BetterInvesting Education

Fundamentals of Stock Investing

This course will help you become familiar with the BetterInvesting stock selection philosophy used by members to identify and select high-quality growth companies to invest in.

Lesson 1: Explaining the BetterInvesting Philosophy

Lesson 2: Evaluating Management

Lesson 3: Assessing Investment Potential

Explaining the BetterInvesting Philosophy

BetterInvesting Education

Course Overview

This course provides a high level view of the BetterInvesting stock selection philosophy. Here you will be introduced to terminology and concepts to help you become familiar with the approach but without going into all the detail. There will be time for that in future courses. You will apply what you're introduced to in this course to future courses that will take you step-by-step through the details of identifying and evaluating high-quality companies to invest in using our online stock selections tools.

What makes BetterInvesting so useful in supporting your investing goals and strategies? We are a team that focuses on educating individuals and investment clubs in the principles and stock selection strategy that has successfully served our members for more than 70 years.

Our mission is to educate individual investors and investment clubs to become successful, lifelong investors. Our goal is to provide the tools and resources needed to achieve that success.

Lesson Objectives:

- Identify the characteristics of a BetterInvesting member.
- Introduce BetterInvesting 's guiding principles.
- Explain the concept of fundamental investing.

What are the characteristics of a BetterInvesting member?

In general, BetterInvesting members have a long-term perspective. We buy stocks of high-quality companies at reasonable prices and continue holding them as long as the company's performance merits doing so.

Guiding Principles

Our philosophy begins with these guiding principles:

1. **Invest a set amount of money regularly.**
   Regardless of the present outlook for the economy or stock market.

2. **Reinvest all earnings.**
   By reinvesting all your dividends and profits from the sale of stock, you'll fully leverage the power of compounding.

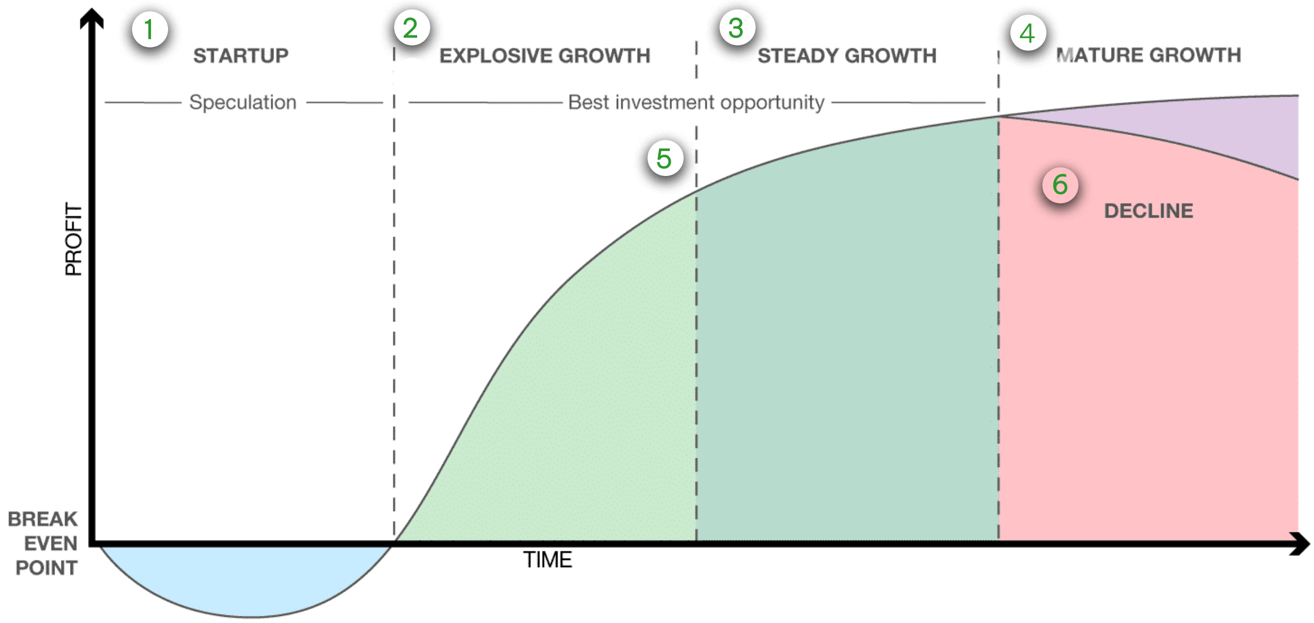
3. **Buy stock in high-quality growth companies.**
   Search for growth companies that increase sales and earnings consistently over time.

