Many value investors believe that if the asset value is greater than what the company is worth, then it can be assumed that it is a direct result of poor management or a bad industry. If the asset value is less than the intrinsic worth of the company, the magnitude of the difference sends an important message to investors. In

this situation, value investors determine that there is considerable strength in the firm's competitive advantage, or there exists a superior management team.

Book value assessment: Some investors rely on the book value of a company to gain insight into what a company would be worth if it were liquidated. Adjustments may need to be made for goodwill and inflation e.g. undervalued property.

Qualitative:

"Take-private" valuation—a valuation based on what an investor reasonably thinks a company could be worth in a privately negotiated transaction—is the valuation used for making a case for a firm's safety levels. The rationale is that if a well-managed and sound publicly traded company trades at a price level that is attractive enough to another entity to raise capital to acquire the company, then that level is what investors can rely on as being the "floor" for the stock.

Getting something for free: A "sum-of-the-parts" valuation can be useful in determining the safety level in a stock price. Value investors often separate companies by division, not because the particular company is breaking up, but rather to determine whether the current price is offering one or more of the pieces of the business for "free."

Dividend yield factor: Dividends can be a source of safety because of the yield generated for investors. A price decline would increase the yield to generous proportions. Investors, particularly those who are income conscious, would adjust the yield accordingly by purchasing the company's shares. Dividend yields, while easily obtained, are seldom ever used as a sole factor in determining margin of safety levels of a given stock.

Historical perspective: Taking this historical perspective of companies could prove beneficial to owners who are assessing what the buyers would be willing to pay for the enterprise. However, these types of exercises should be limited to those companies that are of a more cyclical nature in their business models.

Risk and Uncertainty:

Understanding risk and uncertainty is an important part of assessing a company's margin of safety levels. It is important that investors know the difference between the two, how the difference can change or alter the way an opportunity is assessed, and the tools required to quantify properly the downside potential of any investment. The difference between the two is that risk is quantifiable and uncertainty is not. There are many different categories of risks and uncertainties. In simple terms, taking on risk occurs when an investor is not sure what might happen among a list of scenarios. Taking on uncertainty occurs when an investor does not know what can happen with an unknown range of possible outcomes.

Total Investment Risk = Basic Business Risk + General Market Risk

Value investors, in general, refuse to spend time predicting economic trends or interpreting market sentiment. Time spent trying to predict the future is time not well spent. Focus on the basic business risk.

Assessing the Business Opportunity:

Properly identifying the *type* of opportunity that is presented is critical to successful investing because the type of opportunity determines one's approach and the analytical tools to consider. The opportunities are categorized in the following manner: modest/slow growth, high growth, event driven, cyclical, temporarily depressed, hybrids, and value traps.

Value traps are inexpensively priced companies that do not possess positive catalysts or that may operate in declining industries. Here are some of the more common examples of potential value traps:

Buying cheaply on valuation despite the fact that it may be a bad business

Buying a cyclical company with low valuation at the top of its cycle

Buying a stock solely because it has a low dollar value of say, $3 per share

Buying simply the cheapest company in an industry without understanding the economics of the business.

Buying Right:

Be aware of the direction of interest rates and corporate profits, and be mindful of inflation. Interest rates are one of the most critical factors that affect a firm's valuation. In a 1999 *Fortune* article, Warren Buffet sums up the impact of interest rates to the general market best. "[Interest rates] act on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull."

The Federal funds rate is the interest rate that banks must pay other banks for reserves. A higher rate means that banks will have fewer reserves and will lend less money. The lower the rate, the more reserve banks can have, which makes them able to lend more money for the economy to grow. Of course, this has an effect on the yield curve, which is a graph that shows the interest rate in relation to short-term and long-term bonds. The graph typically slopes upward to show that short-term rates are often lower than long-term rates, given the fact that lenders generally require higher rates for longer-term loans. This "curve" inverts when short-term rates are higher or near equal to long-term rates, after the Fed raises rates to slow down the economy.

After-tax corporate profits are equally important. Value investors buy businesses as a form of investment, in order to recoup their investments plus additional sums of money in the future.

Inflation is monitored very closely by investors because of its powerful impact on real returns, and its ability to redistribute wealth between lenders and borrowers.

Value investors' awareness of interest rates, corporate profits, and inflation help them buy right by getting a better understanding of the mood of Mr. Market.

Value investors use an analytical approach to the market. They think cyclically. Products have cycles, and so do industries, the economy, and the broader stock market.

When employing the dollar cost averaging method, one invests a portion of one's funds and buys more as the stock falls to attractive price levels. Dollar cost averaging is a very good method to ensure that one "buys right," as most investors have the tendency to buy when stock prices are going up rather than down. Dollar cost averaging, with a price level not exceeded by the investor, helps investors control the urge to buy a stock on its way up. In order for dollar cost averaging to be financially worthwhile, one must assess the amount of funds available to invest, and then decide if it makes economic sense to handle the investment in this manner. While the commission fees charged for each transaction may differ, the investor must be keenly aware of the dollar amount required to make each transaction cost-effective before using this method.

Analyzing Earnings Announcements:

Step 1: Look at the trends in the numbers. Take a critical eye to the top line and margins, and how they relate to management's outlook for the company. Calculate the percentage changes on a sequential basis, as well as for year-over-year.

Step 2: Get behind the numbers by taking a closer look at each key line item in the income statement and balance sheet, in order to assess what may be implied for the next few quarters. Value investors look carefully to assess whether or not the company has overstated revenues for the current quarter, as companies try to account for as much revenues as possible before the end of the quarter. An abnormally high or low operating expense number should be examined to determine the source. Low operating expenses in a quarter yield higher operating margins, and the reverse is true for high operating expenses. Value investors consider recurring one-time events in companies' reports red flags, as it may signify unstable business models. In addition to restructuring charges, gains or losses associated with "accounting changes," "discontinued operations," and "extraordinary items" should be checked for accuracy. The next area of focus should be the net interest expense line item. The vast majority of interest expense is from loans the company has from banks (bank debt) and funds borrowed from the public (bonds). Abnormally low tax rates in a given quarter, compared to previous quarters, should be investigated before arriving at net income or net earnings. For the balance sheet, depending on the industry and the circumstance, the focus is typically on the current assets and the company's total debt. Regarding the company's debt, one typically assesses the company's long-term and short-term debt and notes payable to see if there are any unexplained significant changes.

Step 3: Think about your reasons for purchasing the company and ask yourself whether or not anything has changed.

Selling:

Subsequent selling occurs when the following arises:

1. My ongoing research reveals deterioration of the business fundamentals or permanent impairment to the assets of the firm.

2. The company reaches its fair value.

3. The catalyst that I identified prior to making the investment is unlikely to materialize, or is proven ineffective.

Screening for ideas: A blueprint:

Good business: Search for companies with high ROEs, earnings quality and growth, free cash flow, sustainable competitive advantages, and outstanding management.

Cheap price: Depending on the industry, search for companies with price-to-earnings ratio less than 15, price to sales less than 1.5, at or near private market valuations, and at least 40-percent discount to fair value.

Obtainable value: Search for companies off 50 percent or more from 52-week highs in bull markets, and off 60 percent of highs in bear and sideway markets; cyclical companies; and industry leaders in commodity and low-tech industries.

Candidate for catalysts: Search for companies with extremely low margins in high-margin industries; companies trading at, near, or below net cash on their balance sheets; and companies trading below net asset value or private market values.

Margin of safety: Search for companies with pristine balance sheets, with no or very little debt compared to other industry players, tangible book values, and companies trading near take-out or liquidation values.

The specific approach that non-professional investors should take in building their own portfolios is the following:

1. Prepare mentally and emotionally for the volatility in performance.

2. Use the Five Keys of Value framework in a highly disciplined manner.

3. Own between 10 and 20 but preferably 15 good businesses at excellent prices.

4. Allocate wisely—invest more in the companies you like best.

Value Investing.

- Value investing is about identifying shares that are worth more than their current Price.

- Look for value sectors e.g. cyclicals, for expanding margins and for value in emerging industries e.g. tech, biotech, wireless.

General Criteria:

- A low but rising PE combined with growth in profits and sales. Measure against the industry and the share's PE range over the last 5 years. Compare the industry average with its historical range - the industry may be out of favour. Compare with the appropriate Index.

- PBV<1. Compare with historical averages, industry and Index averages.

- Low PSR. Compare historically and with industry.

- Low PCF. Free Cash Flow is Cash Flow less required Capital Spending, Interest, Dividends, and Working Capital needs.

- Good and increasing ROE.

- Good EPS compared to shares in similar industries.

- Smallholdings by major institutions.

- Low debt.

- Special features relating to competitive advantage franchises and brands.

- Rising Dividends with good Dividend Cover. A good Dividend Yield creates a floor for the share Price. As Dividends rise investors will buy the share for income.

- Medium-sized companies.

- Watch out for ‘creative’ accounting.

- Consider the stock if:
  Management change
  Management is open about the problems
  Problem with only one division or product
  Sale of assets e.g. non-productive divisions.

Brown and Bentley Value Investing.

Source: All About Stock Market Strategies by David Brown and Kassandra Bentley ISBN 0-07-137430-2

Screening Criteria:

- Low PE Ratio relative to projected Earnings Growth.
- High projected Earnings Growth. The 3 to 5 year Earnings Growth should be higher than the PE.
- High historical Earnings Growth, although it can be equal to or slightly lower than the PE.
- Low PE relative to its industry and its competitors.
- Low PE relative to its historical range but not essential.
- Selling below its long-term price trend.
- Selling below its 200-day MA.
- High level of insider buying.
- Low PBV and PSR.

Select from the list on the basis of:

1. upward Price momentum
2. lowest PEs in relation to EPS Growth
3. low current Price historically
4. Analysts revising estimates higher
5. positive Earnings Surprises
6. number of buy recommendations
7. good news
8. insider buying
9. healthy industry.

Entry:

- 50-day and 200-day MA crossovers.
- Monthly MACD breakout.
- Breakthrough long-term resistance level.

Exit:

- When PE outgrows EPS Growth.
- Use the same Technical signal as for the Entry.

TMF Pyad Value.

Criteria:

- PE no more than 2/3rds of the market PE Ratio, preferably single digit.
- Yield 50% above the market yield.
- Assets PBV<1.
- Debt 0 and plenty of cash.
- Top 10 Market Capitalisations from FTSE 350 that meet the above criteria.
- 12-month High/Low Price closer to the Low.
- Negative Relative Strength.
- Rising EPS>20% over last actual figures (essential)
- Favourable Directors' comments.

Applied to Jan. 2002 conditions:

- PE<12
- Yield>4
- PBV<1>0
- Debt 0

Applied to September 2002 conditions:

- PE<12
- Yield>5.2
- PBV<1>0
- Debt 0

Benjamin Graham's Value and Safety Criteria.

Source: The Intelligent Investor by Benjamin Graham
http://www.amazon.co.uk/exec/obidos/ASIN/0060555661/qid=1068164665/sr=1-1/ref=sr_1_2_1/026-2297028-0123661

A minimum of one Value criterion and one Safety criterion.

Value Criteria:

- Earnings Yield should be twice the high quality bond yield.
- PE Ratio less than 40% of its highest PE over previous 5 years.
- Dividend Yield should be at least 2/3rds of the high quality bond yield.
- Market Capitalisation should be 2/3rds or less than Tangible Book Value.
- Market Capitalisation should be no more than 2/3rds of its Net Current Assets.

Safety Criteria:

- Total Debt must not exceed Book Value.
- Current Ratio must be at least 2.
- Total Debt should be less than twice Net Current Assets.
- Earnings should be at least double what they were 10 years ago.
- Earnings should be stable, not falling in two years out of ten by 5% or more.

Value Investing Today – Brandes.

http://www.amazon.co.uk/Value-Investing-Today-Charles-Brandes/dp/0071417389/ref=sr_1_14/202-7523631-9877467?ie=UTF8&s=books&qid=1178998814&sr=1-14

- No losses within the past 5 years
- Debt to Equity Ratio<100%
- Share price less than Book Value per share
- Earnings Yield at least 2* long-term Bond Yield

Neff's Low PE Ratio Investing.

Source: John Neff on Investing
http://www.amazon.co.uk/exec/obidos/ASIN/0471417920/qid=1068164746/sr=1-1/ref=sr_1_2_1/026-2297028-0123661

Criteria:

- Look for out-of-favour, overlooked or misunderstood stocks.
- PE Ratio must be 40 to 60% below market.
- Modest Earnings Growth of 7 to 20%.
- High Dividend Yield.
- Total Return to PE Ratio greater than twice the current market average.
- Business well positioned strategically.
- Strong fundamentals in Sales, Earnings, Margins, Cash Flow, ROE.

Investors Chronicle Price-to-Book Value.

1. The price of shares which have had a poor performance are often forced to rock bottom due to over-reaction.

2. Compare PBV with the company's historical standards as well as with the industry.

3. The Graham method is to take Current Assets and deduct all Liabilities. This gives 'net-net working capital'.

4. Check out Jack Petchey at Trefick who measures PBV against a company's historical record.

Piotroski Criteria.

Piotroski thinks that the market often mis-prices firms with recent histories of poor performance. Part of the reason for the mis-pricing is that such companies fall off the radar. Both analysts and investors ignore them. No one wants to invest in, say, a beaten-up poultry producer or a depressed concrete manufacturer, especially if glamour stocks in areas like telecom or biotech are rocketing skyward at the same time. Many of these deep value firms are not even covered by analysts or the press and so, if things do start to improve, management has no way to publicize the turnaround. Piotroski's analysis of his results suggests that his approach works particularly for small or mid-sized companies, firms with low share turnover, and companies with no analyst following. In all these cases, the market appears to be slow to reach to the good news that discerning readers of financial statements can detect early in a turnaround.

Select 20% of the universe of low PTBV:

- **Profits**. Positive current Net Income (adjusted Operating Profit: after-tax Profit).
- **Cash Generation.** Positive current Operating Cash Flow.
- **Earnings Quality.** Current Operating Cash Flow>current Net Income.
- **Financial Gearing.** Recent Total Debt/Total Assets<last year.
- **Liquidity**. Current Ratio greater than previously.
- **Asset Efficiency.** Asset Turnover (Total Sales Revenue/Total Assets) greater than previously.
- **Profit Efficiency.** Current ROA (after-tax Profit/Total Assets at start of year) greater than previously.
- **Oliver Twist Test.** Total Shares Outstanding=<previous year.
- **Profit Margins**. Current Gross Profit Margin greater than previously.
- **Momentum**. Upward price movement in the last 3 months. (IC)

Select shares with scores of 8 or 9.

IC Piotroski Screen.

1. Cheapest 25% by PBV.

2. Market Cap of £10m to eliminate minnows.

3. ROCE>15% and trending up in last few years.

4. Interest Cover 2*+.

5. Positive Cash Flow and trending upwards in last few years.

6. PE>3.

7. Operating Cash Flow per share>EPS.

8. Consistent Director Buying.

9. Screen out companies with Net Borrowings trending upwards.

10. Compare with sector peers on key ratios e.g. ROCE, Net Margin.

Fool Spowley's Value Strategy.

Filter:

- Forecast PE for the current year<15.
- Good consistent dividend.
- Good cash flow.
- Avoid companies with high gearing.
- Buy only profitable companies with growing profits.
- Buy only companies with good tangible asset backing.

Strategy:

- Buy shares prior to results; say one month, if there has been a recent positive trading statement.
- Alternatively buy shares on the day results are released, using TA for timing.
- Apply a stop loss 15%.
- Hold the shares beyond the ex-dividend date, until the payment of the dividend.

Lakonishok Value.

(Investment Titans: Jonathan Burton McGraw-Hill)
http://www.amazon.co.uk/Investment-Titans-Insights-Minds-Street/dp/0071354964/ref=sr_1_2/202-7523631-9877467?ie=UTF8&s=books&qid=1178999204&sr=1-2

1. Patience is the most important tool of value investing.

2. Inefficiencies in the market are based on investor behaviour: the outlook for value stocks tends to be too pessimistic.

3. Use PE, PBV, PCF, and PSR to screen for suitable candidates. PCF is useful for companies that have negative earning but positive cash flow. PSR is useful for companies with erratic or no earnings, with negative book value or cash flow. Then look for companies that are showing price movement or improving analyst estimates.

4. Select the top 25% of companies by Market Capitalisation.

5. Select companies that have at least one of the 4 ratios with a lower value than the industry.

6. The 26-week Relative Strength should be positive.

7. The 13-week Relative Strength should be equal or greater than the 26-week RS.

8. No downward revision by analysts in the last month.

9. Select companies with at least one upwards earnings revision.

10. The current average analyst estimate for the year should be greater than the average estimate from last month.

IC Price to Sales Ratio Screen.

- PSR<0.5
- Prospective Dividend Yield=>5%
- Market Cap.=>£500m
- Net Gearing<50%
- Dividend Cover of at least 50%
- EPS growth rate at least positive in current or coming year
- Director buying

Contrarian Investing.

Criteria by Gallea and Patalon:

Source: Contrarian Investing by Gallea and Patalon
http://www.amazon.co.uk/exec/obidos/ASIN/0735200009/qid=1068161648/sr=1-2/ref=sr_1_16_2/026-2297028-0123661

Major:

- Price down 50% from 52-week high.
- Significant Insider buying.
- Two of the following:
  PE<12
  P/FCF<10
  PBV<1
  PSR<1

Minor:

- Share price of 300p
- Market Capitalisation of £100m.
- Change in management.

Sell:

- 25% Stop-Loss
- 50% gain or three years

Criteria by Dreman:

Source: Contrarian Investment Strategies by David Dreman
http://www.amazon.co.uk/exec/obidos/ASIN/0684813505/qid=1068164860/sr=1-1/ref=sr_1_0_1/026-2297028-0123661

- Buy 20 to 30 stocks spread over 15 or more industries.
- Select medium to large sized out of favour companies.
- As a starting point select the bottom 40% according to PER.
- PE, PCF or PBV should be 20% lower than the index. Dividend Yield should be 1% above the index.
- The company should be in a strong financial position with as many positive ratios as possible. High Current Ratio and low Debt to Equity Ratio. Good profitability e.g. ROE and pre-tax Profit Margins.
- A higher rate of Earnings Growth over 1 year. EPS Growth should be higher than the Index.
- Above average and growing Dividend Yield. Low Payout Ratio (DPS/EPS).
- Sell when the PE approaches that of the market or after 2-3 years.

Criteria for Hemscott adaptation (1998) of Dreman:

- Start with the top 120 shares of the FTSE.
- Select the 48 shares with the lowest PE.
- Select only those where Cash Flow exceeds Earnings.
- Of those, take only those with a Dividend Yield of 5% or more.
- Eliminate shares whose Earnings are not expected to grow in the current year.
- Retain companies with Gearing of less than 70%.

2001 amendments:

- Dividend Yield of 4% or more.
- Gearing of less than 100%.
- Dividend Cover of 1.5*.

Company Valuation Models.

Source: TMF Jaknife

- Dividend Model. Total Dividend * 20 to 25.

- Book Value Model. Tangible Net Asset Value and Net Asset Value.

- Earnings Model. Averaged (Normalised) EPS * 8 to 15. Fair value can be computed by Earnings * fair PE +/- Net Cash/Debt to give a fair value Market Cap. EV/EBIT can be used in place of PE.

- Cash Flow Model. Normalised Operating Profit + Depreciation + Goodwill + Other Non-cash Charges * 6 to 7.

- EBITDA Model. EBITDA* 6 to 7 minus Debt.
- EV =Market Cap + average Debt + buyout of minorities + Provisions - peripheral assets. Proxy for EV is Market Cap + Debt. EBITDA = Op. Profit + non-cash items depreciation + amortization. Average market EV/EBITDA would be 8 to 10.

- EV/Sales. Rule of thumb … Operating Margin 10% Sales Growth 5% = 1* Sales**.** Higher margins & sales should command higher multiples**.** EV/Sales of 5 would be a high valuation.

- Graham's Growth stock valuation. PE = 8.5 + 2G where PE is the price/earnings multiple and G is the anticipated long-term earnings-growth rate. Multiply by the consensus EPS figure. Use only for established companies with stable growth.

Crisis Investing.

Criteria:

- Look for blue chip companies that have been affected by a crisis, and whose shares are subject to an over-reaction. FTSE 100 is preferable but FTSE 350 is acceptable.

- Check the fundamentals to ensure that the company is still profitable and has basic financial strength.

- Avoid companies with too much debt.

- A rising EPS and a decent Yield are useful attributes.

- Measure the depth of the fall using PE and Dividend Yield – possibly 50%.

- Compare the ratios to similar shares not affected by the crisis.

- Short-term play.

Crisis Investing – MrContrarian.

Source: TMF MrContrarian

1. **Profits Warning** - wait until there is definite evidence the company has turned the corner before investing. You will miss the first 10% to 100% though.

2. Use **EV/Sales**, not PSR as a value filter. The reason Dreman and others like low PSR is:
    - A small improvement in margin will give a big improvement in profit.
    - Reversion to the mean – the average Cap of companies is roughly 1x sales (varies with sector). A PSR<0.1 gives a much bigger upside than downside.
    - It makes the company an attractive bid target - you can buy a lot of sales cheaply.

