

>: The Most Undervalued Asset in Corporate America

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MAKING MONEY IN MARKETS LIKE THESE HAS ABSOLUTELY NOTHING TO DO WITH BRAVERY.

History is littered with investors who lost everything because they were "bravely" buying when the facts said they should've been selling.

Nope, the secret to making money in both good markets and bad is knowledge. Knowledge about investment analysis, the markets and a solid knowledge of history.

Knowledge has made me look "brave" when everyone else seemed fearful. Knowledge has made me look like a "visionary" when having a long-term vision has never even crossed my mind. And knowledge has made me look like more of a "contrarian" than I think of myself.

Why am I saying this today? Because you don't need to be brave, a contrarian or a visionary to make money in the stock market. I'm living proof that all you need is a good framework to make investing decisions and that comes with knowledge.

Today I'm going to share with you some knowledge I've never before shared in public. If you don't believe me when I say that, consider the following: I'm a business analyst not a stock analyst. And since I still own a private business that is hunting for opportunities each day, I have to be careful about how much I share.

During the past month, however, I've been urging you to replace the word "Crisis" with the word "Opportunity," as in the "Greatest OPPORTUNITY Since the Great Depression." But I realize doing that is easier said than done. That's why I'd like to share with you a five-step system to help you get started today.

[**Editor's Note:** How to Regain Your Wealth in Five Simple Steps. [Go here now.](#)]

Step One: Consider Opportunity Cost

Let's say you paid \$10,000 for a 10-year U.S. Government bond paying you 5% annually. For an upfront investment of \$10,000, you get a guaranteed \$500 coupon payment each and every year for ten years. Upon maturity in ten years, you redeem your bond and you get your \$10,000 back.

U.S. Government bonds are attractive investments because they're still the safest investments on earth. In exchange for a relatively low fixed coupon of \$500 annually, many investors are willing to lend Uncle Sam \$10,000. A 5% annual return on my investment may not be a lot of money but it's guaranteed so I could sleep at night.

A 5% fixed annual return may be fine for a bond investment with no risk but it's not going to cut it for the risk I take when investing in a stock. Unless I'm convinced I'll earn a 15% AFTER-TAX return each and every year for the next ten years, I won't consider it.

And since I know earning 15% annually in after-tax dollars is very difficult, I won't buy a stock unless I'm convinced I'll own it for ten years, or the same length of time I would own the bond.

But earning 15% annually is hard enough - earning 15% annually in AFTER-TAX DOLLARS is an order of magnitude harder. To even have a chance of reaching that goal, I'm going to have to own this stock for the full ten years to avoid as much tax liability as possible.

What does that mean?

It means I'll have to find a company whose stock offers me the highest probability of reaching my goals over the next ten years. Not only a company I'm almost certain will exist in ten years - but a company whose underlying business is so strong that it's a virtual lock that my "coupons" will grow each and every year.

I don't know about you, but that leaves out most companies I've ever heard of. How many companies would you bet \$10,000 on that will not only exist in ten years but will actually be substantially stronger in ten years than they are today? It's like looking for a 6'5" terrorist hooked up to a dialysis machine in the desert.

But finding a company that's been strong in the past and will almost certainly be stronger in the next ten years is only half the battle. The hardest - and most important part - is to buy the stock at a great price.

Why? Because the price you pay is the single most important factor that determines your rate of return.

Pay too "high" a price and it's almost certain you can kiss any hope of making 15% each year on your money goodbye. Indeed, you'd be lucky not

to lose most of your investment. Just ask investors who bought Intel at \$80 a share back in 2000. Owning stock in a great company isn't good if it takes you 20 years just to break even on your investment.

Buy at a "fair" price and your odds of getting the 15% annual return you require are not likely to be better than 50/50. Even in your "best case" scenario, you'll be at the mercy of the markets, which means your best hope is to have a chair by the time the music stops and the markets stop rising.

But investors who buy shares in great companies at "discounted" prices have two HUGE advantages: (a) they dramatically increase their odds of getting the returns they seek and; (b) they give themselves a margin-of-safety that acts like a floor that offers downside protection on their investment.