4. **Diversify your portfolio.**
   Spreading your stock investments over a number of companies of differing sizes and industries will help reduce the risk of investing in the stock market.

We focus primarily on the third principle: buy stock in high-quality growth companies.

Investing in growth companies is an investment style and strategy that is focused on increasing an investor's capital. Growth investors typically invest in high-quality growth companies — that is, small, medium and sometimes large size companies whose sales and earnings are expected to increase at an above-average rate compared to their industry, sector or the overall market.

Life Cycle of a Growth Company



1 **Startup**
Company just getting started (Initial Public Offerings, a.k.a. IPOs), no track record of profitability, sales and earnings growth or management's ability in general. Highly speculative.

2 **Explosive Growth**
Profitability, sales and earnings growing rapidly, profit not seriously constrained by competition, new products can contribute significantly to growth.

3 **Steady Growth**
Steady or growing profitability, strong and consistent sales and earnings growth although less rapid, serious competition, new products help steady growth.

4 **Mature Growth**
Profitability, sales and earnings growing more slowly, new products are less impactful.

5 **Best Investment Opportunity**
After company has a minimum of five year track record of producing explosive or steady growth in profitability, sales and earnings.

6 **Decline**
Magnitude of existing sales and earnings make it difficult for new products to contribute to growth, difficult to take advantage of new opportunities, sales and earnings growing slowly and erratically, if at all.

In our search for well-managed, high-quality growth companies, BetterInvesting members employ fundamental analysis. Fundamental analysis means studying a company's financial performance, e.g., sales, profitability, growth potential, economic conditions, etc. Over the long-term, applying fundamental analysis in the selection of, and investment in, high-quality growth companies is what works in building wealth.

BetterInvesting's online Stock Selection Guide (SSG) is the primary evaluation tool used by members to identify high-quality growth companies. The SSG arranges the fundamental data of a company in a way that allows users to examine a company's growth and management performance in just minutes.

When using the SSG, we ask two questions when considering a company for investment:

1) Is this a well-managed, high-quality growth company?
2) Is its stock reasonably priced?

Once we've assessed a company's management and determined that the company is a high-quality growth company, we're ready to assess the company's investment potential and whether the stock of the company is reasonably priced.

Investors are good at discovering high-quality companies but experience more challenges in determining the growth potential and proper price to pay for a company's stock.

Key Idea Review

Q) What defines a BetterInvesting member?

A) BetterInvesting members have a long-term perspective. We buy stocks of high-quality growth companies at reasonable prices and continue holding them as long as the companies' performance merits doing so.

Q) What are BetterInvesting's guiding principles?

A)
1. Invest regularly.
2. Reinvest all earnings.
3. Buy stock in high-quality growth companies.
4. Diversify your portfolio.

Q) What two questions do we ask when evaluating a company?

A)
1. Is this a well-managed, high-quality growth company?
2. Is its stock reasonably priced?

Q) Name the primary stock evaluation tool used by members?

A) Stock Selection Guide (SSG)

Evaluating Management

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Lesson Objectives:

- Review the steps to identify a well-managed company
- Identify an ideal graph of a company's growth

When asked what is most important when identifying a high-quality growth company, BetterInvesting co-founder George Nicholson said it this way:

MANAGEMENT, MANAGEMENT, MANAGEMENT!

Therefore, the first thing to ask yourself when determining whether to invest in a company or not is:

Is this a well-managed, high-quality growth company?