3. EV/Sales is better because debt laden firms should be worth less and secondly EV is the normalised cost of buying a company i.e. debt free. The downside of using EV/sales is that it is sometimes not as low as you might expect for a struggling firm. EV/Sales<0.3 is cheap.

4. Ignore the previous price of the share. If the fundamentals say a share is cheap, it is cheap. If the fundamentals say a share is expensive, it is expensive, even if it has fallen by 99% from its peak. If the fundamentals change evaluate the share from scratch.

5. If something does not make sense then someone is probably hiding something. Check out write-downs and bank negotiations and take all statements with a pinch of salt. An admission of wrongdoing is often just the first. A large amount of money going missing is a red flag.

6. Are the profits a pretence? - check against Cash Flow. A company with giant debts needs to make reducing them a priority.

7. Beware of short debt repayment times. It is not losses that kill companies; it is being unable to repay debts.

8. Check **Interest Cover**. Certainly beware of very high gearing (75 %+) but cover is a better indication of debt risk.

9. Beware of negative **Net Assets**. A company makes a return on its assets. Of course, it hopes to make a greater return on debt than the interest paid so companies can and do make profits from negative net assets but it is a lot harder. A strict test is TNAV>0, less strict is NAV>0.

10. Avoid Jam Tomorrow stories. Most new products fail, most engineering projects are late, most business plans to bring new technology to market miss their milestones, most directors fall in love with their wonderful products. Jam tomorrow is a bonus if the company is already a buy on the numbers but do not give much weight to it. It is a great timesaver to see a string of losses, PSR of 100 - just say 'Jam Tomorrow' and move on. You may miss a ten bagger or more but that is the cost of insurance.

11. **Covenants** - be concerned. If a company breaches its debt covenants, the board is no longer in charge and will be dancing to its creditor's tune. If it is not stated explicitly, look for weasel words. However, obtaining waivers from banks for breaches or potential breaches of covenant are routine. Many businesses that are generally well run will, from time to time, have good reasons to breach covenants and will ask their lenders to agree to the breach.

IC Recovery Plays.

- Use the Sales to Market Capitalisation Ratio to filter for value/recovery potential. A high score is said to indicate one of two things – the company is going bust or it is undervalued by the market. Look for – a high cost company with recovering prospects; high turnover with low margins but with the potential for improvement. Note high operational gearing can very quickly turn into dramatically improved profitability.

- Initial slump in share price can provide a buying opportunity.

- Companies likely to make a comeback will have strong management, a reasonable past record of accomplishment, cash flow, and market position.

- Recovery companies will need to display new ideas, make cost savings, and institute sensible working practices. Appointing a corporate trouble-shooter is a good sign.

- The support of the banks is essential; they will support if the company is viable and has a sound recovery plan.

- Broker coverage tends to dry up when company is in deep trouble.

- Companies in trouble will issue profit warnings and will be in breach of their banking covenants. A breach may only be a temporary setback and covenants and can often be renegotiated.

- Key indicators to look for are Interest Cover, Cash Flow Interest Cover (cash flow divided by interest payments) and Net Debt to Net Assets. Check for high levels in Intangibles.

- A company has a good chance of surviving if it generates enough cash to meet its interest payments.

- Timing the purchase is critical. Fidelity Special Situations gets in 3 months before the next set of bad results. Try to judge when problems are coming to a head e.g. news of a rights issue coming at the time of results. Less risky is to buy after restructuring plans have been announced.

Recovery Criteria

- PTBV<1. Look for low figures relative to own history.
- I-yr. negative Relative Strength; I-mt. positive RS.
- Forecast Earnings Growth=>5%.
- PE<10. PE and Yield are less important than PTBV and Net Cash.
- Net Gearing<20%.
- Dividend Cover 2.5%.
- Calculate a target Price by looking at average Margins over the full cycle to get a representative Margin for the future; project Earnings on current Sales at the average Margin and apply a suitable PE.

Catching Falling Knives.

Source: TMF article

- Wait until there's definite evidence the company has turned the corner before buying. You'll miss the initial rapid rises, but may still get in on the long term recovery.
- Ignore the previous price of the share. If your analysis says a share is expensive given the risks, then the fact that it's fallen 90% is an irrelevance. The fundamentals *today* are what's important.
- A low PSR is good. It means a small improvement in margin will give a big improvement in profit and it makes the company an attractive bid target as you can buy sales on the cheap. But beware of the risks here - Enterprise Value vs. Sales is a better measure. That's because enterprise value includes debt - unlike market cap - and too much debt makes the company disposable.
- Watch the cashflow and beware of short debt repayment times. It isn't losses that finish a company off, it's being unable to repay debts.
- Beware of negative Net Assets. Personally, I only look at tangible assets in a crisis. And even they may not be worth a lot in a 'fire sale'. Try and get some knowledge of what tangibles consist of.
- Overall, be *truly* aware of the risks. Catching falling knives is a dangerous game.

Income Investing.

Source: The McGraw-Hill Investor's Desk Reference ISBN 0-07-135945-1

Since the emphasis is on income rather than growth, the approach can be affected by interest rates. Utilities are sensitive to interest rate changes, being capital intensive and with high levels of debt.

Criteria:

- High Dividend Yield but beware if very high
- Stable Dividends
- High and consistent historical Dividend Growth rate. Zero Dividend Growth is a negative signal. A flat Dividend comes before a Dividend cut.
- High projected Earnings Growth
- Calculate Expected Total Return using (Expected Dividend Growth Rate / Current Dividend Yield) + (Current Dividend Yield).
- Low Dividend Payout Ratio (DPS / EPS). Look also at DPS / Cash Flow per Share, which is a truer measure of a company's ability to pay.
- Low short-term Debt as a percentage of Total Debt or Total Capital. Short-term financing can be hit by interest rate hikes.
- Low Debt to Equity Ratio. Rising levels above its historical levels or its industry norms points to reduced financial strength.

High Yield Strategies.

Blue Chip Yielders.

Source: How to Win in a Volatile Stock Market by Alexander Davidson
ISBN 0-7494-3360-4
http://www.amazon.co.uk/exec/obidos/ASIN/0749438037/qid=1068161912/sr=1-2/ref=sr_1_0_2/026-2297028-0123661

Criteria:

1. Select the 10 highest yielders from the Top 30 by Market Capitalisation.

2. Eliminate any with downgrades or internal problems.

3. Select shares with:
    - 2* dividend Cover (EPS/DPS)
    - Cash Flow per share higher than EPS
    - Low PBV
    - Low PSR

4. Select the lowest priced stocks.

5. The Stop-Loss of 20% should follow the share price rises and falls.

6. Reinvest Dividends annually and review the portfolio.

7. Always select a realistic Dividend, good Dividend Cover, positive Earnings Growth, and low Net Gearing.

HYP.

Source: The Motley Fool TMFPyad

Criteria:

- FTSE 100 with Market Capitalisation of £1b.

- Rank forecast Yields in descending order.

- Select one from each Sector, avoiding construction, engineering, technology, and airlines.

- Debt must be <50%.

- Dividends must be increasing over 3 to 5 years.

Investors Chronicle.

Criteria:

- Select shares from the FTSE 350 – above £180m.
- Filter for shares with Yields greater than 5.19% - i.e. 10-year UK Gilt yield.
- Companies should have a record of increasing dividends over the last 5 years.
- Analysts forecast of raised dividend next year.
- Prospective Dividend Cover should be 1.5* and preferably 2*.
- Check Capex as a percentage of Depreciation to ensure that companies are not slashing Capital Expenditure to maintain the Dividend payout.
- Gearing =<100%.
- Make a final check on fundamentals.

Dogs of the Dow.

- Buy the 10 highest yielding shares at the beginning of January.
- Hold a year and reset with the current 10 highest yielding.
- Small Dogs (Puppies). Of the 10, choose the 5 with the lowest Price.

Valuegrowth Investing.

http://www.amazon.co.uk/Value-Growth-Investing-Strategies-Investors/dp/0273656252/ref=sr_1_9/202-7523631-9877467?ie=UTF8&s=books&qid=1178998814&sr=1-9

Criteria:

1. Invest only in businesses you understand, that are within your circle of competence.
2. Managers must be honest and competent.
3. Strong economic franchise.
4. Financial strength. High Return on Equity and low Debt/Equity Ratio.
5. Intrinsic Value based on the sum of discounted owner earnings.
6. High Margin of Safety between the Price and the Intrinsic Value.
7. Expect to hold long term.
8. Sell if there is a mistake in the analysis, or if it no longer meets the Valuegrowth rules, or if a better opportunity arises.

O'Shaughnessy Cornerstone Value and Growth Models.

Source: What Works on Wall Street by James O'Shaughnessy
http://www.amazon.co.uk/exec/obidos/ASIN/0070482462/qid=1068162435/sr=1-1/ref=sr_1_2_1/026-2297028-0123661

Research Findings.

1. M Cap should be above $150m.
2. Low PE stocks perform better.
3. Low PBV shares do better, although a high PBV is one hallmark of a growth stock.
4. Low PCF stocks perform better.
5. Low PSR is the best of the value ratios.
6. High Dividend Yield works well with blue chip companies and in combination with other value ratios.
7. Buying simply on Earnings Growth is a mistake.
8. Stocks with the highest 1-year Earnings Growth usually have the highest PEs.
9. Better to have good Earnings Growth with strong Relative Strength.
10. Using lowest Earnings Growth, 5-year EPS Growth and high Profit Margins as single factors produce disappointing results.
11. High ROE is poor for the top 10% but good for the second 10%.
12. Best 1-year Relative Strength is good although volatile.

Models:

Multi-factor models significantly enhance returns e.g. value factors plus Relative Strength. RS also helps growth stocks to an extent e.g. 1-year Earnings Growth =>25% plus ROE>15.

Value Model 1

- PBV<1.5
- Div Y top 20%
- PE<Mean
- Buy shares with the lowest PCF.

Value Model 2

- Div Y>Mean
- Positive Price Change in previous year. Current Price divided by Previous Price>1.
- Buy shares with the lowest PSR.

Both models work well but they are not as good as low PSR plus high Relative Strength.

Blue chip companies are good when they have low value characteristics but the best is Dividend Yield.

Growth Model 1.

- 5-year Earnings Growth>Mean
- Profit Margin>Mean
- Earnings higher than previous year.

Growth Model 1 is not as good as low PSR plus best Relative Strength.

Growth Model 2

- Earnings higher than previous year
- Buy shares with best 1-year Relative Strength.

Cornerstone Growth Model

- Earnings higher than previous year
- PSR<1.5
- Buy shares with best 1-year Relative Strength.

Relative Strength as the final factor ensures you buy just as the market is beginning to recognise the stocks. Low PSR ensures that they are reasonably priced.

A combined Cornerstone Growth and Value portfolio with a 50/50 split provides the best way to diversify and the best chance to beat the market year on year.

Top Ten Strategies in Rank Order.

- PSR<1; high Relative Strength
- Earnings Yield>5; high RS
- Cornerstone Growth. Earnings higher than previous yr; PSR<1.5; best 1-yr. RS.
- PBV<1; high RS
- United Cornerstone combining value and growth models.
- ROE<15; high RS
- EPS>last year; best RS
- 5 yr. EPS Growth>Mean; Profit Margin>Mean; EPS>last year; best RS
- Yield >Mean; Positive RS; lowest PSR
- 1-yr. EPS Growth>25%; high RS

Buffett Fundamental Investing.

How to Pick Stocks Like Warren Buffett by Timothy Vick
http://www.amazon.co.uk/exec/obidos/ASIN/0071357696/qid=1068162894/026-2297028-0123661

1. **Intrinsic Value** = sum total of future expected Earnings with each year's Earnings discounted by the Time Value of Money.

2. A company's Growth record is the most reliable predictor of its future course. It is best to average past Earnings to get a realistic figure. Each year's Earnings need to be discounted by the appropriate discount rate.

3. Is the stock more attractive than a bond? Divide the 12 months EPS by the current rate of long-term Government Bonds e.g. EPS of £2.50 / 6% or 0.06 = £40. If the stock trades for less than £40, it is better value than a bond. If the share's earnings are expected to grow annually, it will beat a bond.

4. Identify the expected Price Range. Project future EPS 10 years out, based on average of past EPS Growth. Multiply by the High and Low PE Ratios to find the expected Price Range. Add in the expected Dividends for the period. Compute an annualised Rate of Return based on the increase in the Share Price. Buffett's hurdle is 15%.

5. **Book Value**. Ultimately, Price should approximate growth in Book Value and in Intrinsic Value. Watch out for increases in Book Value which are generated artificially a) issuing more shares b) acquisitions c) leaving cash in the bank to earn interest, in which case ROE will slowly fall. Buffett is against the use of accounting charges and write-offs to artificially improve the look of future profits.

6. **Return On Equity**. ROE = Net Income / (end-of-year Shareholders' Equity + start-of-year Shareholder's Equity / 2). [Shareholders' Equity = Assets - Liabilities.] Good returns on ROE should benefit the Share Price. High ROE ~ EPS Growth ~ Increase in Shareholders' Equity ~ Intrinsic Value ~ Share Price. A high ROE is difficult to maintain, as the company gets bigger. Look for high ROE with little or no debt. Drug and Consumer product companies can carry over 50% Debt and still have high ROEs. Share buy-backs can be used to manipulate higher ROEs. ROE should be 15%+.

7. **Rate of Return**. 15% Rule. Collect and calculate figures on the following:

    i current EPS

    ii estimate future Growth Rate or use Consensus Forecasts

    iii calculate historic average PE Ratio

    iv calculate Dividend Payout Ratio

Complete Table:

Price	______	Growth Rate	______
EPS	______	Average PE	______
PE	______	Dividend Payout	______

Year	EPS
20--	____
20--	____
20--	____
20--	____
20--	____
20--	____
20--	____
20--	____
20--	____
20--	____
Total	

Price needed in 10 years to get 15%	£ ____
Expected 10-year Price (20-- EPS * Av. PE)	£ ____
Plus expected Dividends	£ ____
Total Return	£ ____
Expected 10-year Rate of Return	___%
Highest Price you can pay to get 15% return	____ p

Stock Evaluation. Can a company earn its present Market Cap. in terms of future Profits? Does the company have a consistent record of accomplishment?

Shares are Bonds with less predictable Coupons. Shares must beat inflation, Government Bond Yields and be able to rise over time. Shares should be bought in preference to Bonds when the current Earnings Yield (Current Earnings / Price) is at or above the level of long-term Bonds.

When To Sell:

i Bond Yields are rising and about to overtake Share Earnings Yields.

ii Share Prices are rising at a greater rate than the economy is expanding.

iii Excessive PE multiples, even allowing for productivity and low interest rates.

iv Economy cannot get any stronger.

Takeover Arbitrage:

- Buy at a Price below the target takeover Price.
- Only invest in deals already announced.
- Calculate Profits in advance. Annualised return of 20-30% needed.
- Ensure the deal is almost certain. A widening spread may mean the worst.

General Criteria:

- Consistent Earnings Growth.
- High Cash Flow and low level of Spending.
- Little need of long-term Debt.
- High ROE 15%+
- High ROA (Return on Total Inventory plus Plant)
- Low Price relative to Valuation.

Buffett-style Value Criteria and Filter.

1. Earnings yield should be at least twice the AAA bond yield (which is about 5.9%)

2. PE should be less than 40% of the share's highest PER over the previous five years.

3. Dividend yield should be at least two thirds of the AAA bond yield.

4. Stock price should be no more than two thirds of company's tangible book value per share
.
5. Company should be selling in the market for no more than two thirds of its net current assets.

To this, add **Margin of Safety criteria**:

1. Company should owe no more than it is worth: total debt should not exceed book value.

2. Current assets should be at least twice current liabilities - in other words, the current ratio should exceed 2.

3. Total debt should be less than twice net current assets
.
4. Earnings growth should be at least 7% a year compound over the past decade.

5. As an indication of stability of earnings, there should have been no more than two annual earnings declines of 5% or more during the past decade.

Demanding a share price no more than two-thirds tangible assets is asking too much of today's market. The basic search, therefore, used the following **sieves**:

1. PE less than 8.5. This is the implied multiple from the demand that the earnings yield should be more than twice 5.9%. The inverse of an 11.8% earnings yield is a price-earnings multiple of 8.5.

2. A dividend yield of at least 4% - two thirds of the 5.9% AAA bond yield.

3. A Price to Tangible Assets Ratio of less than 0.8 - price less than four-fifths tangible assets.

4. Gross Gearing of less than 100% - the company does not owe more than it is worth.

5. Current Ratio of at least two - in other words current assets are at least twice current liabilities.

TMF Qualiport 'Great Companies at Attractive Valuations'.

Operational:

- 'Buy what you know'.
- Company with a predictable future and a stable product range.
- Identifiable future growth prospects based on organic growth.

Financial:

- Proven past growth record. Notable growth in Sales and Earnings over the last five years. Sales Growth of 8-10% per annum.
- Gross Margins of 50% or more.
- High Operating Margins above 12% reflecting a competitive advantage.
- Interest Cover of more than 10.
- High Return on Equity, preferably 15% or more.
- Strong Cash generator. A Cash Conversion Ratio above 90%. Cash Conversion Ratio = Net Cash from Operations/Operating Profit.

Buying good companies cheaply:

- For a quick valuation, use the Earnings Yield (inverse of the PE calculated as 1 divided by the PE), estimate the future growth rate, and compare to base interest rates. The lower the PE starting point the better.
- Free Cash Flow. Calculation is FCF = Profit before Tax + Depreciation – Total Capital Expenditure – Tax. Divide the Share Price by the Free Cash Flow per share figure to get the Free Cash Flow Yield. Compare with base interest rates.

Growth Investing.

Look for three characteristics of Growth - superior brand, good management, and superior technology.

Buying:

- A PEG less than 0.75
- Market Capitalization greater than £20m
- PE less than 20
- High projected Earnings Growth 1-5 years.
- Highest 1, 3, and 5 year historical Earnings Growth.
- High continuous EPS Growth, historical and current.
- Positive Earnings Surprises.
- High Revenue Growth.
- Positive Cash Flow. Cash Flow per share should be greater than Capital Expenditure per share. Cash Flow per share should exceed EPS. Low PCF ratio.
- Positive Relative Strength over the last 1,3, 6 and 12 months
- Net Gearing less that 50%. Interest Cover, Quick Ratio, and Current Ratio need to be healthy.
- Look for high Margins relative to the sector and a high ROCE.
- Pay attention to Directors' Dealings.
- Check recent Brokers' Estimates.

Entry:

- TA signals.

Exit:

- If the PEG has doubled.
- Trailing Stop/Loss of 10%.

Slater's Growth at a Reasonable Price.

Source: Beyond the Zulu Principle by Jim Slater ISBN 0-75281-384-4
http://www.amazon.co.uk/exec/obidos/ASIN/1587990946/ref=pd_sr_ec_ir_b/026-2297028-0123661

- PEG of 0.75 or less.
- PE of 10-20 with forecast Growth Rates of 15-30%.
- Strong Cash Flow per Share in excess of EPS, over the last year and for the five-year average.
- Positive Cash or Gearing below 50%.
- High Relative Strength for the past 12 months.
- A competitive advantage associated with a high ROCE and good Operating Margin.
- Accelerating EPS.
- Market Capitalisation of £30-250m.
- A Dividend Yield.
- Low PRR and PSR.

The Goldman Sachs Garp Screen.

- PBV>2; PTBV>3.
- PE<20.
- ROCE>15%.
- Net Gearing<50%.
- High Profit Margin in top quarter of market.
- PCF=<5.
- Dividend Yield=>3% and Dividend Cover=>2.
- Positive RS over 3 months.
- Market Cap>£10m.
- Eliminate companies with current EPS decline of 10%+.
- Analyst coverage by two or more.

Peter Lynch's Niche Investing.

Source: One Up On Wall Street by Peter Lynch ISBN 0-7432-0040-3
http://www.amazon.co.uk/exec/obidos/ASIN/0762409819/qid=1068163164/sr=1-3/ref=sr_1_2_3/026-2297028-0123661

A niche share is a fast growing small to medium sized company operating in a niche business and growing aggressively at 20 to 25% per annum.

Strong economic franchise:

- Fast growing company in a slow growing industry.
- Limited competition.
- High barriers to entry.
- Plenty of room to grow.
- Simple business.

Owner orientated management:

- Penny pinching in the executive suite.
- Good labour relations.
- Surplus Cash Flow returned to shareholders.
- Managers owning and buying stock.

Financial strength:

- Strong balance sheet.
- Sales and EPS growth and consistency.
- Free Cash Flow. Positive Net Cash per Share creates a floor for the share price.
- Low Inventory growth. Reducing inventories can be the first sign of a sales recovery.
- Low Gearing.
- Dividends. A history of steadily increasing dividends. Low Dividend Payout ratio.

Low Price:

- Low PE Ratio. Compare with historical average and industry average. Half the Growth rate is good.
- A low PEG.
- Modified PEG, adding the Dividend Yield to the EPS Growth rate. MPEG = (Price/EPS) / (EPS Growth rate + Dividend Yield). 0.5 or less is regarded as attractive value. 1.0+ is too expensive.
- Boring business.
- Little interest from analysts and institutions.