Step Two: Find Stocks That Pay High "Coupons"

(Please Note: In the interest of explaining the following concepts as easily as possible, I'm going to eliminate as much accounting jargon as I can. At this stage it's far more important for you to understand these basic concepts than it is for you to understand the finer points of the analysis and use of financial statements when investing.)

I look at investing in stocks in much the same way I analyze a bond investment. Of course stocks, unlike bonds, offer no guarantees against the loss of your investment. Nor do they offer you a guaranteed fixed payment every year.

But stocks do offer investors something U.S. Government bonds never will - "coupons" that can actually grow each year in value. And the more the "coupon" grows in value each year, the more likely that your principal will increase in value as well.

Let's begin by defining what a "coupon" looks like for a company as opposed to a bond. Since picking the right stock is a by-product of picking the right company, during this step of the selection process it is important to look at a company as if it were a private company not a stock.

Coca-Cola (SYM: KO)										
Co.-Based Perf. Metrics	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Shareldr Equity Per Share	\$3.41	\$3.85	\$3.75	\$4.57	\$4.78	\$5.77	\$6.61	\$6.90	\$7.30	\$9.38
Earnings Per Share (EPS)	\$1.42	\$1.30	\$1.48	\$1.60	\$1.65	\$1.95	\$2.06	\$2.17	\$2.37	\$2.57
Return-on-Equity (ROE)	42%	34%	39%	35%	34.7%	34%	31.5%	31.8%	32.9%	27.5%

As you can see from the graph above, the annual growth of Coke's "coupon" is best understood by analyzing the relationship between Shareholder Equity Per Share (or Book Value Per Share), Return-on-Shareholder-Equity and finally, Net Income Per Share.

We start with Shareholder Equity Per Share (Total Assets - Total Liabilities) because it is the amount left over for stockholders of the company after you subtract out all liabilities. In other words, it's the amount of money that would be left over for stockholders if you bought the whole company and paid off every single creditor you owe money to.

Earnings Per Share (EPS) is the amount of money available to common shareholders after all operating & financing expenses are subtracted from total revenue. I've always found it helpful to look at EPS as the "RETURN" common shareholders receive in exchange for their Shareholder Equity in the form of dividends or it can be reinvested into the company for future growth.

And as its name describes, Return-on-Shareholder-Equity or R.O.E. (Net Income/Shareholder Equity) highlights the "Return" shareholders earn as a percentage of Shareholder Equity in a given year. But the reason understanding ROE is such a critical part of successful long-term investing is because it is LITERALLY THE "COUPON" that can super-size your investment returns.

Highlight: Remember, the goal during this step of the selection process is to look at the business, not the stock itself. So imagine that Coke is a private company and you can purchase stock in this private company for its Shareholder Equity Per Share in any given year.

Had you been able to buy a share of Coke in 1998 for its Shareholder Equity Per Share amount of \$3.41, the EPS of \$1.42 would have amounted to a 42% "RETURN" on your investment (EPS of \$1.42/\$3.41 in Shareholder Equity Per Share). That's roughly eight times greater than the 5% RETURN our bond investor would have earned in the example above.

In 1999, the Shareholder Equity Per Share amount was \$3.85. Had you bought shares at that price, 1999's EPS of \$1.30 would have represented a "RETURN" of 34% on your investment (EPS of \$1.30/\$3.85 in Shareholder Equity). That would have been about seven times greater than the 5% RETURN our bond investor would have earned holding his bonds.

But if you recall from our discussion earlier, finding companies that have high "coupons" is just the first step. The real secret is consistency -

finding a company that is most likely to keep paying high "coupons" as far into the future as the eye can see.

Step Three: Find Stocks Whose Future "Coupons" Seem as Safe as U.S. Government Bond Coupons

If you could sum up the theme of my whole investing philosophy, it would be the "avoidance of risk." Indeed, it wouldn't be an exaggeration to say that I only like to buy stocks in companies whose "coupons" seem as steady to me as coupons you'd get from U.S. government bonds.

That's why buying companies with high ROEs isn't enough: there are hundreds of small companies with high ROEs simply because they have such a small amount of Shareholder Equity Per Share to start with. It isn't hard for a small company with .10 cents in Shareholder Equity Per Share to earn .05 or what amounts to a 50% "RETURN."