Evaluating Management

We seek well-managed companies because talented, capable executives know how to ensure their company thrives over the long term. These are the people who are responsible for driving the growth of the company that fuels an increasing stock price.

When assessing management, we don't know everything about a company's day-to-day operations and boardroom discussions. We do, however, have a great deal of the information needed to make informed and reasonable decisions about the quality and future potential of a company. Next, we'll review some of the fundamental data we use to evaluate a company's management.

Sales and Earnings

Sales is income received by a company in exchange for goods and services recorded for a given accounting period.

Earnings refer to the profits a company generates during the same particular time frame - how much sales exceeds expenses.

An important indicator of strong management is its ability to grow the business in good times and in bad.

Earnings Per Share (EPS)

We also look at earnings in relationship to the number of shares the company has outstanding—or said another way—the amount of company stock currently held by all its shareholders. This is referred to as earning per share (EPS). We use EPS in our evaluation as it's a more common metric to use when estimating a company's value. It indicates how much money a company makes for each share of its stock. It's a key profitability metric used in determining a stock's value and has a major impact on the price of a company's stock.

EPS is most valuable when used to compare against peer companies and industries as a whole. Remember, the price of a company's stock typically follows the earnings growth of the company. The more profitable a company is over the long term, the higher the price will be that the market is willing to pay for its stock.

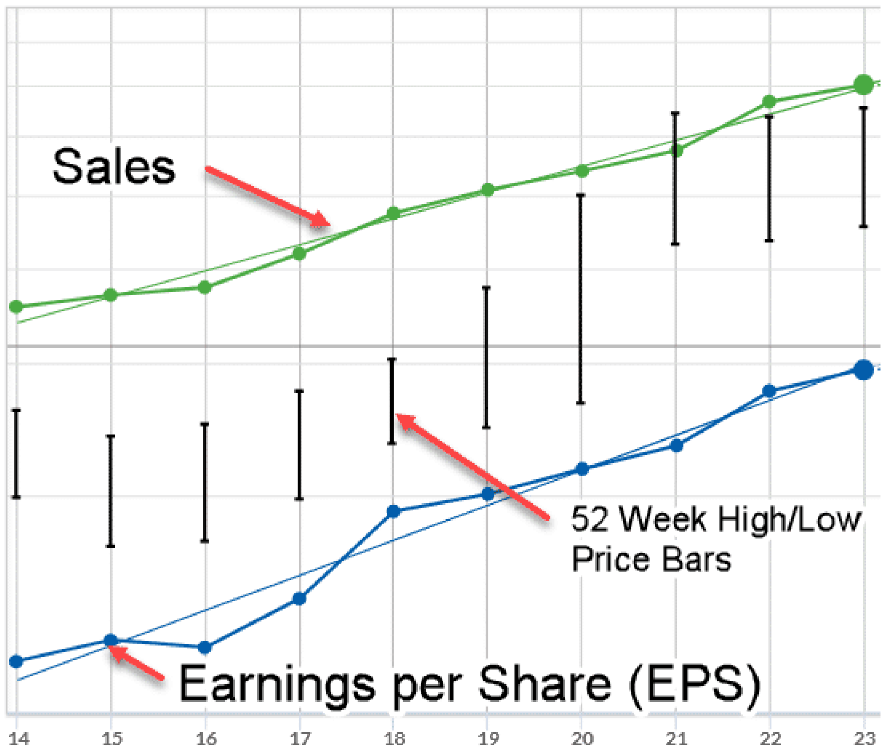
Defining Quality Growth

It's desirable to identify companies with **strong and consistent historical sales and earnings growth**; generally growing faster than the overall economy and inflation combined.

We also seek companies that have grown historical sales and earnings over the long term at a rate that's high relative to their size. Smaller companies generally should be growing sales and earnings by more than 12% a year; mid-size companies, by 7-12% a year; and large companies, by 5 -7% per year.

When a company grows at a rate appropriate for its size and does so consistently over long periods of time, the company management passes our initial assessment used to determine the quality of that company. And although the past is no guarantee of future performance, history informs our decisions regarding future growth.