Sell:

- No further scope for expansion.
- Disappointing Sales and Profits Growth.
- When PEG reaches 1.5 to 2.0

William O'Neil's CANSLIM.

Source: How To Make Money in Stocks by William O'Neil ISBN 0-07-048017-6

C Current Quarterly Earnings per Share should have increased 20% on same quarter last year.

A Annual Earnings per Share for the last 5 years should show an increase over the previous year's earnings, preferably 25% to 50%.

N New Products, New Management, New Highs. Buy shares that are emerging from price consolidation and are at least close to new highs in price.

S Supply and Demand: Small Capitalisation plus big Volume Demand. Select shares that have high percentage ownership by management. Choose companies with low gearing.

L Leader or Laggard? Chose shares with a high Relative Strength of 80% or more. Look for the market leader.

I Institutional Sponsorship. Look for institutional owners with a good performance record. Avoid if the share is over-owned by institutions.

M Market Direction. Identify the current direction of the market to time purchases. Seek to identify when a share has reached a top or bottom. Watch for heavy volume without the price moving up. Check technical indicators.

Martin Zweig Growth Screen.

- PE>5 and <40
- Relative Strength over last year should be positive
- Relative Strength over last 3 months should be positive
- Current EPS growth should be at least 20%
- PEG<1
- Sales per Share trend above 10%
- Market Cap. greater than £35m
- Screen out illiquid shares
- Compare company's debt position with industry peers for low relative Debt
- Insider buying in last 6 months
- Look for Earnings surprises to provide buying opportunity.

Momentum Investing.

Criteria:

- Highest % Price change over last day, week, and month.
- Highest current quarter Earnings Growth compared to same quarter last year.
- Positive 1-month change in Analysts Earnings Estimates.
- Look for a basing period breakout.
- Increased volume.
- Consider top-down factors.

Entry:

- Use trend reversal indicator e.g. RSI, MACD or Stochastics.

Exit:

- Use indicators in reverse.
- Compare with the appropriate Index, looking for divergence.
- Take losses quickly.

Anthony Bolton's Special Situations Approach.

http://www.amazon.co.uk/Investing-Anthony-Bolton-Anatomy-Phenomenon/dp/1905641117/ref=sr_1_2/202-7523631-9877467?ie=UTF8&s=books&qid=1178999681&sr=1-2

General Approach and Influences.

- Basically a value/contrarian approach. He tries to think two moves ahead of the crowd. He looks for unfashionable and cheap companies with something to recapture investor attention. He favours small caps. A bottom-up stock picker rather than a market timer. Not a LTBH investor but holds for 1-2 years and sells when the shares are considered fully valued.
- From Buffett he has learned to look for good business franchises with good free cash flow. He prefers goods businesses run by an average management rather than vice versa.
- He follows Peter Lynch in visiting companies and looking for managers who are consistent in what they say.
- He likes Jim Slater's Zulu Principle. Favourite aphorism is by Mark Twain "History never repeats itself but it sometimes rhymes."
- He uses TA as an additional screen and as an early warning signal. It provides clues about the current balance of advantage between buyers and sellers.

Special Situations

- Companies with recovery potential
- Companies with strong growth potential
- Companies with unrecognised asset value
- Companies with a special product and a niche market
- Companies with takeover potential
- Companies subject to restructuring/changes in management
- Companies under-researched by brokers.

Picking Methodology

- Assess management and the quality of the business franchise. Understand the key variables that drive the business. Is it in control of its own destiny or is it heavily subject to currency fluctuations, interest rates, or tax changes? Prefers simple to complex businesses. Key question is its ability to generate cash. Look for management who are candid and avoid hyperbole, who do not over-promise but consistently deliver a bit more than they indicated. Avoid 'dodgy' management at all cost.

- Valuation metrics include PE, EV/Gross Cash Flow, Free Cash Flow ratios, Cash Flow Return on Capital relative to Invested Capital. Important to compare metrics with industry peer group. Pay attention to absolute valuations and do not just look at how stocks compare to each other. Buy stocks that within the next 2 years will be on single PEs or with a Free Cash Flow Yield above prevailing interest rates.

- Balance sheet ratios. Understand the balance sheet risk; include all forms of debt including pension fund deficits and convertible preference shares that will not be converted. His past losers have tended to be companies with weak balance sheets. Now he looks carefully at z scores.
- Shareholders. Do institutions over- or under-own?
- Director Dealings. Look for multiple transactions.
- TA. Use it as an extra indicator. Look to see if it supports the FA. Best for larger market caps.
- Views of key broker analysts.
- Possible factors to excite interest.

Some General Tips

- Seek ideas from a wide range of sources.
- Re-examine your investment thesis at regular intervals. Back your conviction but avoid pig-headedness.
- Forget the price you paid for your shares. Cut your losses if the situation changes.
- Avoid market timing and major macro bets.
- Be contrarian. Remember that the market is a discounting mechanism – if a feeling is widespread, it is already in the price.
- Hard work, discipline, placid emotionally, understand the crowd, act decisively on your instinct, be independent, and avoid buying what everyone else is buying.
- Always buy stocks for less than they are worth.

Important Ratios

PE
EV
EBITDA
EBITDA margin
EV/EBIT
EV/Sales
FCF Yield
Dividend Yield
ROCE-EBIT less tax
PBV
Long-term Debt to Total Capital
ROE
EPS Growth

How to Value a Company using Discounted Cash Flow.

The value of any asset is the sum of the cash flows it will produce in the future discounted to the present at an appropriate rate. Loss-making companies can be valued at billions of pounds today because they are expected to produce large amounts of operating free cash flow in the future. DCFs can be particularly useful in valuing growth companies.

There are five stages to a DCF:

1. The 'excess return' period
2. The discount rate
3. The terminal value
4. Discount the cash flows and the terminal value
5. Account for net debt

1. The 'excess return' period

A good rule of thumb for an excess return period is one year for companies that operate in competitive, low margin industries, five years for decent growth companies and 10 years for companies with outstanding prospects, operating in sectors with high barriers to entry.

Now we need to estimate the operating free cash flow it will produce in those five years. We work out operating free cash flow by looking at what is left from operating profits after deducting taxes, new investment, and the cost of working capital. Costs such as depreciation and amortisation are not included as these are non-cash charges.

To arrive at this figure the standard technique is to first project the sales growth of the past into the future. Then, by breaking down operating margins, estimated capital expenditure and working capital needs, we can estimate the cash flows likely to be produced:

- **Estimate sales growth.**
- **Estimate future operating margins.**
- **Calculate net operating profit after tax.** Many companies do not pay the official corporate tax rate of 30 per cent on their operating profits. Companies with high capital spending, for example, receive tax breaks. Therefore, it is often better to calculate the tax rate by taking profits before income tax divided by the average income tax a company has paid in the last few years - using information on the profit and loss statement (P&L).
- **Estimate net investment.** Net investment is the amount needed to support the growth of the firm. New companies need property and plant to expand. To reach this figure, we find the amount of capital expenditure highlighted in the cash flow statement (as a percentage of total sales) and subtract the level of depreciation, found in the P&L.
- **Estimate net working capital.** Working capital is funds required to finance every day trading at the company. Businesses need cash to buy stocks and pay debtors. The greater the sales, the higher the cash needs for purchasing stocks. This will be balanced by the extension of credit from suppliers. The formula is: working capital equals debtors plus stock minus creditors.

2. The discount rate

The appropriate discount rate can vary. Analysts often use the company's weighted average cost of capital (WACC). A simpler approach is to take the yield on five to 15-year UK gilts (5 %) - effectively a risk-free rate of return. We take that risk-free 5% and add an equity risk premium, using the historical out-performance of shares over bonds. In the UK, this is around 5%.

3. The terminal value

Having calculated the cash flows for the excess return period, we need to make a sensible assessment of the terminal value for the firm at the end of that period - when it has settled into slow growth, middle-aged maturity. One popular method is to value the company as a perpetuity using Gordon's growth model. It uses the following formula: terminal value equals terminal cash flow (discount factor minus growth rate).

4. Discount the cash flows and the terminal value

We now need to discount the cash flows in the excess return period and the terminal value by 10 per cent to arrive at a total corporate value.

5. Account for net debt

To obtain a fair value of equity the net debt must be deducted from the enterprise value (the company's equity plus net debt). If we divide that figure by the number of shares in issue we obtain a fair value for the company's shares. If the shares were trading at a lower figure than this, trhey could be under-valued.

Discounted cash flow - the pros and cons:

- One of the key features of a DCF model is that small changes in assumptions can have a huge impact on final value. This is why there can be significant share price movements after small surprises in earnings, margins or growth rates. The valuation is only as good as its inputs. If these prove wide of the mark the price produced for the equity will be inaccurate.
- The alternatives are relative valuation techniques, which use multiples to compare stocks within a sector. The basic relative valuation tool is the PE ratio but it has fallen out of favour in recent years and many City analysts now favour EV/EBITDA.
- The Enterprise value (EV) of a company is the equity value and the net debt level combined. EBITDA stands for earnings before interest, tax, depreciation, and amortisation. Advocates of EV/EBITDA argue that earnings per share figures - and hence PE ratios - are often distorted by non-cash charges such as amortisation and depreciation. As a result, they can give a misleading picture of how well a company is performing. Furthermore, PE ratios make no allowance for the amount of debt a company is carrying.
- The merits of EV/EBITDA depend very much on the sector in which a company operates. It is best used when companies have a lot of debt, e.g. telecoms sector.
- Relative valuations are simple to understand and a valuable investment tool. However, they are of little help if an entire sector, or indeed market, is over or undervalued. Investors should not be dogmatic about the methods they employ.

The best route is to examine shares from a variety of perspective to see if a company appears cheap on all of them.

Discounted Cash Flow Calculations.

Source: Analysing Companies and Valuing Shares – Michael Cahill

Operating Free Cash Flow. Defined as Net Operating Profit After Tax NOPAT + Depreciation + Amortization – Maintenance Capital Expenditure – Working Capital requirements.

Forecasting Operating Free Cash Flows. This is over the initial growth period which may be 5 to 10 years.

Establishing the Terminal Value. This comes at the end of the forecast period. The Multiple method takes the forecast Operating Profits at the terminal stage and multiplies by an appropriate industry multiple e.g. 7 times. The Steady State Growth approach uses the formula: Terminal Value = Operating Free Cash Flow / WACC – growth rate. In both approaches, the values are discounted back to the present.

Determining the Discount Rate. This is done by calculating the Weighted Average Cost of Capital. Cost of Debt = Interest Rate % * 0.7 for Tax Relief. Cost of Equity = Risk-free Rate + (Equity Risk Premium * Beta). Weighted Average Cost of Capital = (Market Cap / (Market Cap + Debt)) * Cost of Equity + (Debt / (Market Cap + Debt)) * Post-tax Cost of Debt.

Final Calculation. OPFCF / (1 + WACC) + OPFCF2 / $(1 + WACC)_2$ + OPFCF3 / $(1 + WACC)_3$ ……………………OPFCFN / $(1 + WACC)_n$.

Popular Approaches, Mechanical Strategies and Stock Filters.

Popular Approaches.

TMF PaulyPilot Cash Situations:

- Use a mechanical strategy to identify a shortlist.
- Look at the most recent accounts, and work ‘adjusted net assets’, calculated as 80% of freehold property, 100% of cash, 50% of debtors, and 20% of stock, less all creditors.
- Read the most recent accounts and make an estimate for cash burn, and forecast it out 6 months ahead, adjusting the net asset figure accordingly. Sort the spreadsheet into descending order of market cap vs. adjusted net assets in 6 months time.
- Study the shortlist closely and weigh up the subjective factors. The best targets are ones where the business is so obviously a crushing failure that nobody in their right mind would seriously want to continue supporting the business. That makes it a softer target, since management will probably be demoralised.
- Smaller, uncomplicated businesses are to be preferred - ones which have few ongoing liabilities (important to check out leasehold liabilities in notes to accounts), and preferably with few staff (under 100 where possible), since redundancies will then be quick and cheap.
- Businesses where management have large shareholdings, although harder to bully, are more likely to act in shareholders interests, and use the MBO route.
- Try to avoid any company with less than £5m net cash, as these are too risky. Some unexpected large cost will take a much higher % of the cash away than for a business which has say £10-20m cash.

Risers and Fallers:

Risers:

- Monitor the top ten risers.
- Identify companies that has benefited from positive news.
- Select share that has risen between 5% and 10% by 8.30 to 9 am.
- Sell around 4.20 pm.

Fallers:

- Monitor the top ten fallers.
- Identify a company that has dropped by 10% or more for reasons outside its control, or where a possible over-reaction has taken place.
- Purchase around 4.15pm before the price rises.
- Sell before the end of the following day.

Trading Volumes:

- Ignore big companies with volumes of around 50 million shares.
- Select smaller companies with significantly increasing volumes.
- Increasing volume might indicate the possibility of a share suspension. This usually applies to unknown small companies. Watch out for well-known people becoming directors.

Directors' Dealings:

- Look for sizeable transactions which amount to 10% of the Director's resultant holding.
- Select companies where Directors have a sizeable stake.
- Dealings by CFOs, Executive Chairmen and Chief Executives are most significant. Several Directors buying in unison is more significant.
- Insider buying with a rising share Price.
- Directors' dealings just before the Closed Period – 2 months before an announcement – may have increased significance.
- Some selling may merely be to improve liquidity.

PP Takeover Targets:

Look for:

- A share in which another company owns a large shareholding e.g. 30%
- Assets worth considerably more than its share price. Low P/BV
- Low capitalisation making it suitable as a 'shell' company
- Low PE compared to its competitors so that a rival could take it over and lower its PE
- Undervalued brand names/subsidiaries that could be sold off profitably
- Elderly Chairmen or Directors
- Companies that have fallen on hard times, which have undergone restructuring and are on the point of a turn-round but which has not yet been recognised in the share price
- A would-be bidder testing the market by buying and selling the shares over a period. Look for rises and falls and a rising price higher than before
- Persistent rise in share price especially if it is against the market or company trend
- Cash rich companies
- Low Debt/Equity Ratio

IC Takeover Targets (IC 17/09/2004):

1. Aim to be there before the rumours begin by choosing likely candidates.

2. Using value criteria is a useful starting point because of the commonalities between takeover targets and undervalued companies.

3. Companies with barriers to entry make suitable targets e.g. supermarkets, out-of-town retail parks, builders with good land banks, airport and port operators.

4. Sub-scale companies can provide the bigger players with economies of scale e.g. pharmas, brewing, branded drinks, and hotels.

5. Companies trading below NAV are very attractive to potential bidders as are firms trading at less than their cash reserves e.g. biotech and tech firms, and property rich companies (even if they are trading over NAV their property may not have been revalued for some time). A low Tobin's Q firm is more likely to be a takeover target.

6. Poor trading performance in a profitable industry or with sound assets may be the trigger to put a company in play. Look for a management that has lost the support of its institutional shareholders.

7. Bidders are attracted to strong brands that are hard to replicate e.g. luxury brand businesses.

8. Consider companies with prime city-centre locations.

9. Avoid situations where controlling shareholders have no interest in selling out. Look out for two-tier share structures.

Takeovers – The Superstock Investor (LaLoggia and Mahon):

http://www.amazon.co.uk/Superstock-Investor-Profiting-Undervalued-Companies/dp/0071360832/ref=sr_1_1/202-7523631-9877467?ie=UTF8&s=books&qid=1178999840&sr=1-1

The key to this approach is interpreting the news for telltale signs. A super stock has the potential to rise significantly in price regardless of what the general stock market is doing.

Catalysts:

- Usually a takeover bid.
- A massive partial stock buyback at a premium.
- A large one-time cash or stock dividend, where a company distributes accumulated cash or shares in a wholly owned subsidiary to its shareholders.
- A spin-off.

They are the logical conclusion to a series of interrelated developments that, when properly noticed and analyzed, can clearly point the way to many takeover bids that seem very unpredictable to outside observers.

Action:

- One of the strategies to identify a potential takeover target is to monitor stocks in takeover-lively industries that are acting suspiciously well relative to other stocks in the industry or relative to the stock market in general.

- Look for no debt and plenty of cash - these cash-rich, low-debt companies tend to lag behind the market due to a lack of analytical support.

- Pay particular attention to those who talk about 'growth through acquisitions'.

- Take note of every large merger announcement you see, and pay particular attention to the reasoning behind that merger.

- Get a list of the top 10 to 15 companies in that industry and zero in on those with little or no debt and high cash and/or working capital relative to their stock prices, on the theory that a merger trend in motion tends to stay in motion and that once a large merger has occurred in an industry, more will inevitably follow.

- Take note of every merger that falls apart, on the theory that the buying company will look around for another target.

- Take note of situations where two companies are trying to acquire the same target, on the theory that only one of them can win the prize, and the company that loses out will eventually look around for another company to buy.

- Make a note of every outside company that is raising its stake in another company through open-market stock purchases.

- Take notice of every company that announces a stock buyback of 5 percent or more, and put a red circle around those that operate in industries where a great deal of takeover activity has occurred.

- Make note of every company that enacts a 'Shareholder Rights Plan' designed to make a takeover more difficult.

- Make note of every company in a consolidating industry where 10 %+ of the stock is held by a brokerage firm, a buyout firm, or an investment partnership that does not maintain long-term investments in the normal course. The theory behind this is that a sophisticated stockholder will recognize the opportunity to maximize its investment and will act as a 'catalyst' for a takeover bid.

- Take note of companies selling or spinning off non-core operations, especially when the parent company or the spin-off operates in an industry where takeovers are occurring, because such corporate restructurings often precede a takeover bid.

- Finally, subscribe to a service that presents charts organized by industry group. These enable you to see at a glance if a particular stock in an industry group is suspiciously outperforming its peers—often a sign that some sort of takeover development is brewing.

Value:

Where does the stock price come from?

- earnings expectations and ii) the present value the market is willing to place on those earnings expectations.

What causes Price/Earnings ratios to shift so dramatically?

- The major determining factor is interest rates. When interest rates rise, price/earnings ratios tend to fall. When interest rates decline, P/E ratios tend to rise. In other words, as interest rates on less risky investments rise, a certain amount of money will leave the stock market to lock in that return.

What is Discounted Present Value?

- Discounted Present Value estimates what a future earnings stream is presently worth. High interest rates will result in the present value being lower, while low interest rates will result in present value being higher.

What is a 'value' stock?

- A 'value' stock is one that sells at discount prices, significantly below its value as a business, where there is a reasonable possibility that someone will step up and offer to pay that value, thereby forcing the stock market to reflect that value in the stock price. The evidence seems to indicate that the stock market is a good 'discounting' mechanism that takes into account everything that is knowable at any given time. The only way for an individual investor to get an 'edge' is to go off the beaten path and focus on areas of the market where analytical attention is slim or nonexistent.

Therefore:

- Research individual stocks and do not try to predict the market or compete with analysts tracking the large-cap stocks.

- Much valuable public information is available that is not reflected in stock prices, especially small-caps that are not widely followed.

Signs to Watch for:

- In a **creeping takeover**, the outside owner progressively adds to his stake in the potential target company by purchasing shares on the open market. If the outside beneficial owner continues to purchase large blocks of stock on the open market, it is a strong indication that there is good value at those price levels. If the price declines, the outside beneficial owner tends to go into the open market to purchase more shares, thereby supporting the price.

- A **triple play** occurs when an outside beneficial owner, the company itself, and its corporate officials (insiders) are all buying stock on the open market. This is just about as good as it gets in terms of identifying a severely undervalued stock that is going to go significantly higher.

- Even when you clearly spot the Telltale Signs that an event is about to occur that will drive up the price of an undervalued stock, you may have to be very patient.

- You should also take a close look at stocks where an outside beneficial owner has indicated a desire to sell. Companies that sell or spin off ‘non core’ operations are often preparing to sell themselves to a larger company as a pure play.

- One of the tricks to picking genuine takeover candidates is to look for companies that are already partly owned by other companies and have demonstrated they are in an acquisition mode. When a company whose stock is being bought by a third-party ‘beneficial owner’ announces a stock buyback, it is usually a strong signal that i) the company is worried about a takeover, and ii) the company believes its stock is severely undervalued and the potential acquirer will attempt a low bid that might be above the current market price but still below the true value of the company.

- When the ‘hot’ money sells to move into something temporarily more exciting, it creates buying opportunities in the genuine takeover candidates for those with the insight, foresight, and patience to take advantage of these opportunities.

- Browsing through charts with no particular stock in mind can often lead you to notice a potential super stock chart pattern. Create your own list of potential takeover candidates.

Eighteen Telltale Signs:

1. An outside company or individual accumulates more than 5 percent of a company's stock.

2. A company, which already has one outside 'beneficial owner', attracts a second or even a third outside investor who accumulates a position of 5 per cent of more.

3. An outside beneficial owner says that he is seeking ways to 'enhance shareholder value', 'maximize shareholder value', or speak to management/other shareholders about 'exploring strategic alternatives'. All are code for potentially putting a company up for sale to get the stock price higher.

4. An outside 'beneficial owner' pays substantially more than the current market price of the stock in a private transaction with the company to establish an initial position or increase its stake, or agrees to provide services or something else of value to a company in exchange for an option to purchase shares where the option's exercise price is substantially higher than the current market price of the stock. This is often a strong indication that all parties involved see substantially higher values ahead for the company and its stock.

