

## >: 4 Questions to Ask Before Buying ANY Stock

Tuesday, February 27, 2007 | Dylan Jovine

I'm often amazed by the sheer quantity of investment ideas I hear on a daily basis. Regardless of the medium - print, electronic or television - we're bombarded by a variety of 'experts', each with a different opinion about the exact same subject - where to invest your money.

Is the economy growing? If so, you should be buying cyclical stocks. Are interest rates going higher this month? Sell your Savings and Loan stocks.

Trying to predict the direction of interest rates, the stock market or the economy is Wall Street's great game - and its great distraction.

It's a game because trying to predict the future is like riding a merry-go-round. You go around and around without advancing much.

It's a distraction because it takes your mind as an investor away from far more profitable thoughts.

But the biggest problem is that it simply doesn't work.

Anybody who tells you that they know the direction of the economy, interest rates or the stock market is either a) inexperienced or b) selling you something you don't want.

And while it is not our intention to eliminate the jobs of many entertaining Wall Street soothsayers, it is our intention to share with you the four essential questions you should ask yourself before buying the stock of any company, public or private.

### **1. Do I understand the business?**

Tip O'Neil, the late Speaker of the House, once said, 'All politics is local.' All business is local, too. But how does one come to understand a business?

Start by trying to understand a local company you enjoy doing business with. It doesn't matter if it's public or private, large or small. One of the most successful Tycoons in America once told me that he learned how to analyze companies by studying the local pizza place.

Then ask yourself a few questions: What do they sell? Who do they sell to? How do they market themselves? Where do they get their product(s) from? Who are their competitors? Are they different from their competition?

As you start to answer these questions, you begin to get a qualitative understanding of the business you're studying. The size of the company itself is irrelevant; if you know how to study the strengths and weaknesses of a small, private company, you will know how to do it for the large, public one.

Last but not least, don't forget to use your own business experience to guide you. Too often throughout my career, I've found successful businesspeople (employees and owners) who knew how to study their own company inside and out but, for some reason, didn't believe it translated to other companies.

It does. The knowledge you have about the company you work for is directly relevant.

### **2. Am I comfortable with management?**

First let me state the obvious: you have to be able to trust management with the cash register. For private companies, it's literal. For public companies, it's compensation and perks. But there are other areas that are not so obvious that you must consider as well.

One scenario I think through is this: What if, after a few years of great growth, the company were sitting on a pile of cash? But the growth rate of the business has slowed and the company could not find any good investment opportunities.

What would management do with the cash? Would they invest it into a low-returning business under the guise of diversification or would they return it to shareholders?

The answers to these questions offer important clues to management's understanding of Return on Invested Capital.

### **3. What is the business worth?**

We use many valuation tools here at Fallen Angel Stocks (and discuss them in detail in our newsletters,) but let's focus today on earnings.

Specifically, let's explore the relationship between price and earnings (p/e).

To estimate what a business is worth, you have to be able to value it. To properly value a business, you have to be able to predict what earnings will look like in the future. To estimate what earnings will look like in the future, use the past as a guide.

Here at Fallen Angel Stocks, we go back through ten years of annual reports to get an average annual growth rate. By going back ten years, we're able to see how the company has performed through at least one economic cycle (expansion and contraction.)

If you're looking at a private company, make sure you have audited financials for at least five years, and you have a business accountant verify them.

Once you have an average annual growth rate of earnings, apply it to earnings for each of the next three to five years.

This should give you a basic idea of what a company's earnings will look like in the near future.

#### **4. What do I have to pay?**

Having a wonderful company with great earnings and a strong management team is one thing. Getting it for a good price is entirely different (try convincing a dealer to sell you the latest Mercedes for \$10,000.)

Hence, the sole objective here is to quantify the difference between value and price (what something is worth versus what you have to pay for it.)

Let's take ABC Company (a public company) as an example.

If you've estimated that ABC Company will earn \$1.00 a share three years from today and for the past 10 years has never sold below 12 x earnings, ABC may well be worth \$12 in 3 years.

But what is ABC Company selling for today? If ABC's stock is now selling for \$15 per share, it's clearly selling for more than its worth?it's overvalued. If ABC is selling for \$8 per share, it appears to be undervalued.

Now here's where you have to determine what rate of return is acceptable to you. As an investor, if you require a 20% annual return on your money, then you should not pay more than \$6.90 for ABC today (\$12 per share in 3 years discounted by 20% to today's dollars.)

If your required rate of return is 15%, however, then \$7.80 per share is a good price to pay (\$12 per share in three years discounted by 15% to today's dollars.)

George Soros, the famed investor, is fond of saying that he's an "insecurity" analyst, not a security analyst.

Keep that in mind when you begin to ask these questions about potential investments?they're a starting point, not an ending point.

And as a subscriber to Fallen Angel Stocks, we'll tackle these types of issues in-depth each month. In the meantime, practice asking yourself these questions.

Not only will you become a better investor, you'll become a better businessperson.



Dylan Jovine  
Chief Investment Officer

≥