Strong and Consistent Growth



Let's take a look at what strong and consistent historical sales and earnings growth looks like. The graph on this page represents 10 years of historical sales and earnings growth of a sample company. Note the railroad-track-like growth of the company's sales and earnings moving upward from left to right. The upward slope of the lines reflects the rate of growth and needs to align with the growth rates presented previously. Consistent performance, demonstrated by the straightness of the graph lines, reassures us about the capability of management and aids us in determining the future potential of the company.

Growing and consistent historical sales and earnings are the most fundamental of fundamental measures. Higher sales typically lead to higher earnings, which typically leads to a higher stock price. Eventually, someone will pay more for something that has increased in value, especially if it does so consistently over long periods of time.

In summary, we favor strong and consistent historical sales and earnings growth over the long term. This graph provides an ideal visual representation of a company's historical growth plotted on an SSG study.

Stretch Your Thinking...

Why do you think a smaller company could pose a bigger risk investing-wise?

Smaller companies can be a higher investment risk because they haven't yet demonstrated the long-term viability evident with larger companies. Also, younger companies haven't developed enough of a track record for assessing management performance.

We want smaller companies to have higher growth rates to compensate us for this additional risk. We would expect the higher growth rate to lead to higher stock prices, and if we do a good job of assessing these companies, we'll see handsome returns.

Evaluating Management (continued)

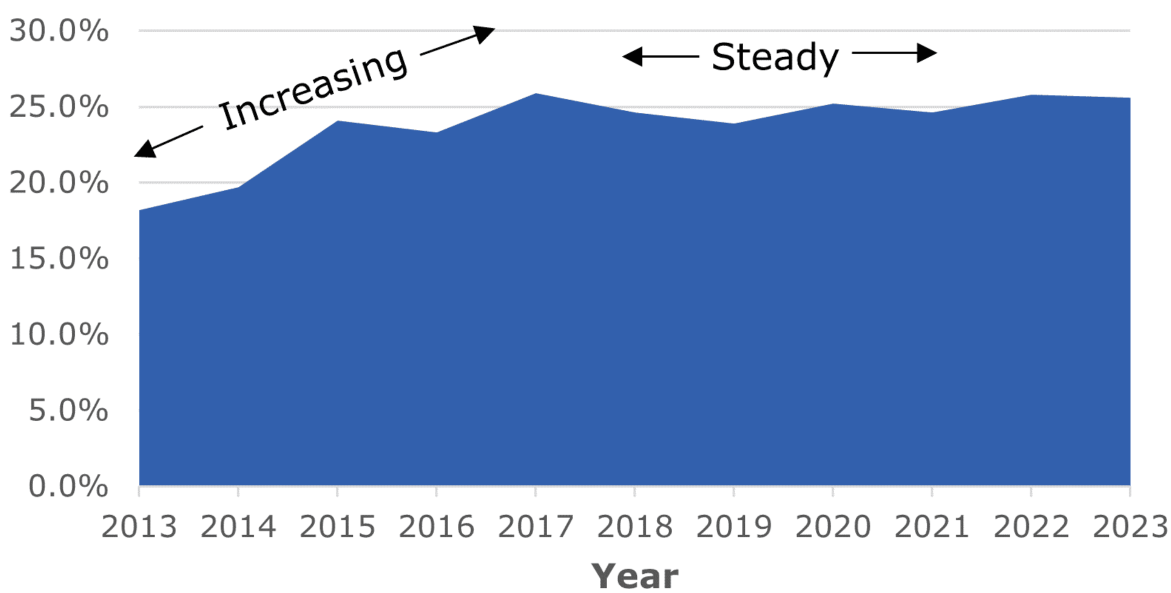
We continue our review of the fundamental data we use to evaluate a company's management by looking at two profitability ratios:

%Pre-tax Profit on Sales and %Earned on Equity.