5. An outside beneficial owner adds to his stake in a company through additional open market purchases of its stock.

6. An outside beneficial owner expresses an interest in selling his stake in a company and says it will review strategic alternatives—often code for a desire to have the target company acquired by a third party to maximize the value of the beneficial owner's investment.

7. A dispute between an outside beneficial owner and the company, in which it owns a stake, breaks out into the open—often a signal that a battle for control of the company is underway.

8. A company, in which an outside beneficial owner holds a stake or is accumulating additional shares and/or which operates in an industry where takeovers are proliferating, announces a stock buyback programme.

9. A company, in which an outside beneficial owner holds a stake or is adding to its stake, is the subject of insider buying by its own officers and/or directors.

10. A company, with an outside beneficial owner and/or operates in an industry where takeovers are proliferating, announces a 'shareholder rights plan' designed to make a hostile takeover more difficult.

11. A company in a consolidating industry sells or spins off 'non core' assets or operations, thereby turning itself into a 'pure play', which is often a signal that the company is preparing to sell itself to a larger company within its core industry.

12. A company in a consolidating industry takes a large 'restructuring' charge - in effect putting past mistakes behind it and clearing the decks for future positive earnings reports. Such action can be important to a potential acquirer and is often a sign that a company is preparing to sell itself.

13. A company in a consolidating industry announces a restructuring charge that causes the stock to decline sharply and becomes the subject of significant insider buying and/or announces a stock buyback. This is usually a sign that the stock market is taking a short-sighted, negative view of what may actually be an early clue that a takeover is on the horizon.

14. A company in a consolidating industry is partially owned by a 'financially oriented' company or investor, such as a brokerage firm or buyout firm, that has a tendency to buy and sell assets and that would be ready, willing, and able to craft a profitable 'exit strategy' for itself by engineering a takeover of the company in question, should the opportunity present itself.

15. The founder of a company who owns a major block of stock (10 %+) dies. This type of situation often leads to a desire by the estate to eventually maximize the value of the stock—in other words, a desire to have the company acquired.

16. Two or more bidders try to acquire a company in a certain industry, resulting in a bidding war. Since only one of these bidders can be a winner of the target company, there is a good chance that the losing bidder will look elsewhere for another acquisition target within the industry. In a case like this, you should browse through other companies within the industry looking for one or more of the Telltale Signs.

17. A small-to-medium-size company in a consolidating industry achieves a breakout from a 'super stock breakout pattern'; i.e., the stock penetrates a well-defined resistance level at least 12 months in duration following a series of progressively rising bottoms or support levels, which indicates that buyers are willing to pay increasingly higher prices to establish a position. This pattern creates the appearance of a 'rising triangle' on the chart. The best super stock breakout patterns occur when volatility decreases markedly in the weeks or days prior to the breakout.

18. A company that owns a piece of another company is itself acquired. Many times, it can pay dividends to look into a situation where a stake in one company is 'inherited' through a takeover of another company. Often, if Company A acquires Company B, which, in turn, owns a stake in Company C, you will find that Company C becomes a takeover target in one of two ways: i) Company A may eventually bid for the rest of Company C if this fits its overall business/acquisition strategy or ii) Company A may sell off the inherited stake in Company C to a third party, which then bids for the rest of Company C. A takeover of a company whose stock is 'inherited' through another takeover becomes even more likely when there is already a business relationship between Company A and Company C.

Commentary:

- You should also pay close attention to all merger announcements every day, making note of which industries are experiencing consolidation and what the reasoning behind that consolidation may be.

- You should also read and listen to any interviews of CEOs of companies that are making acquisitions for clues about what their future acquisition plans may be. You may find, for example, that an outside beneficial owner you have been tracking in one company also owns a piece of another company in a related industry.

- When you add insider buying into the mix — i.e., when you see officers and directors buying shares along with the outside beneficial owner at a certain price level — you have a double-barrelled vote of confidence that a stock has reached a compelling price point in terms of its value as a business.

- It is always dangerous to try to predict a bottom in a stock that has been falling precipitously. What you want to look for is an easing of the selling pressure, a levelling out of the stock price, and ideally, the formation of a sideways trading range, or base pattern, which indicates that buyers are finally stepping in and that the supply/demand situation is coming back into balance.

- Normally, a 'standstill agreement' might be viewed as an impediment to a takeover. However, that is not always the case. What is a standstill agreement? Sometimes, when one company buys a sizable stake in another company, the purchase is subject to certain conditions. One of the conditions may be a limitation on any future purchases of stock for a specified period. Generally, these agreements will say that Company A cannot increase its stake in Company B beyond a certain percentage without expressed permission from Company B. Whenever a large part of one company is owned by another, check the terms of the standstill agreement to see what the terms are and, most importantly, when the standstill agreement expires.

- You should note that companies implement shareholder rights plans for one reason only: They believe their stock is undervalued relative to its true value as a business, and they feel vulnerable to the possibility that an unwanted suitor might make a bid at a premium to the current market price, which would still represent a substantial discount to the company's true worth.

- Focus on stocks moving higher with significant volume increases. Volume-alert tables are a valuable tool - stocks that have just reached new price highs, or stocks that have had an extraordinarily large increase in volume. Look for a group of stocks that are acting well relative to the market, showing signs of unusual volume, and are at — or not very far above — key breakout-levels on the charts.

- One of the strongest clues that the stock market is severely undervaluing a stock is a combination of outside beneficial owner buying and insider buying on the part of a company's officers or directors. When you see a situation where the outside beneficial owner and a company's officers and directors are consistently buying stock on the open market, this is the '**double play**' — a bullish signal that should not be ignored.

- When you also have the company itself buying back stock, this is the rare '**triple play**'. When a company has growing earnings, the market will recommend the stock at almost any price. However, when earnings are slipping or stagnant, it seems that the market is not interested at any price. This creates a large gap between a stock price and the true long-term value of a business, an environment that creates takeover bids at large premiums. No matter how dismal the news may seem on the surface, if an outside beneficial owner, company insiders, and the company itself are all buying stock on the open market, it is almost always a signal that you have a potential super stock on your hands and that the news is about to get better.

- When animosity develops between a company and its major outside shareholder, the eventual result is often a takeover bid. A useful rule of thumb is that you should pay close attention when disagreements arise between a company and an outside 'beneficial owner', especially when these disagreements break out into the public arena.

- Investment companies in particular have been taking a more active role in recent years to get corporate managements to take actions that will increase the stock price. It is not unusual for an institutional investor to take a stake in a company, sit with it for a while, and then write a letter to management suggesting the company take steps to 'enhance shareholder value' or 'maximize shareholder value'. Sometimes, the institutional investor will release the letter to the press, perhaps do a round of television interviews, and feign outrage over the manner in which the company has been managed or mismanaged. Any management that has been paying attention to recent trends should respond with a polite letter thanking the institution for its thoughts, and then go back to running the business. This sort of publicity gambit will not usually lead to a takeover bid.

- It is usually a lot easier to figure out that a takeover bid is coming than it is to determine the price at which the takeover bid will take place. In most cases, you will see a takeover bid take place at a premium — sometimes a significant premium — to a stock's 52-week high. In nearly all cases, a takeover bid will a carry a premium to a stock's average trading price over the past 30 or 60 days. When a certain industry is consolidating and a number of takeovers have already taken place, it is often possible to establish a benchmark value that will give you a general idea of what a company would be worth in a takeover situation.

- Understand the term **Book Value** and how misleading this figure can be in certain circumstances. When a company carries an asset on its balance sheet, that asset must be assigned a certain value, called 'book value'. Usually, the asset is initially valued at its historical cost, which may or may not reflect the actual value several years down the road. In the case of a piece of machinery, for example, the value of that machinery will decline over time, as the machine's useful life grows shorter. Eventually, the machine will wear out and become virtually worthless. As a result, the accountants came up with the concept of **depreciation**, whereby a company is allowed to deduct a certain portion of that asset's cost each year from its earnings. The depreciation 'expense' is not really a cash expense; it is just a bookkeeping entry that allows the company to reduce its tax bill somewhat and reduces the carrying value, or 'book value', of the asset each year. It saves in taxes because it reduces reported earnings.

- Selling off its assets and paying out cash to its shareholders. This type of **self-liquidation** is common today - it usually occurs when a company believes its assets are worth far more than its stock price and when the stockholders would be better served by selling the assets and paying the proceeds directly to the stockholders.

- You should always take a close look at 'spin-offs' as potential super stock candidates. In order to become a pure play, a company needs to remove non-core businesses from the mix. There are two ways to do this: sell the businesses outright, or spin them off to shareholders as a separate company. In a pure spin-off, 100 percent of the stock of the non-core business is distributed to shareholders of the parent company, and the spin-off starts a new life as an independent, publicly traded company. There are a number of theoretical benefits to spin-offs, including the probability that the management of the new company will be better able to manage the spin-off's business once it is separated from the parent. Another theoretical advantage to owning shares in a spin-off is that the value of a fast-growing subsidiary hidden within a larger corporate structure may have been overlooked by the market. A third possibility is that by spinning off a company in an industry where there is a lot of takeover activity, the spin-off could become a takeover target. As a super stock investor, you should look at every announced spin-off and ask yourself: Which company operates in an industry where there is a great deal of takeover activity, the parent company, or the company being spun off? Whenever you see an announcement involving a spin-off, analyze the parent company. Check to see if there has been any recent takeover activity in the parent company's industry.

- When you have a large block of stock in a small company in a consolidating industry controlled by the founders of the company, you will very often find that these stockholders recognize the proper moment to 'cash out' and become part of a larger company. They realize that it will soon be dominated by a handful of giant companies that will be consolidating operations, cutting costs, and squeezing the profit margins of its smaller competitors.

- When a takeover trend engulfs a certain industry, take a close look at smaller companies in that industry in which the founding family still owns a large stake. More often than you might think, these major stockholders recognize the optimal moment to cash out.

- Whenever you see any indication that two or more large stockholders of a company have made any sort of pact to act in concert, to require mutual approval, or in any way have indicated that they have discussed how they will sell their shares, you should take this as an indication that these stockholders are at least considering the possibility that the company will be sold at some point in the future.

- If you believe a takeover wave is about to strike a particular industry, and if you are on the lookout for potential takeover targets, you should concentrate on smaller to mid-sized companies because they will be the most vulnerable to takeovers.

- Look for companies in a takeover-lively industry that appear to be transforming themselves into 'pure plays'. Any company that operates in a takeover-lively industry and is taking restructuring charges or implementing cost-cutting measures or closing down marginal or unprofitable operations is also a candidate for putting up a 'For Sale' sign.

- All things being equal, you should take special note of companies in which a large block of stock (say, 10 percent or more) is held by a single shareholder.

- Look for super stock chart patterns. Pay particular attention to smaller companies that are bumping up against well-defined, multi-year resistance levels. A 'super stock breakout' pattern involves a stock that is breaking out to the upside above a very well defined, multi-year resistance level. Resistance level is a price level that has contained at least three previous attempts to move higher over a period of at least 1 year. Either way, a breakout above a multi-year resistance level is usually a sign that a stock is going to move significantly higher.

- You may have to endure a 20 percent, 30 percent, or even a 50 percent decline in the stock price. If you insist on limiting your losses to 10 percent, you will be 'stopped out' of ultimate winners.

- When corporate officers and directors purchase shares in their own company on the open market immediately following a negative surprise that seems like a one-time, non-recurring item, it is usually a sign that the stock market has overreacted in a negative way and that the news from there on will be considerably better.

- When one or two large takeovers in any given industry take place, the fear factor kicks in among other companies within that industry. After a couple of strategic acquisitions occur - sometimes it only takes one - other players within the industry become fearful. And, then they become fearful that if they do not play 'follow the leader' by acting now and buying somebody, they will be left out of the parade when the reasoning becomes apparent to everyone, or they'll be forced to pay too much even if they do identify a takeover candidate. Sometimes it is simply the fear of being acquired itself that leads a company to take over another company, as an act of self-defence.

- The '**domino effect**': corporate managers can act like lemmings. Sometimes a merger wave in an industry is touched off for logical and perceptive reasons, and everybody else in the industry can be jolted into awareness by the brilliance of the initial takeover transaction, which forces them to get into the act before it is too late. Then there is the 'greed' factor - corporate CEOs can have large egos.

- The investment bankers earn good money on such takeovers; they make sure that the necessary euphoria exists. They claim investors are better off owning shares in the acquiring companies rather than the target companies. Their enthusiasm for the acquiring companies is designed to i) create buy recommendations for institutions that were more inclined to buy higher-priced, liquid high-capitalization stocks anyway, and ii) keep the stock prices of the acquiring companies going higher so they could continue to use their stock to acquire more companies, and so their rising stock prices would serve as inducements for other companies to do the same, thereby keeping the takeover assembly line humming and keeping those huge investment banking fees rolling in.

- The way to make money investing in takeovers is to own shares in a company that becomes a takeover target of another company willing to pay a premium for the target company's stock. If you buy a stock because you believe it is a takeover candidate, and you are fortunate enough to receive that takeover bid, take the money and run.

- As an investor searching for potential super stock takeover targets, you should not underestimate the lemming like mania that at times can overpower corporate executives. The more you understand the impulsive manner in which decisions like this can be made, the less surprised you are apt to be at the speed and scope at which a takeover wave can engulf an entire industry, turning a highly competitive industry landscape into a barren wasteland consisting of a handful of behemoths with stomach pains.

- There is no money to be made for shareholders in' merger of equals' companies, so ignore such deals. If you own stock in either company involved, sell it and move on.

Management Buyouts:

1. Managers own 20%+ of the equity.

2. Very low PE.

3. Good Dividend Yield.

4. Exceptionally strong Cash Flow.

5. Consistently depressed Share Price.

6. Market Capitalisation up to £50m.

Hemscott criteria:

- companies promising a yield of at least 4%
- covered at least 1.5 times by earnings
- with manageable borrowings of no more than 60% of assets
- with interest payments covered 4 times by operating profits
- where the shares are worth less than tangible net assets

Index Changes:

- Look at Market Capitalisation rankings to identify companies that might soon move up an Index. Buy the shares before its inclusion.

- For companies about to be dropped from an Index, wait for the share price to fall before buying.

International Time Differences:

- If Wall St. falls but is expected to pick up again buy UK shares early the next morning.

- When Wall St. reopens at 3.25pm and the market turns up sell the shares bought that morning.

Options.

- If a lot of Call option business is being done on particular shares this may indicate an expected rise in the share price.

Rolling Share Strategy:

- Identify shares with good fundamentals under £15 in price.

- Study the Charts to identify 3 or more annual buying opportunities, with a profit of at least 15%. Look for shares that have fallen from a higher price.

- Filter suitable shares using Chart factors. The share must fulfil three of the following:
- Price at the Support Level

- Stochastics with the fast line crossing the slow line in the bottom Buy Area

- Volume moving positive

- Moving Averages with the short moving average above the longer moving average and both moving upwards

- MACD when the short line crosses above the longer line and crossing the Zero line

- Draw in Support and Resistance lines to identify Entry and Exit prices.

- Buy at the Entry Point and Sell at the Exit Point.

- Let the trade run beyond the Exit Point if it is moving strongly but keep a watch for the reversal.

- Check the Stochastics and Moving Averages for Sell signs. Sell when the 50-day average crosses below the Price Line and heads towards the 200-day average. Spiker Charts do not give reliable Sell signals.

Mechanical Strategies.

The Motley Fool: Source: The Motley Fool **www.fool.co.uk/**

Cornerstone Value

- A value strategy based on James O'Shaughnessy's book 'What works on Wall Street. The method works as follows:
- Select only those companies who have Market Capitalisation in excess of £350 million and a Price to Sales Ratio (PSR) of less than 0.85
- From 1 select the five companies with the highest dividend yield.

JT Value

- A value strategy based on low PE, low PSR and normally high Yield. The method works as follows:
- Select only those companies whose Market Capitalisation is greater than £100 million
- From 1 select only those companies whose PE is less than 10
- From 2 select the companies whose EPS is forecast to grow by more than 20%
- Sort 3 by ascending PSR
- From 4 buy the top five in equal pound amounts
- Hold for exactly one calendar year then sell

PEG5

A growth strategy. The method is as follows:

- Select only those companies who are members of the FTSE350 Index and have a price earnings ratio greater than zero. I.e. they actually make a profit
- From 1 sort the companies by descending 6 month price appreciation (RS26) and select the top 25
- From 2 select the 10 companies whose EPS is forecast to rise by the greatest percent over the coming year
- From 3 select the five with the lowest PEG

Pyad26

A high yield strategy devised by TMFPyad:

- Select the largest company (by Market Capitalisation) in each sector that has a five year unbroken record of increasing its dividend per share.
- Select only those shares whose market capitalisation is above £2 billion.
- List the shares by descending dividend yield and purchase in equal pound amounts the top five.
- Hold for one year then sell.

RS26

A method based on Relative Strength devised by Paul Marshall:

- Using only the constituents of the FTSE100 index calculate the 26 week / 6 month relative strength and list in descending order
- Purchase in equal pound amounts the top five shares. I.e. those shares that have risen the most in percentage terms over the past 6 months
- Hold for exactly one calendar year then sell.
- Very volatile. When the market is rising this strategy tends to outperform the indices. In a bear market trend, RS investing has been shown to suffer losses of 70% or more.

RS-JT

A Relative Strength strategy:

- Select only those companies that are members of the FTSE100 Index
- From 1 calculate RS-JT using the following formula: 0.4 x 3 months Price Appreciation + 0.2 x 6 months Price Appreciation + 0.2 x 9 months Price Appreciation + 0.2 x 12 months Price Appreciation
- From 2 select the five stocks with the Highest RS-JT.

The system has beaten the FTSE100 on average since the 1980s but not quite as spectacularly as in the great Bull market of the mid to late 90s.

Spark

A growth strategy developed by Sparfarkle on the Motley Fool USA site:

- Select only those companies whose normalised EPS has grown more than 20% over the past year
- From 1 select only those companies whose share price has risen more than 20% over the past six months
- From 2 select the companies whose EPS is forecast to growth by greater than 25%
- Sort 3 by descending Market Capitalisation

This strategy is likely to do very well in strong bull markets, but may suffer when times are more difficult.

Zulu

A growth with value strategy based on Jim Slater’s book 'Beyond the Zulu Principle':

- Select only those companies who are members of the FTSE Small Cap Index and have a Market Capitalisation in excess of £100 million
- From 1 select only those companies whose PEG is between 0 and 0.6
- From 2 select the companies whose earnings have increased over the previous two years historically
- From 3 select the five with the highest RS-JT.

Markman's Mechanical Strategies:

Source: Online Investing by Jon Markman. ISBN 0-7356-0650-1
http://www.amazon.co.uk/exec/obidos/ASIN/0735611238/qid=1068163863/sr=1-2/ref=sr_1_0_2/026-2297028-0123661

Momentum:

Basic:

- Medium sized.

- Current Price greater than the Price 3 months ago.
  Stock Price History / % Price Change Last Quarter>= 0.1%.

- Current Price greater than the 200-day Moving Average.
  Stock Price History/ Previous Day's Closing Price>=Trading & Volume / 200-Day Moving Average.

- Rank by Bull Flag Chart Pattern, which gives the best 12-month Price advance with 3 month and 1 month sideways movement (Mean Regression).

- Stock Price History / % Price Change Last Year - % Price Change Last Quarter - 3* % Price Change Last Month. Choose High As Possible.

- Buy the top 3 to 10.

Advanced:

- Medium sized.

- Revenue of at least £30 m.
  Current Financials / 12-Month Revenue>=£30m.

- Return on Equity > 0.1%.
  Investment Return / Return on Equity>0.1%.

- Current Price greater than the Price 3 months ago.
  Stock Price History / % Price Change Last Quarter>=0.1%.

- Current Price greater than the Price 1 month ago.
  Stock Price History / % Price Change Last Month>=0.1%.

- Strong daily Volume greater than 800,000 over past month.
  Trading & Volume / Avg. Daily Vol. Last Mo.>=800,000.

- Rank by Bull Flag Chart Pattern, which gives the best 12-month Price advance with 3 month and 1-month sideways movement (Mean Regression).
  Stock Price History / % Price Change Last Year - % Price Change Last Quarter - 3* % Price Change Last Month. Choose High As Possible.

- Buy the top 3 to 7 shares.

Large-Cap Growth:

Large Cap.

- 15% Growth in Revenues and Earnings Per Share in the past quarter and year.
  Growth Rates / EPS Growth Qtr vs Qtr>=15. Growth Rates / EPS Growth Year vs Year>=15. Growth Rates / Rev Growth Qtr vs Qtr>=15. Growth Rates / Rev Growth Year vs Year>=15.

- 15% Growth in Earnings Per Share expected over the next year and 5 years.
  Analyst Projections / EPS Growth Next Yr>=15. Analyst Projections / EPS Growth Next 5 Yr>=15.

- Earnings Surprise in the most recent quarter.
  Analyst Projections / recent Qtr Surprise %>=1.

- Rank by 52-week share price percentage gain.
  Stock Price History / % Price Change Last Year High As Possible.

Defensive Growth:

- 12 month Revenues greater than £300m.
  Current Financials / 12-Month Revenue>=£300m.