Looks can be deceiving when looking at companies with high ROEs in other ways as well. A one-time accounting gain can make one-year ROE much higher than would appear under normal operating circumstances.

I protect myself from that mistake by looking for companies that (a) are mature and have been in business for at least 5 decades, (b) sell products that I understand with a heavy bent toward consumer products and (c) have earned high ROEs for at least a decade.

Using the Coke example from above, you can see that the lowest RETURN on shareholder equity Coke investors received during the period between 1998 and 2007 was the 27.5% earned in 2007. Going back 20 years offers more evidence as Coke investors received ROEs averaging roughly 50% each year from 1992 - 1998.

Step Four: Only Buy Stocks That Will Offer You the Annualized Return You Require

So far we've talked about how to analyze private companies, not their stocks. In the real world, it's unlikely you'll ever get a chance to buy a share of Coke on the New York Stock Exchange for a price anywhere near its Shareholder Equity Per Share. (Although if this were really the "Greatest Crisis Since the Great Depression," you may get lucky).

But how do you translate all of this company research into an actionable investment decision? How do you take what you've learned from analyzing a company and apply it to analyzing the stock price of that very company?

Before I answer that question, I first have to reveal one of the most important - yet least understood - investing secrets on earth: the stock market rewards companies with high ROEs much greater than companies with average or below average ROEs.

The companies that are rewarded the most (a) are mature and have been in business for at least five decades, (b) sell products that I understand with a heavy bent toward consumer products and (c) have earned high ROEs for at least a decade.

But how exactly does the stock market "reward" a company like that?

Below is the SAME EXACT COCA-COLA GRAPH I used earlier but with one key difference. Instead of just focusing on the performance of the company, the graph below highlights how the stock market has rewarded that performance during the 10-year period from 1998 - 2007.

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Mkt.-Based Perf. Metrics	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Avg Stock Price Per Share	\$72.84	\$61.75	\$55	\$48.80	\$49	\$44	\$46.50	\$42.70	\$43.80	\$53.90
Market \$ For Every \$1 in Shr. Eq	\$21	\$16	\$14.80	\$10.60	\$10.40	\$7.63	\$7.04	\$6.17	\$6	\$5.74

One of the most important investing secrets I could ever share with you is in the row titled "Market \$ for Every \$1 in Shr. Equity" or Average Stock Price / Shareholder Equity Per Share.

It explains one of the least understood relationships in investment analysis to this day: the relationship between Shareholder Equity Per Share and the actual Market Price Per Share, or what a stock can be bought or sold for on any given day on the NYSE. It helps me to look at it as the relationship between the company and its stock price, between the corporation and the market.

Here's how it works:

The average American corporation has an annual ROE in the 12% range. Over the long-term, the market tends to add \$1 in stock market value for

every \$1 in Shareholder Equity to companies with "average" financial performance.

Companies with above-average financial performance are rewarded much differently...

As you'll notice, the general rule is the higher Coke's ROE, the higher the multiple. For every \$1 in Shareholder Equity Per Share Coke the company had in 1998, Coke the stock was rewarded with \$21 in stock market value.

Conversely, the lower Coke's ROE, the lower the multiple. As ROE slid into the low 30% range in 2004, the multiple slid as well. It's no coincidence that Coke's lowest multiple during the past decade came in 2007 when its ROE was also at its low point for the decade.

An investor who simply looked at earnings growth or P/E ratios might have missed that though. From 1998 to 2007, Coke's earnings have increased at a healthy rate each and every year, giving the casual observer the appearance of a strong investment prospect. But now you'll have the tools to look deeper.

Step Five: Putting It All Together

Coke has grown its Shareholder Equity Per Share at a rate of 11.4% annually for the past decade. If it continues to increase Shareholder Equity Per Share at that rate, by 2012 it should be at \$16. For the past 10 years the stock market has placed a premium of between \$5.74 and \$16 in Market Value for every \$1 in Shareholder Equity.

The low end of the range, \$5.74 in Market Premium X \$16 in Shareholder Equity would suggest Coke's shares would be worth \$91 in 2012. Excluding dividends, that would mean an annual return of 14.6% if you bought the stock at today's price of \$45.80 and held onto it for 5 years.



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