- 12-month Income greater than £20m.
  Current Financials / 12-Month Income: Cont. Ops.>=£20m.

- Earnings Growth in the past 12 months greater than 1%.
  Growth Rates / EPS Growth>=1%.

- Beta greater than 0.5.
  Trading & Volume / Beta>=0.5.

- Beta less than 1.9.
  Trading & Volume / Beta<=1.9.

- Current Price greater than the Price three months and one month ago.
  Stock Price History / % Price Change Last Mo.>=1. Stock Price History / % Price Change Last Qtr.>=1.

- Market Capitalisation of £4 billion.
  Company Basics / Market Capitalisation>=£4 billion.

- Rank by 52-week share price percentage gain.
  Stock Price History / % Price Change Last Year High As Possible.

- Select the top 4.

Garp Value:

- Market Capitalisation greater than £600m.
  Company Basics / Market Capitalisation>=£600 million.

- Earnings Growth next year greater than 15%.
  Analyst Projections / EPS Growth Next Yr>=15.

- Earnings Growth in the next 5 years greater than 15%.
  Analyst Projections / EPS Growth Next 5 Yr>=15.

- Past 5 years' Earnings Growth greater than 15%.
  Growth Rates / 5-Year Earnings Growth>=15.

- Past year's Earnings Growth greater than 15%.
  Growth Rates / EPS Growth Year vs Year>=15.

- PE based on next year's estimated Earnings lower than the next five years' estimated Growth Rate.
  Analyst Projections / Forward Year PE<=Analyst Projections / EPS Growth Next 5 Yr.

- Current Share Price no more than 20% above the share's 52-week low.
  Stock Price History / Previous Day's Closing Price<=52-Week Low * 1.2.

O'Shaughnessy Value:

- Market Capitalisation greater than £100m.
  Company Basics / Market Capitalisation>=£100m.

- PSR less than 1.5.
  Price Ratios / Price/Sales Ratio<=1.5.

- Earnings in the current year greater than in the past year.
  Growth Rates / EPS Growth Year vs Year>=0.1.

- Rank by 12-Month Relative Strength.
  Stock Price History / % Change Last Year High As Possible.

- Choose the top 3 to 5 and hold for a year.

RBI Value:

- 12 month Revenues greater than £300m.
  Current Financials / 12-Month Revenue>=£300m.

- 12-month income greater than £20m.
  Current Financials / 12-Month Income: Cont. Ops.>=£20m.

- Earnings Growth in the past 12 months greater than 1%.
  Growth Rates / EPS Growth>=1%.

- Beta greater than 0.5.
  Trading & Volume / Beta>=0.5.

- Beta less than 1.9.
  Trading & Volume / Beta<=1.9.

- Current price greater than the price three months and one month ago.
  Stock Price History / % Price Change Last Mo.>=1. Stock Price History / % Price Change Last Qtr.>=1.

- Market Capitalization of £4 billion.
  Company Basics / Market Capitalization>=£4 billion.

- PSR less than 4.
  Price Ratios / Price/Sales Ratio<=4.

- Rank by 52-week share price percentage gain.
  Stock Price History / % Price Change Last Year High As Possible.

- Select the top 4.

Stock Filters.

Hemscott Growth

- PE<12
- EPS Growth>12%
- PEG<0.8
- CFPS/EPS>1
- 1-month Relative Strength>0
- ROCE>15
- Net Margin>10%

Hemscott Momentum

- 1-month Relative Strength>0
- 3-month Relative Strength>0
- 6-month Relative Strength>0
- 12-month Relative Strength>0
- EPS Growth>12%
- PE<12

Hemscott Income

- Dividend Yield>5
- Dividend Cover>2
- EPS Growth>12%
- Net Gearing<50%
- Interest Cover>2
- CFPS/EPS>1

Hemscott Value

- PE<10
- EPS Growth>0%
- Net Gearing<50%
- Dividend Yield>5
- Dividend Cover>2
- Interest Cover>2
- P/BV<1.5

Harrison Growth

- PE>20
- P/BV>4
- 3 year EPS Growth>15%
- Dividend Yield<2
- I month Price Momentum>0

Harrison Value

- PE<10
- P/BV<1
- 3 year EPS Growth<5%
- Dividend Yield>6.5
- Dividend Cover>1
- Market Cap.>£10m

Harrison Income

- Dividend Yield>3
- Dividend Cover>3
- 3 year EPS Growth>10%
- Interest Cover>5

Margin of Safety search

- PE<10
- Expected Earnings Growth>20%
- 1 month Relative Strength>10%
- Market Capitalisation>£10m
- Dividend Cover>2

Trading Well but Out of Favour Search

- FTSE 350
- PE<10
- Dividend Yield>5%
- Positive Sales/Share trend
- Operating Margin>10%
- Net Gearing <10%

Out of Favour Blue Chip Search

- M Cap=>£1.5 billion
- PE<15
- Dividend Yield>4%
- Dividend Cover=>1.5
- Cashflow>Earnings
- Net gearing<70%
- 12-month rising EPS

Accelerating Earnings Growth Search

- PE<15
- Earnings Growth Rate 20–30%
- a PEG
- High Yielder Search
- Earnings Growth>25%
- a PEG
- Dividend Yield>1%
- Dividend Cover=>2

Undervalued Momentum Search

- PE<12
- Expected Earnings Growth>15%
- 1 year Relative Strength underperformance>10%
- Cash Flow>Earnings

GARP with Safety Net Search

- PE<12
- Expected Earnings Growth>12%
- a PEG
- Cash Flow>Earnings
- Positive Relative Strength over last month
- Net Gearing<50%

FTSE 250 Low PE Search

- PE<10
- Net Gearing<50%
- Interest Cover>3
- Current Ratio>1
- PBV<1.5

New 52 week Highs Search

- New 52 week High
- Current Price 2* 52 week Low
- Positive Earnings Growth
- Prospective PE<15

Speculative Low PE Search

- Lowest PEs
- Net Gearing<50%
- Interest Cover>3
- Current Ratio>1
- Price/Tangible Book Value<1.5

ROCE Search

- Return on Capital Employed>15%
- Profit Margin>10%
- Cash Flow>Earnings
- Relative Strength Search
- FTSE All Share
- PE<20
- Negative RS over 1 year
- Positive RS over last month

Best Value Medium sized Search

- FTSE 250
- a PEG
- Cash/Share=>Earnings/Share
- Positive Earnings Growth>10%
- Adequate Dividend Cover
- PE<16

Growth with Income Search

- PEG<1
- Dividend Yield>3.5%
- Dividend Cover>2
- Interest Cover>4

Recovery Play Search

- EPS Growth 20–50%
- PE<15
- Positive Relative Strength over 3 months
- Relative Strength over 1 month=>30%

PEG AIM Search

- AIM
- PEG<1
- PE<15
- ROCE>15%
- Positive Relative Strength over last month

Momentum Charge Search

- Relative Strength over last month>20%
- Positive Relative Strength over 3 months
- Positive Relative Strength over 1 year
- PE<12
- Price within 10% of its high
- Positive Earnings forecast

Cohen Analyst

- Net Gearing<0
- Positive Cash Flow>0
- ROCE>20%
- Dividend Cover>2
- 5 years of Earnings and Dividend Growth

Strong Asset Backing Search

- PTBV>0<1
- M. Cap>£10m
- Gearing<50
- Div. Y.>3
- Div. Cov.>2

Rodriguez Contrarian

- M Cap=>£180m
- PE<15
- PSR<1
- PBV<2.2

Malter Go For It

- M Cap=>£1b
- Projected 3-5 Years Earnings Growth=>10%
- Dividend Yield<Index
- Debt/Equity Ratio<50%
- ROE=>20%

Puglia Garp

- M Cap=>£3b
- ROE=>15%
- Projected 3-5 years Earnings Growth=>15%
- Prospective PE=<twice projected Earnings Growth

Kattke Dividend

- M Cap=>£3b
- PE=<2/3rds Market
- PBV=<2/3rds Index
- Dividend Yield>1%
- Debt/Equity Ratio<100

Discount to NAV with Yield

- M Cap>£30m
- Dividend Yield>4%
- Dividend Cover>3
- Gearing<50%
- Cash Flow per Share=>EPS

Momentum Play

- Within 5% of 12-Month High
- 1-month positive Relative Strength against the FTSE All Share
- PE<10
- Prospective Earnings Growth>15%
- M Cap>£20m

TBS Cheap Earnings

- Div Yield>=6%
- PE>=10
- Growth>=10%
- Gearing<=50%
- Div Cover>=2
- CF/EPS>=1

Oonagh Cheap Assets

- PE>0 and PE<15
- Yield>5
- Div Cover>1
- PBV<1
- Gearing<50
- Int. Cover>2
- Mkt. Cap>70
- EPS Growth>10

Investment Fables – Damodoran.

Models:

Low Price to Book Ratio

- PBV<0.80
- Beta<1.5 or Debt to Capital Ratio<70%
- ROCE>8%

Stable Earnings

- Increasing EPS over the last 5 years
- Beta<1.25
- SD over the last 3 years<60%
- PE<15
- Expected growth in EPS over the next 5 years=>10%

Good Companies

- EVA has to be positive [EVA = (Return on Invested Capital-Cost of Capital) (Capital Invested)]
- Top Company ranking
- PBV<2.5
- PE<current industry-average PE

Growth

- Projected Earnings Growth>15% over the next 5 years
- PEG<1
- Revenue Growth>10% per year over the last 5 years
- Beta<1.25
- SD<80%
- ROE>15%

Recovery

- Bottom 25% on Relative Strength
- SD<80% or Beta<1.25 or Debt to Capital Ratio<50%
- Positive Earnings in most recent period
- Increased Earnings over previous period

Takeover Targets

- Poorly managed companies e.g. ROE more than 4% below peer group ROE and investor returns lag peer group returns by more than 5%
- Insider holdings <10%
- Debt to Capital Ratio<50% or SD<80%

Momentum

- Relative Price Strength and Relative Volume Strength>1.4
- Beta<1.2 or SD<80%
- PE<20

General Guidance:

1. Beware of fancifully-named investment strategies.

2. High Return = High Risk.

3. Remember the fundamentals.

4. Most cheap stocks are cheap for a reason.

5. Good companies may not be good investments.

6. The only predicable thing about shares is their unpredictability.

7. Numbers can lie.

8. Markets are more often right than wrong.

9. Define a strategy to suit your personality.

10. Luck tends to dominate skill.

Market Cap Investing.

Blue Chip Investing.

Criteria:

1. Strong Brand name.

- Reputation for quality.
- High repeat purchase.

2. Good Fundamentals.

- EPS, Turnover, and Profit increasing steadily year by year.
- Healthy Cash Flow – Cash Flow per Share greater than EPS; Cash Flow per Share greater than Capital Expenditure per Share.
- Good management – a stable but ambitious CEO and Board. Forward-looking with an ability to embrace new technology.
- Good financing – good Interest Cover and Dividend Cover and a Quick Ratio near to 1.

3. Healthy Debt Position.

- Profit Margin would need to be around 10% to be able to service debt.
- Interest Cover of 7 is good. Interest Cover of 4 is poor unless very low or negative Gearing.
- A high ROCE would be needed to cancel out the effects of high borrowing.
- High borrowing would need to be justified by the CEO in the annual report.

4. Consistent record of success.

- Steadily rising EPS.
- Increasing Dividend Yield.

5. Competitive edge.

- Sector dominance.
- Higher than average ROCE for the sector.
- Good profit margins.
- Good portfolio of patents, licences and copyrights.

6. Share price that is low for no reason.

Blue Chip Covered Calls.

1. Buy 1000 shares in a company that can be held for the longer term.

2. Buy shares whose Options will produce a minimum of 7% over 3 months, 10 over 6 months or 15% over 9 months. Profit = Striking Price – (Share Price + Option Premium). % = Profit/Share Price*100.

3. Select shares which are moderately volatile and offer a healthy Call Premium. (12-mth High – 12-mth Low) /12-mth Low * 100.

4. Check the Beta for relative volatility.

5. Look for a Delta greater than 1.00 where the movement in the Call Premium exceeds the movement in the share price.

6. Do not select a Striking Price below the Cost Basis unless the Option Premium offsets the difference.

7. Try not to buy shares that have Earnings Announcements before the Strike Date. If unavoidable, watch the shares carefully.

8. Sell the Call only after the share price has appreciated somewhat.

9. Do not invest more than 20% of portfolio in one stock.

10. Check the closing prices every day.

11. Compare returns on exercising the Option versus closing and selling the Option.

12. To reduce the risk of exercise when the Stock Price is rising use the Roll Forward Technique. Buy back the Option and sell a later Call at the same Striking Price.

13. Buy the Covered Call back when the price of the share shoots up 10% or more to lock in an immediate profit.

14. Cut losses early by buying back the Call. This should be around 1 point below the break-even point (Share Price – Option Premium).

15. A Roll Down can be used to replace a Call with another that has a lower Striking Price.

16. A Roll Up can be used to replace a Call with another that has a higher Striking Price. Make sure that the loss in the original Call does not exceed the gain in the increased Striking Price.

17. Total return includes Stock Appreciation, Call Premium and Dividend Income.

18. Add in broker fees when assessing likely returns.

19. Diversify the Covered Call Portfolio with shares from different industries and sectors.

20. Complete a Covered Call Sale Criteria Sheet for every purchase and stick to the limits.

Covered Call Sale Criteria Sheet	
Rate of Return If Unchanged	
Dividends £______	
Call Premium £_____	Total £_____
	Cost of Stock £_____
	Gain ____%
Rate of Return if Exercised	
Dividends £______	
Call Premium £_____	
Stock Gain _____	Total £_____
	Cost of Stock £_____
	Gain ____%
Option Purchase Criteria	
Maximum Time Value: ____%	
Time until Expiration: ____ months	
Number of Options: ___ contracts	
Target Rate of Return: ___%	
Sell level: increase to £____ or decrease to £____	

FTSE 100 Financial Spread Betting.

Source: How To Win at Financial Spread Betting by Charles Vintcent
ISBN 0-273-65413-6
http://www.amazon.co.uk/exec/obidos/ASIN/0273654136/qid=1068164010/sr=1-6/ref=sr_1_0_6/026-2297028-0123661

Fundamentals:

- Stick with the FTSE 100 for narrower spreads.
- Establish the trend of the sector as positive, negative, or neutral.
- Avoid investing before ex-dividend dates.
- Select shares which have strong positive or negative direction, and with strong momentum – that is, a short time span between the falls and rises.
- Do not go against market sentiment.
- Watch press comments for a change of sentiment.

Technicals:

- Signs for a rise in price are double bottom, triple bottom, cup shape, reverse head and shoulders, chart breakout upwards.
- Signs for a fall in price are double top, triple top, dome shape, head and shoulders, chart breakout downwards.
- Select shares trending at an angle of 45 degrees.
- Establish the trading range and decide if there is enough movement to cover the spread and show a profit.
- Check if there is enough room between the current price and the next resistance or support level to make a profit.
- Wait until the share price has turned up or down before placing a bet.
- Check on the dates of interim or final announcements to see if they fall within the time frame of the bet. Check if the expected results are already discounted in the price.
- Cut losses quickly when the share price goes against.

AIM Shares.

- Select companies that are profitable, have a proven product or service, an experienced management and a plan for growth.
- Select Sectors in favour.
- Select companies with a trusted Nominated Advisor and Broker like Teather & Greenwood and Beeson Gregory.
- Buy on a low PE.
- Hold shares for a reasonable period to give the company a chance.
- Use standard Valuation criteria.
- Select companies worth more than £30 m.
- Select shares with prices more than 50p to avoid a wide spread.

Small Cap Risks. (IC)

- Try to choose companies that pay dividends. Dividend Cover of 2 is adequate and 3.5 is good.
- Beware of companies that have Net Gearing over 50%. Interest Cover should be no less than 3-4 and preferably above 10.
- Current Ratio should be 1 or more.
- Check the Cash Flow. If stated earnings are shooting ahead but net Cash Flow is heavily negative with extensive use of debt, this is a warning sign.
- Profit warnings are particularly negative for small caps.
- If both Sales and Profits are falling, that is likely very bad news.
- Check the number of shares in free float and who owns them. Watch out for poor liquidity.
- Look for institutional ownership but preferably more than one institution.
- Be cautious if the only broker coverage is from the in-house broker.

Small-Cap Dynamics – Pradhuman.

http://www.amazon.co.uk/Small-cap-Dynamics-Insights-Bloomberg-Professional/dp/1576600297/ref=sr_1_1/202-7523631-9877467?ie=UTF8&s=books&qid=1179000551&sr=1-1

Investing Framework:

- Are Earnings Expectations improving or declining?
- Have all expectations been priced in?
- What is the market consensus?
- Are the shares under-valued or over-valued?

Models:

Momentum. The basic principle is that a company announcement of good news tends to ripple over into subsequent reporting periods. Selecting a 1-month period of price out-performance does not appear to be significant – in fact, after the sudden bounce, there tends to be a reverse. A 12-month period seems to be best, beating the Small-Cap Index by a significant margin. The weakness in the strategy is Market Risk - a declining market wrecks havoc on momentum investing.

Earnings Expectations. Selecting the best Earnings revisions based on the prior 3 months, and compared at the end of the current month, clearly out-performs the market. As with momentum, this strategy under-performs in a downward market.

Value. Relative Multiples are better for Small-Caps than Dividend Discount Models etc., which make too many assumptions based on limited analyst coverage. The best Valuation measures based on price performance are:

1. Price to Cash Flow
2. Price to Sales (but volatile)
3. Price to Earnings
4. Price to Book Value

Value models hold up well in down markets, providing better downside protection than Momentum or Earnings Expectations models. Cheap shares can be viewed as the ultimate low-Beta stocks.

Multi-Factor Models. For example, a low valuation and high expectations model could combine Earnings Expectations with Price to Cash Flow.

N.B.

- Growth is best when the economic cycle is down, and Value is best when the economic outlook is robust, bringing marginal companies into play.
- Sector-adjusted PCF is best for small firms and sector-adjusted PBV best for larger firms. This may be due to small firms running earnings deficits and trying to turn a positive cash flow. Sector adjustment removes the bias in favour, say, of technology against cyclical and financial sectors.
- To remove look-ahead bias, incorporate a Quarter's worth of lagging data e.g. Price Dec. 2004 / Earnings end of third Quarter 2004.

Covered Warrants

General Strategy:

1. Know the fundamentals of the underlying share.

2. Be careful with 'cheap' out-of-the-money warrants.

3. Use a Scenario Selector, starting with the LSE selector from www.londonstockexchange/coveredwarrants.

4. Identify your risk/reward profile. In-the-money warrants are less risky; higher gearing has greater risk.

5. Avoid deeply out-of-the-money warrants with a short time to expiry. Out-of-the-money warrants have a value consisting only of time value and that quickly evaporates towards expiry. A short-dated slightly out-of-the—money warrant can be highly profitable but it is high risk.

6. Spreads on covered warrants do not vary throughout the trading day. The maximum spread is 10% or 1p.

7. Covered warrants are a useful way into commodities.

8. Set up a Squaregain watch list on covered warrants and try the virtual trading game.

9. SG, Goldman Sachs, and DrKW charge £1 per trade (not JP Morgan).

10. No stamp duty. Liquidity is guaranteed.

Trading Strategies:

1. Decide on where you think the price of an underlying will be heading within a specific period.

2. Select from the available range according to your risk/reward profile.

3. Enter your parameters in the Warrants Selector tool.

4. You can modify the levels of volatility using the SG site at www.warrants.com.

5. Straddles are useful when a company is at a make-or-break moment. Buy a Call and a Put with the same Strike Price and Expiry. Work out the break-even points on the upside and the downside. Upside Strike Price + Price of 1 Call + Price of 1 Put; Downside Strike Price – Price of 1 Call + Price of 1 Put; you make a profit if the underlying moves outside the upside and downside range.

6. Hedging Your Portfolio. You could, for example, buy a FTSE 100 Put.

7. Cash Extraction. You could take profits on a winning share and keep exposure to the upside by buying the same amount of Calls.

Basic terminology:

Strike Price:	the price at which you have the right to buy.
In The Money:	the market price is higher than the strike price
Profit:	(market price minus strike price) minus cost of warrant
Delta:	deals with the response of the warrant in response to movement in the price of the underlying. It varies between 0.0 and 1.0 with a warrant out of the money close to zero and a warrant deeply in the money close to 1.
Gearing:	the price of the underlying divided by the price of the warrant. Effective Gearing is Gearing times Delta.
Gamma:	the rate at which the delta changes as the underlying changes.
Theta:	the rate at which a warrant loses value as time passes. This speeds up towards the end of the warrant's life.
Volatility:	high volatility warrants are worth more than low volatility. If volatility rises, so should the value of the warrant.
Interest Rate Rise:	Calls become more expensive and Puts become cheaper.

Financial Ratios.

Company Refs Ratios.

Earnings per Share
EPS = Company Earnings / No of shares

EPS Growth Rate
The EPS Growth Rate indicates the predicted rate of increase (or decrease) of earnings per share, using brokers forecasts. EPS Growth Rate is calculated as:
EPS Growth Rate = (Future Predicted EPS - Current EPS)/ Current EPS

Market Capitalisation
Market Capitalisation is the total value of a company if the value of all its shares were added up. Market Capitalisation is calculated as:
Market Capitalisation = Share Price * No Of Shares

PEG (Price-Earnings Growth factor)
The PEG is used to calculate how much future predicted future share growth has already been built into a share price. The lower the PEG, the less future growth is already in the share price. REFS give a company a PEG when:

- There are brokers forecasts
- EPS growth is seen in 4 consecutive years (including future years)
- There has been no profit loss in the last 5 years

PEG is calculated as: PEG = PE / EPS Growth rate

Dividend Yield
The Dividend Yield represents the annual dividend per share as a percentage the share price. Dividend Yield is calculated as:
Dividend Yield = Dividend per Share / Share Price

Cash Flow
Cash Flow represents the volume of cash generated by a business from which the dividend must be paid. Cash Flow is calculated as:
Cash Flow = Operating profit + Returns on Investment - Interest Paid - Dividend to Preference Share and Minority Holders - Tax Paid

Shareholders Funds
Shareholders Funds are calculated as:
Shareholders Funds = Ordinary Share Capital + Preference Share Capital + Reserves

Net Gearing
Net Gearing indicates how much a company is in debt relative to shareholders funds. Net Gearing is calculated as:
Net Gearing = (Total Borrowings - Cash and Near Cash Assets) / Shareholders Funds

Relative Strength
Relative Strength shows how well the share price has performed relative to the FTSE All-Share Index. It is said that on balance, shares that win continue to win. Relative Strength is calculated as:
Relative Strength = Gain in Share price / Gain in FTSE All Share Index.

Financial Ratio Values.

PE

- Compare with the industry average. 25% above might suggest that it is the clear leader.
- If Earnings Growth rate is greater than PE, could be a sign it is undervalued.
- To set a Price Target multiply current PE by the Consensus Earnings estimate.
- Check its PE range to see if it is over- or undervalued.

PEG

- Less than 1 would suggest that it might be undervalued. Greater than 2 suggests that it is overpriced.

PCF

- A low figure is attractive. It should be lower than the PE. A low PCF is good for dividends. It ensures that earnings are real.

PSR

- A low figure is good, preferably less than 1. O'Shaughnessy sets a maximum at 1.5 and Markman at 4.
- It is good for recovery/turnaround potential.
- Watch out if the company is highly geared.

PBV

- A PBV less than 1 represents good value.
- A very low PBV can point to a takeover.

PTBV

- Same as above with intangible assets subtracted.

PRR

- A single digit figure is best for the Price to Research Ratio.

Revenue Growth

- Sales growing faster than its industry is good, suggesting a competitive advantage.

Earnings Growth

- 15% is very good. Good sign if earnings accelerating faster than revenue.

Profit Margin

- Improving margins give a competitive edge.
- Varies by industry- 15% might be good in one industry - software is high and retail is low.
- Too high a margin can invite competition.

Relative Strength

- Measures a share's performance relative to the market.

Gearing
- A Debt to Equity Ratio of 50% or lower is good.
- A declining ratio is a good sign. It falls when a company pays off debt.
- ROCE should be higher than the cost of borrowing, profits should be rising.

Current Ratio
- Current Assets divided by Current Liabilities.
- Measures short-term debt paying ability.
- It should be 2 or higher, but restaurants can carry 1.0.
- Supermarkets could survive on less than 0.5

Quick ratio
- Current Assets minus stocks divided by Current Liabilities.
- Should be 1 or better. Harder test than Current Ratio.
- Sign of a solid conservatively run business.

Interest Cover
- It should be 2*, but the higher the better. Deteriorating figure is bad.

Leverage Ratio
- Total Assets divided by Total Equity.
- A number lower than its peers is good.

ROE
- A double-digit figure is good. A value play would need 15%. 20% is excellent. 26% is the gold standard.
- A climbing ROE leads to a climbing share price.

ROCE
- A high ROCE means efficient use of resources.
- It should be greater than 20%.
- It should be higher than the return on gilts.
- Compare to sector peers.

ROA
- Net Income / Total Assets
- Useful ratio in banking and manufacturing.
- Look for a rising trend.
- Compare to industry peers.

Dividend Cover
- EPS divided by DPS.
- A measure of a company's ability to maintain its dividend.
- It should be a minimum of 2*.

Stockturn
- A measure of how fast a company sells its goods.
- The higher the figure, the leaner the company.

Investment Ratios.

Profit Margin
= operating profit x 100 / turnover

Return on Capital Employed
= operating profit x 100 / total capital employed

Sales as a Multiple of Capital Employed
= sales or turnover / capital employed

Stockturn
= sales or turnover / year-end stocks

Debt Collection
= trade debtors / sales x 365

Payment of Trade Creditors
= trade creditors / sales x 365

Cash-to-Cash Cycle
= stock days + debtor days - creditor days

Gearing Percentage
= total liabilities x 100 / shareholders' funds

Interest Cover
= net profit / interest paid

Current Ratio
= current assets / current liabilities

Quick Ratio
= current assets - stocks / current liabilities

Earnings Per Share (EPS)
= earnings / number of shares in issue

Price/Earnings Ratio (PE)
= current market price of share / EPS

Price to Earnings Growth Factor (PEG)
= prospective PE / estimated future growth in EPS

Dividend Per Share
= dividend paid / number of ordinary shares in issue

Dividend Yield
= dividend per share x 100 / share price

Dividend Cover
= earnings per share / dividend per share

Net Asset Value (NAV)
= current assets - current liabilities

Net Asset Value per Share
= net asset value / number of shares in issue

Price to Sales Ratio
= share price / sales per share or market cap / total sales

Price to R & D Ratio
= market capitalisation / R&D expenditure

Price to Book Value
= share price / asset value or market cap / total net assets

Debt/Equity
= net borrowings x100 / shareholders funds

EPS Growth
= (Prospective EPS – Historical EPS) * 100 / Historical EPS

Free Cash Flow
= operating profit + depreciation +/- change in working capital – cash interest payments – cash taxes – maintenance expenditure

Free Cash Flow Yield
= free cash flow / share price

Company Financial Analysis.

Accounts Receivable
If Inventories are also increasing, Caution!
Rising Accts. Rec. means customers are not paying their bills, which may mean they are not satisfied with the product.

Inventories
Compare with other companies in the industry
If Inventories are rising faster than sales, competition or pricing are likely the problem.

Sales or Revenues
Sales to Accts Receivable Ratio: Accts Receivables should not be growing faster than Sales.
Sales to Inventories Ratio: Sales should be growing faster than inventories.

Plant & Equipment
Sales should be increasing as fast or faster.

Long-term Debt
A small change is not considered a serious negative.

Total Interest Coverage
[Pre-tax Profit + Total Interest Paid / Total Interest Paid]
Any number below 5 is worrisome. A number below 3 is very worrisome.

Number of shares outstanding trend
[Curr. Yr. Shares/Prior Yr. Shares]
A small change of up to about 2% is not considered too consequential.

Cost of Sales
[Cost of sales this year/Cost of sales prior year as a % change]
A small change is not considered too serious.

Cash Flow Growth
[Curr. Yr. Cash from Operations/Prior Yr. Cash from Operations]
Cashflow should increase at the same rate as Sales - or greater.

Free Cash Flow Margin
[Free Cash Flow / Sales]
Anything over 10 is great - substantially over 10 is excellent.

Return on Free Cash Flow - compare to Yield on 10 yr. Bond
The return is less than the bond rate. Is company spending cash wisely?

Earnings Confidence Rating -- Measures quality of Earnings
[Net Income/Net Cash from Operations]
Generally the closer this is to 1, the higher the quality of Earnings.

Cash Position per Share
[Net Cash / Shares outstanding]
Offers price support in falling market if positive.

Long-Term Debt to Equity Ratio
[Long-term Debt / Total Equity]
Normal Long-term Debt -- less than 25% debt.
Ratios are more meaningful if compared to other companies in the same industry.

Quick Ratio
[Cash+Marketable Securities+Accts Rec. / Total Liabilities]
About 1:1 is normal. The higher the better.
This is a relatively severe test of a company's liquidity and its ability to meet short-term obligations.

Working Capital Ratio
[Total Current Assets / Total Current Liabilities]
About 2:1 is normal for manufacturer. 1:1 normal for Utilities.

Inventory Turnover Ratio
[Cost of Sales / Inventory]
Also, note the number of days that Inventories are held before they become a product and sold.
The higher the ratio the better. Indicates quality merchandise & proper pricing.

Plant Turnover Ratio
(Sales / Prop. Plant & Equip.)
The higher the ratio the better. If plant or equipment is added, sales should increase.
Be aware it takes time for a new plant to come on line and benefit sales. Check to see what the funds for PP&E were spent on.

Price to Sales Ratio
[Today's Price / Revenues per Share]
The lower the amount the better. This is the amount invested for each pound of sales. This ratio is industry sensitive.
The ratio will be higher for companies with high profit margins and growth. Compare to same industry companies.

NOTE: If there are large changes in year-to-year results, check to see if acquisitions have skewed the results of the analysis.

Business Evaluation Ratios.

Glossary

- Current Assets = Cash + Accounts Receivable (Debtors) + Inventory (Stock)
- Current Liabilities = Money owed to Creditors, due within 1 year
- Working Capital = Current Assets – Current Liabilities
- Net Worth = Shareholders' Equity = Balance Sheet difference between Assets and Liabilities
- Total Assets = Current Assets + Fixed (Long-term) Assets
- Accounts Receivable = Money owed to the company by Debtors

Liquidity Ratios (firm's ability to pay its debts)

Current Ratio = Current Assets (Cash + Debtors + Stock) / Current Liabilities.
Best is 2:1. Low ratio suggests inability to pay bills on time. High suggests too much liquidity is tied up.

Quick Ratio (Acid Test) = Cash + Debtors / Current Liabilities.
Some analysts reduce Debtors by 25% for bad debt provision. Best is 1:1.
Good Current Ratio/poor Quick Ratio suggests slow-moving Inventory.

Working Capital Ratio (Turnover of Cash) = Net Sales / Working Capital.
Best is 5 to 6*. Low ratio means too much cash; high means may have difficulty in paying some creditors.

Debt to Equity Ratio = Total Debt (i.e. Total Liabilities) / Equity (i.e. Net Worth or Shareholders' Equity or Total Assets less Total Liabilities).
Current Liabilities / Equity should not exceed 80%.
Long-term Debt / Equity should not exceed 50%.
Companies with no debt can be too conservative, missing the potential profit that gearing brings - i.e. borrowing cheaply and earning a higher rate of return on sales. Gearing works against the company in a sales slump.

Profitability Ratios (measure returns on sales, assets, and investment)

Rate of Return on Sales Ratio = Operating Income (i.e. Net Profit) / Net Sales.
The higher, the better. Industries differ on acceptable levels e.g. supermarkets low.

Rate of Return on Assets (ROA) Ratio = Income before Taxes / Total Assets.
Variations are Return on Current Assets and Return on Fixed Assets.
Look out for the distorting effect of a large amount of intangible assets.

Rate of Return on Investment (ROI) or Return on Equity (ROE) Ratio = Income before Taxes / Shareholders' Equity (i.e. Net Worth). Variation is EBIT / Shareholders' Equity.
Look for 15%+ which allows company to fund growth through its operating income.
A high ratio could mean that a company is under-capitalised with minimal long-term debt.

Efficiency Ratios

Average Debt Collection Period Ratio = Accnts. Rec. (Debtors) * Days / Net Sales.
This is the average number of days to collect cash from credit sales.
Best if within 10 to 15 days of normal collection period, which is 30 days.
A high figure may be due to bad accounts or using credit to generate sales.
Excessive debtors lowers ROCE and may cause liquidity problems.

Average Creditors' Payment Period = Creditors / Purchases (Cost of Sales) * 365.
Delaying payment can be an indication of cash problems.

Inventory Turnover Ratio = Cost of Goods Sold / Average Inventory.
Av. Inventory is beginning stock + ending stock / 2.
This figure measures how many times a company's stock is replaced in one year.
The rule of thumb is 6 to 7*. A good figure increases cash flow and reduces costs.
A low figure could be the result of obsolete items or over-stocking. A high figure suggests fast-moving stock or perhaps lack of stock. A small business should not carry more than 100% of its working capital figure in inventory.

Fixed Asset Turnover Ratio (Net Sales to fixed Assets Ratio) = Net Sales / Fixed Assets.
This measures the effectiveness in generating sales from fixed assets.
Best between 3 and 5*. A low figure suggests too many assets chasing too few sales.
A high figure indicates greater profitability. The figure can be distorted if assets are heavily depreciated. Comparisons with firms and industry need to be based on similar asset figures.

Interest Cover = Profit before Tax and Interest / Interest Paid.
Should be at least 5*.

Basic Market Ratios

Earnings per Share (EPS) = Net Earnings (i.e. Net Income) /Average shares outstanding.
A decline raises questions about future growth and profitability.

Price to Earnings Ratio = Market Price / EPS.

Dividend Yield =Dividends per share / Market Price.
A reduced payout generally leads to a decline in Market Price.

Dividend Cover = Shareholders' Profit / Dividend.

How to Research Shares - MSN Money.

When considering the purchase of shares in a company, investors should find answers to five key questions:

- **Fundamentals** What is the company's business, is it financially sound and is it growing?
- **Price History** How much have investors been willing to pay for the shares in the past?
- **Price Target** How much are investors likely to pay for the shares in the future?
- **Catalysts** What catalysts will change investors' perceptions of the shares in the future?
- **Comparison** How do the shares compare to others in the same industry?

Fundamentals

How much does the company sell and earn?
Investors need to know the quantity of goods or services a company sells, and how much of that total it keeps as income (or profit) to grow its business or return to shareholders. The more of each, the better. In general, look for companies that sell and earn more than their peers.

- Last Year Sales:
- 1-year income:

How fast is the company growing?

- 1-year sales growth:
- 1-year income growth:

How profitable is the company?
Investors prefer companies that increase profit margins - the percentage of sales that they keep - every year. This is accomplished either by lowering expenses or raising prices. Look for companies that consistently find ways to squeeze more profits out of sales than their peers.

- 1-year net profit margin:
- Difference from the company's 5-year average net profit margin:

How is the company's financial health?
The debt/equity ratio shows how much a firm has borrowed long-term as a percentage of its stock equity. The lower, the better.

- Debt/Equity Ratio:
- Difference from the average for the Industry group:

Price History

How has the stock performed?
Investors need to know how a stock has performed relative to all other stocks. Generally, they attempt to hold the market's top-performing securities -- those that have done better over the past year than the majority of stocks in their industrial group and all stocks in our database. Look for a positive trend in the 12-month, 3-month, and 1-month periods.

- Price Change in past 1 month:
- Difference from the average for the Industry group:
- Percentage of all stocks that company has outperformed:
- Price Change in past 3 months:
- Difference from the average for the Industry group:
- Percentage of all stocks that company has outperformed:
- Price Change in past 12 months:
- Percentage of all stocks that company has outperformed:

Price Target

What is the best guess for the share price in 1-2 years?
Investors fix targets for most stocks by estimating future earnings per share and then applying a price-to-earnings "multiple", also known as the P/E ratio. Companies with the most consistent earnings history or strongest growth prospects receive the highest P/E multiples. We calculate price targets for the current and next fiscal year by applying the stock's current multiple to the average professional analyst's estimate.

Valuation using company’s current multiple (P/E):

Fiscal Year	*Est Low/High Price Range*	*Avg. Est. Price*	*% Change for Average*
2005			
2006			

- Current Price:
- Current multiple (P/E):

- Average 2005 estimate:
- Low 2005 estimate:
- High 2005 estimate:
- Average 2006 estimate:
- Low 2006 estimate:
- High 2006 estimate:

What is the best guess for the stock if it were valued like its peers?
Investors often come to believe that a stock is undervalued or overvalued compared to other stocks in its industrial group. To calculate an alternate target price for the current and next fiscal year based on those beliefs, investors can apply the average P/E multiple for a company's industrial group to the average professional analyst's earnings estimate for the company in those periods.

Valuation using the industry's current multiple (P/E):

Fiscal Year	Est. Price	% Change
2005		
2006		

- Current price:
- Industry group current multiple (P/E):

- Average 2005 analyst estimate:
- Average 2006 analyst estimate:

Investors estimate the level of unanimity about a stock's prospects among analysts by calculating the range between the most optimistic and most pessimistic estimates.

- Average number of analysts covering company:
- Company analysts' high/low spread:
- Company analysts' confidence:

Catalysts

What will change an investor's opinion of the stock?
Stock prices change when investors alter their opinion about a company's prospects. Catalysts for new ideas can come from:

- Company announcements and news:

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Comparison

How does the stock stack up?
Investors want to know how a company matches up in key categories against others in its industry. Select up to two peers to compare. Best figure for each criteria is highlighted.

Name: Industry:

Estimated share price future
Current
FY End
% Change
Next Fiscal Yr
% Change

Sales and income (past 12 months)
Total Sales
Total Income

Sales and income growth (past 12 months)
Sales Growth
Income Growth

Share price relative to earnings
Price/Earnings Ratio

Financial health
Net Profit Margin
Debt/Equity Ratio

Company Price Performance
1-Mo Price Change
3-Mo Price Change
12-Mo Price Change

Industry Price Performance
1-Mo Price Change
3-Mo Price Change
12-Mo Price Change

Company relative to all stocks
1-Mo Relative Strength
3-Mo Relative Strength
12-Mo Relative Strength

Company Evaluation Sheet.

Company: **Epic:**

Index:

Business Summary

- Describe the company's business. What does the company do to make money?
- Does it focus on one product or does it diversify into several industries?
- Is it regional, national, or global in scope?
- Is there a seasonal sales pattern?

Business Outlook

- Describe positive and negative influences on the company's business, such as acquisitions, divestitures, cost control, cost increases, management changes, successful or dismal product strategies, the economy, currency exchange rates, and competition.
- Is the company's sales growth sustainable?

Business Strategy

- Determine how the business grows: from acquisitions, increased market share, higher volume, higher profit margins, building stores, developing new products, or other approaches.
- SWOT analysis provides a framework for analyzing a company's current situation. SWOT analysis begins with an inward look at the company's strengths and weaknesses, such as its product lines, management, human resources, or infrastructure. An outward look considers the opportunities and the threats present in the environment in which the company operates. For example, demographics might change consumer demand for the company's products and services. Competitors or technological changes can affect products and prices.

Analysis of Accounts

Cost Control:

Comparison to Sales

- Turnover less Cost of Sales = Gross Profit
- Gross Profit less Overheads = Net Profit
- Percentage Cost of Sales = Cost of Sales / Turnover
- Are Cost of Sales growing or contracting as a % of sales?

Exceptional Items

- How exceptional are the exceptional items?

Depreciation

- Has it recently changed its policy on depreciation and why?

Working Capital Ratios

- Current Ratio = Current Assets / Current Liabilities
- Acid Test = [Current Assets – Stock] / Current Liabilities
- The Current Ratio should normally be 2:1.
- The Acid Test measures solvency more than liquidity. It should be 1:1.

Profitability:

Profit Margins

- Gross Margin = Gross Profit / Sales
- Net Margin = Net Profit / Sales
- How do Margins compare with previous years and with equivalent companies?

ROCE

- Return On Capital Employed = Profit before interest and tax * 100 / Net Capital employed
- What is its return on Capital Employed? Any reasonable company should at least produce 10%.

EBITDA

- EBITDA = Pre-tax profit + interest + depreciation
- A positive EBITDA may disguise a lack of profit.

Cash:

- Does the company reinvest?
- Creditor period = [trade creditors * 365] / Cost of sales
- Debtor period = [Trade debtors * 365] / Sales
- Is the number of debtor days increasing or decreasing?

Asset Backing:

- Asset-backed companies survive hard times better.
- Market value = Issued shares * Share price
- Enterprise value = Market value + Total debt – Total cash
- Price to Book value + Share price / Shareholders' Funds per share
- Are fixed assets being replaced?
- When was property last valued?
- Net assets = Fixed assets + Current assets – Liabilities
- Premium or Discount = [Market capitalisation – Net assets] / Net assets
- How much cash does the company have?
- How liquid are the current assets?
- What provision has been made for bad debts?
- Stock turn = Sales / Stock
- Stock days = 365 / Stock turn
- Burn rate = Cash / Monthly operating expenses

Debt:

- How much debt does the company have?
- How secure is the debt funding?
- How much is the company paying in interest on the debt?
- When is its debt repayable?
- What is the company's credit rating?
- Interest cover = [Pre-tax profit + Net interest paid] / Net interest paid
- Interest cover should be above 5.
- Gearing = [Total borrowings – Cash] / Shareholders' funds

Hidden Nasties:

- Liabilities ratio = Liabilities / Costs and expenses A figure of around 0.2 is fairly healthy but should not go much higher.
- Does it have large contingent liabilities relative to profits?
- Does it have a significant pension fund deficit?

Management:

- Has management a coherent strategy?
- How does director pay compare with the company's performance?
- How many shares does each member of the Board have?
- Have they recently bought or sold shares?

Dividends:

- What is the stated dividend policy?
- What is the historical level of dividend?
- Dividend cover = EPS / Dividend per share Cover of 3 or 4 is healthy.
- EPS = Net profit / Issued shares
- Diluted EPS = Net profit / (Issued shares + options and convertible shares)
- P/E = Share price / EPS
- Dividend Yield = Dividend per share / Share price
- Total return = Dividend yield + Capital growth
- PEG = P/E ratio / Earnings growth

Threats:

- What are the different equity and debt instruments?
- Who are the significant shareholders?
- Is there a threat of significant dilution?
- Are there any external threats?

Accounting:

- Is there massaging of the figures through anticipating profits, capitalising expenditure, off-balance sheet financing?

Good Health Signs:

- Share price is less than two-thirds of net assets divided by number of shares.
- Owes less than half its worth.
- The number 100 divided by the P/E ratio is at least 3 points higher than the current bank base rate.
- Current asset ratio of at least 2.0.
- Total return over the last 5 years of at least 5 percent above inflation.
- Steady increase in EPS above market average.
- Dividend cover of at least 3.0.

Cash Flow:

- Does the net income on the income statement closely equal the cash from operating activities? If it does, the company's earnings are primarily from operations, and the business can support itself.
- Are net income and cash from operations growing at about the same rate? When cash from operations grows slower than net income growth, cash flow problems may arise.
- Are accounts receivable increasing faster than sales?
  This indicates that a company cannot collect what it is owed, which hurts cash flow, but also may indicate problems with product quality or obsolescence.
- Are inventories growing faster than sales or cost of goods sold?
  Buying supplies and producing inventory require cash, so increasing inventory decreases cash flow and may indicate problems with products.
- Did cash increase or decrease?
  Decreasing cash might lead to additional financing activities, which eventually negatively affects the value of stock shares.
- Is cash flow from operations negative over time?
  Negative cash flow may indicate a rapidly growing company - without financing, the company can grow only as fast as it can generate cash from operations. However, it is a bad sign when a company is not growing quickly but still cannot generate cash.
- Is the company increasing cash by selling assets?
  This can be a double problem. First, selling assets to raise cash might mean a company cannot borrow money anymore, which means banks do not like what they see. Second, assets often produce growth, so selling assets means the company will be less able to generate cash in the future.

Comparing Year-to-Year Results:

Percentage change = ((Ending Value / Initial Value) - 1) * 100

Assets
If a company's current assets are growing, it may mean that the company is accumulating cash, a positive sign. On the other hand, if the receivables component of current assets is increasing, the company may be having trouble collecting on customer invoices, which would not be good. Look at the changes in cash, receivables, and inventory to find an explanation for the changes.

Cash
Is the value of cash and cash equivalents (such as securities that can be readily sold) declining? If so, what are the reasons for the drop? Has the company been using its cash recently to expand operations? Or have profit margins or revenues been falling, which requires the company to use more of its cash position to fund operations?

Inventory
Are inventories growing, shrinking, or stable? Too much inventory might mean that the company's resources are tied up in warehouses and not being sold to customers. The company might be ramping up for a future expansion, or it might have a dud product that consumers do not want.

Accounts Payable
If this liability is growing, is it because the company cannot pay its bills on time or because they are rapidly growing their business? When a company grows, it buys more supplies, which leads to an increase in accounts payable. If accounts payable have increased without a corresponding increase in sales, check turnover ratios and cash flow for signs of a cash crisis. Maybe the company has negotiated better terms with its suppliers. If accounts payable have declined, have sales also been falling?

Debt
Is the company paying down its long-term or short-term debt? On the other hand, have they borrowed more money from the bank, increasing their level of debt? If they have been borrowing money, find out if it has been to fund expansion or to simply pay their current bills.

Interest Expense
If interest expense is growing faster than sales and profits, determine the cause. If a company is borrowing additional money to finance operations or an expansion, then their interest expense might rise. However, if the increase is due to higher interest rates on its debt, particularly in businesses that require a lot of capital to build plants or other high-cost items, interest expense increases could lead to decreased net profits in the future.

Revenues
A company must grow revenues over the long term in order to grow its profits. A company can increase its profit margins only so far by increasing productivity, lowering costs, or raising prices. Falling revenues can be a sign of trouble. However, small companies often grow faster than large companies do, so revenue growth typically slows as small companies mature.

Pre-Tax Income
Changes in pre-tax profits can often be a warning sign of trouble. If pre-tax income has fallen, is it because of slowing revenue growth, increased expenses, or external factors such as an unfavourable economic climate

Earnings Per Share (EPS)
EPS is probably the most closely tracked figure when investors research public companies. As a result, it is usually quite easy to find a company's explanation for its falling earnings or slowing growth. It is up to you, however, to determine whether the factors that contributed to the decline will continue to affect the company's future.

Capital Expenditures
A decline in capital expenditures might mean that the company is stretching the usable life of its capital assets or is not currently funding expansion. However, reduction in this measure might indicate cash flow problems.

Growth rates:

Evaluate historical growth for consistency and compare to the growth of direct competitors. Research unusual growth events, such as losses, major dips, or changing trends.

Ratios:

Evaluate financial measures and ratios for the company, and compare measures to the industry average and to competitors. Research above or below average performance, or positive or negative trends in the values.

- PE Ratio = Current Share Price / Current Annual EPS
- Dividend Yield = (Annual Dividend Paid / Market Value per share) * 100
- Payout Ratio = (Annual Dividend / Annual EPS) x 100
- Relative Value = (Current PE Ratio / Average PE Ratio) * 100
- PEG Ratio = (PE Ratio) / EPS Growth Rate
- Price/Book Ratio = Current Price / Book Value per Share
- Price/Sales Ratio = Current Price / Sales per Share
- Price/Cash Flow Ratio = Price per Share / Cash Flow per Share
- Current Ratio = Current Assets / Current Liabilities
- Quick Ratio = (Current Assets - Inventory) / Current Liabilities
- Debt-to-Equity Ratio = Total Debt / Shareholder's Equity
- Long-Term Debt-to-Equity Ratio = Long-Term Debt / Shareholder's Equity
- Interest Coverage = (Earnings Before Interest and Taxes) / Interest Expense

- Return on Equity = (Annual Net Income / Average Shareholders' Equity) * 100
- Return on Assets = (Annual Net Income / Total Assets) * 100
- Asset Turnover Ratio = Total Revenue for Period / Average Assets for Period
- Inventory Turnover Ratio = Total Revenue / Average Inventory
- Receivables Turnover Ratio = Total Revenue / Average Receivables
- Gross Profit = Total Revenue - Cost of Goods Sold (COGS)
- Gross Margin = (Gross Profit / Total Revenue) * 100
- Operating Profit Margin = (Operating Profit / Total Revenue) * 100
- Pre-Tax Profit Margin = (Net Income Before Tax / Total Revenue) * 100
- Net Profit Margin = (Net Income After Taxes / Total Revenue) * 100

Valuation:

If a company's growth rates and financial ratios look good, you can take the next step of evaluating its historical PE ratios, PEG ratio, relative value, and other valuation measures to see if purchasing at the current stock price provides you with sufficient return on your investment.

Evaluation Summary:

- Does the company grow quickly and consistently enough to warrant consideration?
- Do its business strategy and current environment bode well for continued or better performance in the future?
- Do the company financial measures look good compared to its industry and competitors and are the ratio trends desirable?
- Is the company at a price that provides enough total return to meet your investment objectives?

SharelockHolmes Search and Results Analysis and Ratios.

Results

Acquisitions

- Acquisitions and Disposals. Is negative for Acquisitions and Positive for Disposals.
- Is the company regularly acquisitive? Does the EPS growth come from Acquisitions?
- Is the company disposing of its assets to turn into a cash shell or return cash to shareholders or are sudden disposals a sign of financial stress?

Adjusted EPS

- Earnings per Share calculated by dividing Net Profit minus Exceptionals and Goodwill by the Number of Shares. This is also known as Normalised EPS. Because it takes into account Exceptional Items, it should be a truer reflection of business performance than the Basic EPS. However in some companies Exceptional Items recur remarkably often.
- The closer the Basic EPS is to the Adjusted EPS the better the Earnings Quality.
- Adjusted EPS is used in the calculation of PER, PEG and EPS Growth.

Basic EPS

- Earnings per Share calculated by dividing the Net Profit by the Number of Shares. This is the strict EPS also known as FRS3 EPS. Because it does not take into account Exceptional items it tends to jump around from year to year far more than Adjusted EPS.
- The closer the Basic EPS is to the Adjusted EPS the better the Earnings Quality.

Capex

- Capital Expenditure. Purchases and sales of assets. Subtracted from Net Cash Flow to give free Cash Flow used to calculate PFCF.
- Compare Capex with Depreciation to see if assets are being replaced. The Capex figure tends to be quite volatile from year to year.

Cash

- Cash and Short Term Investments. The most easily valued asset.

Creditors < One Year

- Creditors requiring payment in less than one year. Also known as Current Liabilities or Creditors Short. This will include Bank Overdrafts, Debt due for payment, Hire Purchase, Trade Creditors, Dividend Payments and Accruals.
- Are the creditors rapidly increasing together with stocks and debtors? This may be a sign of overtrading.

Creditors > One Year

- Creditors requiring payment in more than one year. Also known as Non Current Liabilities or Creditors Long. This is usually mostly Long Term Debt.

Current Assets

- The Working Capital of the Company. Stocks, Debtors and Cash.

Depreciation

- Reduction in value of assets over time. Also includes amortisation of intangible assets excluding goodwill.
- Compare with the capital expenditure to see if assets are being replaced.

Debtors

- Trade Debtors. Amounts owing to the company also known as Accounts Receivable.
- May be less than stated due to bad debts. Watch out for debtors increasing in comparison with trade creditors as it can indicate poor cash flow management.

Dividend

- Result. The Interim Dividend per Share is shown for an Interim Result.

Equity Funds

- Book Value (PBV), when added to Preferred Funds gives Shareholders' Funds.

Exceptionals and Goodwill

- Exceptional items are charges or credits that are expected to be non-repeatable for example sales of assets or restructuring charges. Goodwill Amortisation is the writing off over time of the excess value of an acquisition above its Asset Value. Exceptionals and Goodwill are excluded when calculating the Adjusted EPS.
- If Exceptionals are consistently at a very high level compared to profits then it is wise to treat the Adjusted EPS figure with caution and to look at the Basic EPS figure.

Finance Servicing

- Interest Payments plus non-equity and minority dividend payments.

Fixed Assets

- Intangible Assets, Tangible Assets and Fixed Asset Investments.

Intangible Assets

- Assets that do not have visible form such as Goodwill, Patents, Copyright or Mining Rights. Industries such as Media or Software companies often have valuable Intangible Assets.
- Care should be taken when valuing goodwill from acquisitions as often companies overpay and the goodwill subsequently becomes worthless. This is why many Value Investors will only consider Tangible Assets.

Interest

- Group Net Interest payments or receipts. Excludes Interest payments by subsidiaries. Used to calculate Interest Cover.

Investments

- Fixed Asset Investments. Non-current Investments such as Joint Ventures or Investments in own Shares.

Minorities

- A Minority interest. This is when a parent company has one or more controlled subsidiaries that are not wholly owned. This is included when Gearing is calculated but not included in Price to Book Value.

NAV

- Net Asset Value. The Value of Total Assets of a company minus total liabilities. Will equal Shareholders' Funds.

NTAV

- Net Tangible Asset Value. The Value of Total Tangible Assets of a company minus total liabilities. Will equal Shareholders' Funds minus Intangible Assets.

Net Cash Flow

- Net Cash Inflow (or Outflow) from Operating Activities minus Finance Servicing and Taxes. The Cash flow available for Capital Expenditure, Dividends, buy backs or paying off debt.
- Good positive cash flow is usually a very good sign for an investment.
- Used to calculate PCF.

Net Current Assets

- Current Assets minus Current Liabilities. Shows the capital base of a company.
- Any company valued less than Net Current Assets is extremely cheap.

Net Debt

- Interest bearing liabilities minus Cash and Short Term Investments. Is negative for Net Debt and Positive for Net Cash. Used to calculate Gearing.
- A high Net Debt compared to Assets or Market Cap is a dangerous sign except in stable industries such as Utilities or Tobacco. such as Utilities or Tobacco.

Net Profit

- Profit for the year after Exceptionals, Goodwill, Interest, Tax, Minority payments, and Preference dividends but before ordinary dividends.
- Used to calculate the Basic EPS.

Operating Cash Flow

- Net Cash Inflow (or Outflow) from Operating Activities. This will be the Operating Profit plus Depreciation, Amortisation, Changes in Working Capital, Sales or Purchases of Assets and Write down of Assets. It shows the cash coming into a business before Interest payments, Taxes, Capital Expenditure of Dividends.
- Used to calculate the Operating Cash flow Yield.

Operating Profit

- Group Operating Profit. The profit a company makes after deducting sales and administrative expenses but before interest payments, taxes, exceptional items, and goodwill amortisation. Does not include profits from subsidiaries.
- Is used to calculate interest cover.

Other Current

- Other Current Assets. Can include Current Assets Investments, Pensions Credits, or Deferred Tax amongst other items.

Preferred Funds

- The Value of Preference Shares, also known as Non-Equity Shareholders' funds or Prefs. When added to Equity Shareholders' Funds gives Shareholders' Funds.

Profit and Loss

- Profit and Loss Account. The retained earnings of a company out of which dividends are paid. An amount retained to provide for a liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which it will arise.

Profit Before Tax

- Profit before tax, but after interest payments, exceptionals, and goodwill amortisation.

Stocks

- Stock ready for sale or work in progress. Also known as Inventory. Care should be taken in valuation, as for instance last year's fashion items may be almost worthless.
- A sudden increase in stocks can be a sign that a product is not selling.

Tangible Assets

- Assets with a visible form such as Plant, Machinery and Property. Their true value can vary widely from that quoted.

Taxation

- Taxation charge or refund in the profit and loss statement or in the cash flow statement.

Turnover

- Group Turnover. Also described as Sales. Does not include Turnover of subsidiaries or Sales Taxes.
- Is used to calculate PSR and EV/Sales.

Search

Cash Flow / EPS Ratio

- Net Cash Flow / Net Profit
- Ratio of Net Cash Flow to Net Profit.
- It is a good sign if the ratio of Net Cash Flow to Earnings is consistently above 1.

Cash Flow Growth Historic: Cash Flow Growth 3 Yr

- (Net Cash Flow - Previous Net Cash Flow) x100 / Previous Net Cash Flow
- Growth in Net Cash Flow.
- A good investment normally has good cash flow, though it can be a volatile measure.

Current Ratio

- Current Assets / Creditors Short
- Ratio of Current Assets to Current Liabilities. Current Assets are as Cash + Debtors + Stock + Other Current Assets.
- A ratio of two or more is a sign of financial strength. A ratio < 1.2 can be a sign of weakness.

Div Cover: Div Cover Historic: Div Cover Projected: Div Cover Rolling: Div Cover Projected 2: Div Cover Rolling 2

- Adjusted EPS / Dividend per Share
- Ratio of Adjusted EPS to Dividend per Share.
- Shows how sustainable a Dividend is. Dividend Cover < 1.5 may indicate a danger of a cut unless in very stable industry such as a Utility. Above 2 is regarded as healthy.

Div Growth Projected: Div Growth Historic: Div Growth 3 Yr

- Div per Share - Previous Div per Share x 100/ Previous Div per Share
- Dividend Growth as a Percentage.
- A steady dividend growth shows the Directors' confidence in the state of the business.

Earnings Quality

- Basic EPS / Adjusted EPS
- The ratio of Basic EPS to Adjusted EPS.
- This shows how much of the EPS has been adjusted for Exceptional and Goodwill. Ideally, should be 1.

EV /Sales

- (Market Cap + Net Debt + Preferred + Minorities) / Turnover
- Enterprise Value (EV) to Sales ratio. EV is Market Capitalisation + Net Debt.
- EV/Sales is similar to PSR but takes account of the fact that to buy a company you would also have to take on its debt.

EV/EBITDA

- (Market Cap + Net Debt + Preferred + Minorities) / Profit before Tax - Interest - Exceptionals + Depreciation
- Enterprise Value (EV) to Earnings before Interest, Taxes, Depreciation and Amortisation (and Exceptionals). EV is Market Capitalisation + Net Debt.
- Often used to value loss-making companies. Became a popular measure in the Tech boom.

Final Ex Div Date

- The last date shareholder is eligible to receive the Final Dividend.

FTSE Index

- The FTSE index of the Share. Either FTSE100, FTSE250, AIM or nothing

Gearing

- Net Debt/ (Equity Funds + Preferred Funds)
- Net Debt as a Percentage of Net Assets (or Shareholders' Funds).
- A gearing of over 100% is regarded as high. If Gearing is negative, it denotes Net Cash. If AR is shown next to Gearing, it means it is calculated from the last final result as no interim net debt can be obtained. If the Gearing shows " " and the company is not a financial then the net debt could not be obtained.
- An approximate value can be derived from Cash + Debtors – Short Creditors - Long Creditors.

Gearing Tangible

- Net Debt/ (Equity Funds- Intangible Assets + Preferred Funds)
- Net Debt as a Percentage of Tangible Net Assets.
- A gearing of over 100% is regarded as high. If Tangible Gearing is negative, it denotes Net Cash. Preferred measure of Gearing by many Value Investors as it strips out potentially worthless Intangible Assets such as Goodwill from Acquisitions.

EPS Growth: EPS Growth Projected: EPS Growth Projected 2: EPS Growth Historic: EPS Growth Rolling: EPS Growth Rolling 2: EPS Growth 3 Yr

- ((Adjusted EPS - Prev EPS) / Prev EPS)*100
- EPS Growth as a Percentage. EPS Growth shows the Rolling EPS Growth. Calculate in a similar way to PER Rolling.

Forecast Change Week: Forecast Change Month: Forecast Change 3 Month: Forecast 2 Change Week: Forecast 2 Change Month: Forecast 2 Change 3 Month

- EPS Forecast - Previous EPS Forecast x 100 / Previous EPS Forecast
- Percentage change in the EPS Forecast over 1 wk, 1 mth, and 3 mths.

Graham Ratio

- Market Capitalisation / (Net Current Assets Creditors Long - Provisions)
- A Ratio used by Ben Graham the famous Value Investor. It is defined as the ratio of Net Current Assets minus non-current liabilities to the Market Capitalisation. Graham was looking for companies with a ratio of less than two thirds. Very few shares meet his criteria these days.

Interest Cover

- Operating Profit / Interest
- Ratio of Group Operating Profit to Interest Payments. Shows how easily a company can support its interest payments.
- An interest cover of over four would usually be regarded a reasonably safe. Note that Interest is defined as Group Interest and does not include subsidiary payments. Operating Profit will exclude Goodwill Amortisation and Exceptional Items.

Interim Ex Div Date

- The last date that a shareholder is eligible to receive the Interim Dividend.

Last Price Change

- (Last Price - Previous Price) x 100 / Previous Price
- The percentage price change over the previous closing price.

NAV Growth Historic: NAV Growth 3 Yr

- (NAV - Previous NAV) x100 / Previous NAV
- Growth in Net Asset Value. This is particularly useful for property companies, which are normally valued by their Net Assets.

NTAV Growth Historic: NTAV Growth 3 Yr

- (NTAV - Previous NTAV) x100 / Previous NTAV
- Growth in Net Tangible Asset Value i.e. Net Assets minus Intangible Assets. This is particularly useful for property companies, which are normally valued by their Net Assets.

Net Profit Margin

- (Operating Profit/Turnover) x 100
- Ratio of Net Profit to Turnover as a percentage. The Net Profit includes Exceptional Items and Goodwill Amortisation. Compare to Sector.

Operating Margin

- (Operating Profit/Turnover) x 100
- Ratio of Operating Profit to Turnover as a percentage. The Operating Profit excludes Exceptional Items and Goodwill Amortisation.
- Compare the Operating Margin to others in the Sector. A decreasing Operating Margin is a potential sign of problems.

Oper Cash Flow Yield

- Operating Cash Flow / EV
- EV =Turnover + Prefs + Minorities + Net debt
- Percentage of Operating Cash Flow to Enterprise Value (EV). This ratio is often used by Private Equity firms looking for companies with strong cash flow characteristics. A company with a Yield of over 20% may indicate a possible buyout.

PBV

- Market Cap / Equity Shareholder Funds
- Price to Book Value. Ratio of Market Capitalisation to Equity Shareholders' Funds. Used by Value Investors to compare the value of a company to its Assets.
- A PBV of less than 1 is usually cheap but the quality of the assets (especially Intangibles such as Goodwill) must be examined. Many Value investors prefer to use PTBV.

PBV Hist Avg_Ratio

- PBV / Historical Average PBV
- Ratio of the PBV to the historical average PBV of a company back to 03/2000

PBV Sector Ratio

- PBV / Sector PBV
- Ratio of the PBV to the PBV of the Sector a company is in.

PTBV

- Market Cap / (Equity Shareholder Funds - Intangible Assets)
- Price to Tangible Book Value. Ratio of Market Capitalisation to Tangible Equity Shareholders' Funds. Used by Value Investors to compare the value of a company to its Assets.
- A PTBV of less than 1 is usually cheap but examine the quality of the assets. Cash is the best asset but the value of stocks, property, and machinery can vary widely from their quoted value.

PCF

- Market Cap / Net Cash Flow
- Price to Cash Flow ratio. Ratio of Market Cap to Net Cash Flow.
- In healthy firms, the PCF should normally be lower than the PER. If PCF is consistently higher than PER or negative, the reasons should be examined closely.

PFCF

- Market Cap / (Net Cash Flow – Capital Expenditure)
- Price to Free Cash Flow ratio. Ratio of Market Cap to Net Cash Flow - Capital Expenditure.
- Positive Free Cash Flow is a good sign. Free Cash Flow can support dividends or share buy backs.

PER

- PER Rolling
- Price Earnings Ratio.
- A PER of over 20 is regarded as relatively expensive, and under 10 cheap.
- The PER is based on the Adjusted Diluted Rolling EPS, which strips out exceptional items, allows for Share Option Dilution and uses both the historic EPS and Forecast EPS. See PER-Rolling.

PER Projected: PER Historic: PER Projected 2

- Price per Share/Adjusted EPS (forecast or historic)
- PER Historic is based on the Adjusted Diluted EPS from the last Final Results. PER Projected is based to the next forecast EPS. PER Projected 2 is based to the 2 year forecast EPS.

PER Rolling

- Rolling PER Price/ (((12 - Mon)/12) x Hist EPS + ((Mon/12) x For EPS))
- Mon = Months since last Year End Date
  Hist EPS= Historical EPS
  For EPS = Forecast EPS
- Rolling Price Earnings Ratio. If both forecast and historic PE ratios are available then the rolling PER will be based on both, as a ratio of the time passed since the results year-end date. E.g. If the date is 30 April and year-end for a company was 31 December, the historical EPS is 4p, the forecast EPS is 6p and the price is 100p then:
  Rolling PER = 100 / (((12-4)/12) x 4 + ((4/12) x 6)) = 100/4.66 = 21.4p

PER Rolling 2

- Rolling PER Price / (((12 - Mon)/12) x ForEPS + ((Mon/12) x For2EPS))
- Mon = Months since last Year End Date
  For EPS = Forecast EPS
  For 2 EPS= Forecast 2 Year EPS
  Price = Share Price
- Rolling 2 Year Price Earnings Ratio. If both forecast and 2 year forecast ratios are available then the rolling 2 year PER will be based on both, as a ratio of the time passed since the results year end date. E.g. If the date is 30 April and year-end for a company was 31 December, the forecast EPS is 4p, the 2 year forecast EPS is 6p and the price is 100p then:
  Rolling PER=100 / (((12-4)/12) x 4+((4/12) x 6)=100/4.66=21.4p

PER Hist Avg Ratio

- PER / Historical Average PER
- Ratio of PER to historical average PER of a company back to 03/2000

PER Sector Ratio

- PER / Sector PER
- Ratio of the PER to the PER of the Sector a company is in.

PEG: PEG Historic: PEG Projected: PEG Rolling: PEG Projected 2: PEG Rolling 2

- Rolling PER/ Rolling EPS Growth
- Price Earnings Growth Ratio. Only calculated for Growth companies with a four year EPS growth record, including forecast growth if applicable.
- A PEG of less than one indicates a good growth stock candidate.

PEG All

- Rolling PER/ Rolling EPS Growth
- Price Earnings Growth Ratio. The same as PEG but does not require a four-year EPS growth record.

Piotroski Score

- A scoring system used for measuring the health of low Price to Book companies. It varies from 0 to 9, 9 being healthiest. Property companies and Financials are excluded.

Price High Yr

- The Highest Share Price attained in the last 52-week period.

Price Low Yr

- The Lowest Share Price attained in the last 52-week period.

Price NCA

- Market Cap / Net Current Assets
- Price to Net Current Assets ratio. Net Current assets are the Current Assets (Stocks, Debtors and Cash) minus the Current Liabilities (less than one year).
- A ratio of less than one is extremely cheap.

Price Net Debt

- Market Cap / Net Debt
- Price to Net Debt (or Cash) ratio. Is negative if the company has net debt and positive if it has net cash.
- A company priced less than net cash (i.e. >0 and <1) is extremely cheap although the cash flow should be examined to make sure there is not a high 'cash burn'. Financials may give misleading results as some of the cash may belong to customers.

PSR

- Market Cap / Turnover
- Price to Sales (Turnover) Ratio. A low PSR (< 0.5) is often used as an indicator of Value. It should be compared with the average for the sector as some sectors e.g. Distributors have naturally low PSRs.
- A low PSR and positive Relative Strength is one of the most successful investment strategies historically. See also EV / Sales.

Quick Ratio

- Cash + Debtors / Creditors Short
- Ratio of Quick Assets to Current Liabilities. Quick Assets are those that can be disposed of quickly and are defined as Cash + Debtors but excluding stock and work in progress.
- A healthy quick ratio = 1+.

ROCE

- (Profit Before Tax + Interest Paid) / (Tangible Assets + Minorities + Gross Debt) x 100
- Return On Capital Employed. Percentage of Profit Before Interest to Tangible Assets + Gross Debt. Show how profitable a company is at using its capital.
- Return on Capital should exceed the Cost of Capital.

ROE

- (Profit Before Tax / Shareholder Funds) x 100
- Return On Equity. The percentage Profitability of a company compared to its capital base.
- Some sectors naturally have a higher ROE than others due to their lower requirements for plant and machinery etc.

Perf Month: Perf 3 Month: Perf 6 Month

- Similar to Perf Year
- Actual future Performance of a share relative to the FTSE 100 over one month, 3 months and 6 months, relative to the back test date selected. This is only used for back testing purposes when the date is not set to "CURRENT" in the Share Selection Screen.

Perf Year

- APY=(((PY - P) / P)-((PFY - PF)/PF)) x 100 / (PFY / PF)
  APY = Relative Performance over 1 Year
  P = Price at selected date
  PY = Price one year in the future from selected date
  PF = Price of FTSE at selected date
  PFY = Price of FTSE one year in the future from selected date

RS Month: RS 3 Month: RS 6 Month: RS 9 Month

- Similar to RS Year
- Relative Strength of the share price compared to the FTSE 100 over one month, 3 months, 6 months, and 9 months.

RS Year: RS 2 Year: RS 3 Year

- RSY=(((P - PY) / PY)-((PF - PFY)/PFY)) x 100 / (PF / PFY)
  RSY Relative Strength over 1 Year; P =Current Price
  PY =Price one year ago; PF =Current Price of FTSE
  PFY =Price of FTSE one year ago
- Relative Strength of the share price compared to the FTSE 100 over one year, 2 years, and 3 years.

Sector

- The type of business of a company. The value shown is the main sector

Sub Sector

- The detailed type of business e.g. sector MINING; Sub Sector of Gold Mining.

Turnover Growth Historic: Turnover Growth 3 Yr

- (Turnover - Previous Turnover) x 100 / Previous Turnover
- Growth in Turnover (or Sales). Also known as top line growth. Helps to identify true growth companies, rather than growth in EPS from cost cutting or share buybacks.

Year End Date

- The date of the financial year-end.

Yield

- Yield-Rolling
- Dividend Yield as a Percentage. The Yield is based on Rolling Dividend Yield. See Yield Rolling.

Yield Historic: Yield Projected: Yield Projected 2

- (Dividend Per Share/Price Per Share) * 100
- Dividend Yield as a Percentage. Yield Historic is based on the Dividend from the last final results. Yield Projected is based to the next forecast Dividend.

Yield Rolling: Yield Rolling 2

- Rolling Yield = 100 * (((12 - Mon)/12) x Hist DPS + ((Mon/12) x For DPS)) / Price
  Mon = Months since last Year End Date
  Hist DPS = Historical Div per Share
  For DPS = Forecast Div per Share
  Price = Share Price
- Rolling Percentage Dividend Yield. If both forecast and historic dividend per share (DPS) are available then the rolling Yield will be based on both, as a ratio of the time passed since the results year-end date. E.g. If the date is 30 April and year-end for a company was 31 December, the historical DPS is 2p, the forecast DPS is 3p and the price is 150p then:
- Rolling Yield = 100*(((12-4)/12) x 2 + ((4/12) x 3)) / 150 = 1.55%

Z Score

- Z Score 1.2(WC/TA) + 1.4(RA/TA) + 3.3 (EBIT/TA) + 0.6(MC/TL) + 1.0(S/TA)
  TA = Total Assets
  TL = Total Liabilities
  WC = Working Capital
  RE = Retained Earnings (Profit and Loss)
  EBIT= Earnings before Interest and Tax
  S = Sales
  MC = Market Cap
- Z Score. A ratio devised by Robert Altman to describe the financial health of a company, and its likelihood of financial distress. A Z-Score of over 3 is very healthy but less than 1.8 could be a problem. It is worth looking at the Z Score over a number of years. If the Z Score is falling towards 1.8 then it is a good sell signal. Z-Score works best with manufacturing companies, but not at all with financials and property companies.

Understanding Accounts.

Source: The Investor's Guide to Understanding Accounts – Robert Leach.

1. Is The Company Growing?

Source of Sales:
- What does the company do?
- How does the company compare with peers in the same sector?
- Which parts of the company are growing and which are contracting?
- Is there a seasonal sales pattern?

Business Focus:
- Has the business stuck to its existing products and trading methods?
- Is the emphasis on organic growth or more risky acquisitive growth?
- What does management say about the future direction of the company?

Sales Outlook:
- Is the company's sales growth sustainable?
- Is it a growing company with a significantly higher Market Share than Stock Share – measured by Company Market Cap as a % of Sector Market Cap?

2. Are Costs Under Control?

Comparison to Sales
- Are Cost of sales growing or contracting as a % of Sales? Percentage Cost of sales = Cost of sales / Turnover.
- Are Distribution Costs and Administrative Expenses growing or contracting as a % of Sales?

Extraordinary and exceptional Items
- How extraordinary are the extraordinary items?
- How exceptional are the exceptional items?

Depreciation
- What is the company's depreciation policy and is it credible?
- Has it recently changed its policy? Has it lengthened its depreciation period to increase profits?

Working Capital
- Is the company solvent? Current ratio = Current Assets / Current Liabilities. Current ratio should be 1.
- Has it got sufficient liquidity? Acid test = [current Assets – Stock] / Current Liabilities.

Tax

- How much tax has the company paid? Multiply Net Profit before Tax by 30% to compare with the actual tax figure. If greater, it may be spending little on new fixed assets. Expanding and healthy companies usually have a tax charge below 30%.
- Is there a hidden asset in the form of deferred tax, where losses can be offset against future profits?

Research and Development

- In a good company, R&D expenditure can be regarded as a fixed asset.

3. Does It Make A Profit?

Profit Margins

- What are the Gross and Net Profit Margins? Turnover is Sales; minus Costs equals Gross Profit; minus expenses equals Net Profit. Gross Margin = Gross Profit / Sales. Net Margin = Net Profit / Sales.
- How do margins compare with previous years?
- How do they compare with equivalent companies?
- Are the Margins under pressure?

Gross Profit

- How is it achieving its increased/decreased profit – by selling more, price rises or cost cutting?
- What scope is there for increasing profit – expanding product range, increasing market share, buying up competition, selling more expensive product ranges, expanding abroad?

ROCE

- What is the Return on Capital Employed? ROCE = Profit before Interest and Tax * 100 / Net Capital Employed. (Profit before Interest and Tax = Net Profit before Tax + Interest Payable. Net Capital Employed NCE is the sum of all the Balance Sheet assets minus Current Liabilities). A high ROCE of at least 10% is good.
- Does the ROCE exceed the Cost of Capital? A high ROCE in itself does not mean a good investment as it may be over-priced.

EBITDA

- Is the company emphasising EBITDA rather than Profit? A company declaring a positive EBITDA (Pre-tax Profit + Interest + Depreciation) is likely making a loss.

4. How Much Cash Does It Have?

Cash Generation and Consumption

- Does the company generate or consume cash?
- Does the company reinvest? Look in the section in the Cash Flow Statement marked 'Capital Expenditure and Financial Investment' under the sub-heading 'Purchases less disposal of Fixed Assets'.

Paying Suppliers

- How long does the company take to pay creditors? Creditor Period = [Trade Creditors * 365] / Cost of Sales.

Getting Paid by Customers

- How long does the company take to get paid by its customers? Debtor Period = [Trade Debtors * 365] / Sales.
- Is the number of Debtor Days increasing or decreasing? An increase could indicate lax credit control. The Debtors to Sales Ratio shows the % of Sales outstanding at year end.

5. Is Its Market Value Supported By Assets?

Market Value

- How much is the company worth? Market Value = Issued Shares * Share Price.
- What is its Enterprise Value? EV = Market Value + Total Debt – Total Cash.

Fixed Assets

- What value is given to Fixed Assets? PBV = Share Price / Shareholders' Funds per Share. Shareholders' Funds is the same as Shareholders' Equity or Net Tangible Assets or Net Assets – this is the value of the business excluding Goodwill.
- Does the company have additional value as a trading entity? Is the Share Price greater than Net Assets per Share and is this extra value justified?
- Are the Assets worth more than stated on the books?
- Is the company asset-backed with plenty of Fixed Assets to assist its survival?
- Are Fixed Assets being replaced? The Ratio of Fixed Asset Expenditure to Depreciation is healthy if it is between 1 and 2.
- When was the property last valued?
- What significance is the figure for Minority Interest? Up to 20% is an investment; 20-50% an associate; 50%+ a subsidiary.

Current Assets

- What is the value of Net Assets? Net Assets = Fixed Assets + Current Assets – All Liabilities.
- What premium or discount is the Share Price to Asset Value? Premium or Discount = [Market Cap – Net Assets] / Net Assets. Compare with figures for the sector.
- How much cash does the company have?
- How liquid are the Current Assets – cash, debtors, stock?
- What provisions have been made for bad debts?

- What is the company's Stock Turn? Stock Turn = Sales / Stock. Stock Days = 365 / Stock Turn. Compare changes year on year.
- What is the Burn Rate? Burn Rate = Cash / Monthly Operating Expenses. It represents the number of months a company can survive. Monthly Operating Expenses = the total of Operating Expenses listed between Gross Profit and Net Profit minus depreciation and Amortisation.

6. Is It Using Debt Wisely?

Level and Type of Debt

- How much Debt does the company have?
- How secure is the Debt funding?

Paying Off Debt

- How much is the company paying in debt interest?
- When is the debt repayable?
- Is it earning enough profit on its borrowings to cover its debt? See the P&L for Interest Payable and Net Profit.
- What is the Interest Cover? Interest Cover = [Pre-tax Profit + Net Interest Paid] / Net Interest Paid. Any figure below 5 suggests a company is heavily indebted. A low figure makes a company vulnerable to interest rate rises.
- What is the Gearing Ratio? Gearing = [Total Borrowings – Cash] / Shareholders' Funds. Low is <100%; medium 100-200%; high 200%+.
- What is the Gearing Balance Point? Gearing Balance Point = Net Profit after Tax / Total Capital. It is the point where EPS is not affected by gearing. Total Capital is all debt instruments plus share capital plus retained profit. If the percentage of Net Profits after Tax exceeds the Gearing Balance Point, then the gearing works in your favour.

7. Are There Any Hidden Nasties?

Level of Liabilities

- What is the Ratio of Liabilities to Costs and Expenses? Liabilities Ratio = Liabilities / Costs and Expenses. It measures the % of annual costs and expenses outstanding at year end. A figure of 0.2 is fairly healthy.

Contingent Liabilities

- Does the company have Contingent Liabilities that are large in relation to Profits and likely to concern?

Pension Liabilities

- Is there a risk of a huge liability to maintain the pension fund?

8. Is Management Good Enough?

Strategy

- Has management articulated a coherent strategy?

Salaries

- How does the pay compare with the company's performance?
- Are the Share Options set at sensible targets? The table of share options gives an insight into what the Directors think the share price will be.

Share Holdings

- How many shares do Directors hold?
- Have they recently bought or sold?

9. Can A Reliable Income Be Expected?

Dividend Policy

- What is the company's stated Dividend Policy?
- What level of Dividend has the company paid historically? Gentle increases, subject to profits, are probably best.
- What is the Dividend Cover? Dividend Cover = EPS / Dividend per Share. Dividend Cover between 3 and 4 is healthy. In judging the merits of various dividends, you can multiply the Dividend Yield by the Dividend Cover.
- Has the company skipped or reduced its Dividend?

The Price of Dividend Income

- What are its Earnings per Share? EPS = Net Profits / Issued Shares. Diluted EPS = Net Profit / (Issued Shares + Option and Convertible Shares etc)
- What is its PE Ratio? PE = Share Price / EPS.
- What is its Dividend Yield? Dividend Yield = DPS / Share Price.
- What is the Total Return? Total Return = Dividend Yield + Capital Growth.
- What is its PEG Factor? PEG = PE Ratio / Earnings Growth.

10. Are There Threats To Shareholder Interests?

Who Owns the Company?

- What types of financial instruments are used?
- What is the Cost of Capital?
- Is it part of a group? Who is the parent company?
- What is the investor profile of the company?
- Is there a risk of significant dilution?

Insolvency

- Does the company owe more than it is worth?

The Motley Fool Numbers.

Source: The Motley Fool UK Investment Workbook – Berger and Jackson.

Some Basic Concepts.

Market Capitalisation. Large-Caps above £3 billion; Mid-Caps between £300 million and £3 billion; Small-Caps between £50 million and £300 million; Micro-Caps below £50 million.

Foolish Flow Ratio. Calculated as Current Assets – Cash / Current Liabilities – Short-term Debt. The aim is to identify how well a company is managing its non-cash liquid Net Assets. High Stocks and debtors is bad. The closer the Flow ratio is to 1 or lower, the better. The ideal company will demand cash from its customers and , therefore, have low levels of Debtors. It will have low Stock levels and high Creditors.

Cash Conversion Ratio. Net Cash from Operations / Operating Profit. 100% is ideal. A company with a Cash Conversion Ratio of less than 80% should be treated with caution.

Fool Ratio. PE Ratio / Earnings Growth rate. In a fair value situation, the PE should roughly equal the future EPS growth rate. Look to buy below 0.60; over-valued at 1.51 or more. It works best for smaller companies and is less effective when PEs are above 20 to 25. Not appropriate for recovery shares where Earnings are depressed.

The Ideal Set of Accounts.

Balance Sheet:
- Plenty of Cash and little or no Debt.
- Low Stock levels.
- Low Trade Debtors or Accounts Receivable – check Days Sales Outstanding. DSO = Debtors / (Turnover / 365).
- High Trade Creditors or Accounts Payable – check Days in Payables = Trade Creditors / (Cost of Goods Sold / 365).
- A low Foolish Flow Ratio.

Profit and Loss Statement:
- High Turnover growth – large firms 8 to 10%; smaller companies 15 to 25%.
- High Gross Margin – 50% or above.
- Operating Margins above 12% and rising.

Cash Flow Statement:
- A Cash Conversion Ratio above 90%.

Winning Companies:
- Strong brand.
- The best company in the business.
- Repeat business.
- Operating Profit Margins above 12%, coupled with a high ROE.
- Proven past growth record.

IC Key Financial Ratios.

Price to Sales ratio (PSR)
- Market Cap divided by latest Annual Sales. If Interims reported, use Rolling Annual Sales i.e. Annual Sales + latest H1 Sales - previous year's HI Sales.
- One of the best guides to share performance, according to O'Shaughnessy.
- PSR<1.
- Meaningless for companies with high Turnover and low Margins.

Price to Net Assets Ratio (PBV/PTBV)
- Divide Share Price by Net Assets per Share or Market Cap by Net Assets (Shareholders' Funds). For PTBV, subtract Intangible Assets from S/Funds.
- PBV/PTBV<1.

Price to Free Cash Flow Ratio (PCF/PFCF)
- Free Cash Flow is the Net Cash Inflow after essentials have been paid. From Cash Flow from Operations, subtract Tax Paid and Capital Spending on Fixed Assets. Divide the resulting number into Market Cap.
- PFCF<10.

Operating Cash Flow to Operating Profit Ratio
- Divide Operating Cash Flow by Operating Profit.
- Operating Cash Flow should be higher than Operating Profit.

The PEG Factor
- Prospective PE Ratio divided by expected Earnings Growth.
- PEG<1.

Return on Equity (ROE)
- Profit after Tax divided by Shareholders' Funds multiplied by 100. shareholders' Funds should include Intangibles and Goodwill. 'Cumulative Goodwill written off' should be added back to Shareholders' Funds.
- ROE>10 is the absolute minimum.
- Combine ROE with the Payout Ratio. Reinvested Return on Equity = ROE multiplied by % of profits retained in the business.

The Acid Test Ratio (Quick Ratio)
- Current Assets minus Stocks divided by Current Liabilities.
- Asset Test Ratio at least 1 and preferably 1.5.
- Check for deterioration over recent years.

Debtor Days & Creditor Days
- Debtor days = divide Trade Debtors by Sales and multiply by 365.
- Creditor days = divide Trade Creditors by Cost of Sales and multiply by 365.
- Look for consistency. It is important that sales are collected at the same rate as, or more quickly, than payments to suppliers. It is bad news if debtor days have been rising and creditor days falling.

Gearing
- Gearing = Total Debt minus Cash divided by Tangible shareholders' Funds.
- Gearing<60%.

Notes