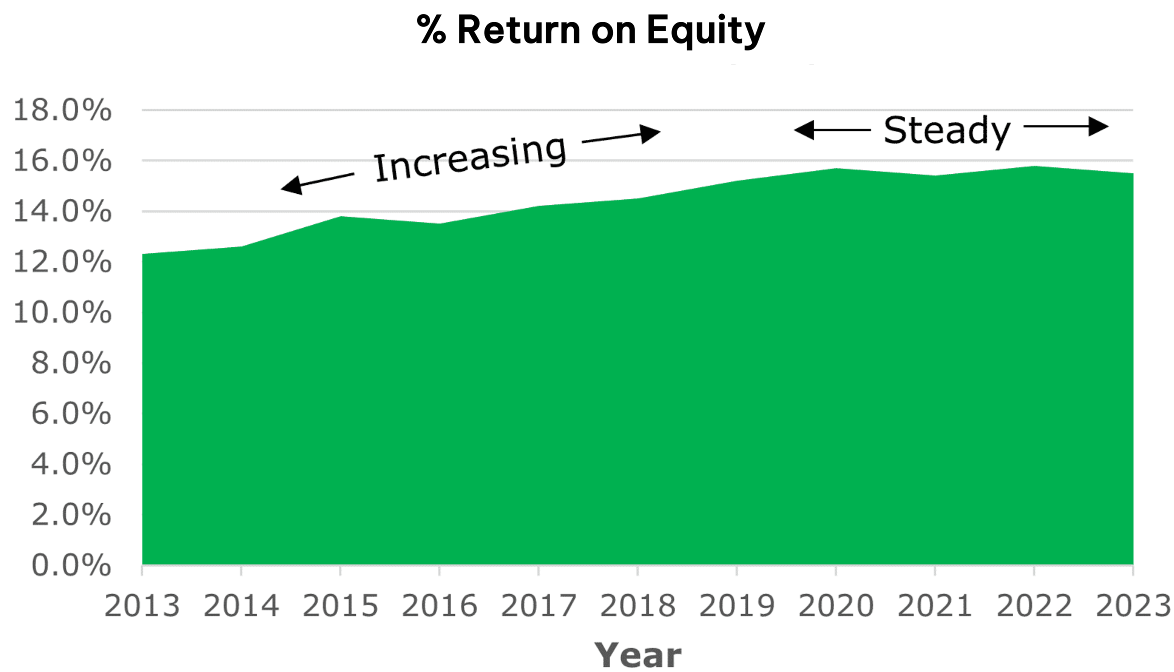
Profitability ratios are a class of financial measures that are used to evaluate a company's ability to generate earnings in relationship to sales and other financial data from a specific point in time. They are among the most popular metrics used in financial analysis.

A company's profitability ratios are most useful when compared to those of the company's competitors, the company's own performance history, peer group and industry average ratios.

% Pre-tax Profit on Sales



First, we check the company's % pre-tax profit on sales. The % pre-tax profit on sales, as shown in the SSG, is the percentage of profit that the company gets to keep, before taxes, of what it makes in sales. That percentage is known as a profit margin. Steady or increasing % pre-tax profit margins show that management can balance the strategies that increase sales and contain or decrease costs.



Next, we check to see how well management is using the equity invested in the company. Equity refers to stock investors' money, including earnings retained in the business for future growth. The% return on equity is the return that management achieves on this money. We like to see steady or increasing % return on equity.

Comparing the company's sales, earnings, % pre-tax profit on sales and % return on equity with those of its peers helps determine whether this is a company built for a long voyage or is simply benefiting from the rising tide for its industry.

When a company meets the growth and consistency we require in sales and earnings and also demonstrates stable or steadily increasing % pre-tax profit on sales and %return on equity, we typically consider it a well-managed, high-quality growth company. That will lead us to conduct further evaluation on the company where we ask: is the stock reasonably priced?

If the company doesn't meet all of our standards, we will end the study and look for another company.

Key Idea Review

Q) What fundamental data do we look for to answer the question: Is this a well-managed, high-quality growth company?

A) Strong and consistent sales and earnings growth in relationship to company size, and steady or increasing % pre-tax profit on sales and % earned on equity.

Assessing Investment Potential

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Lesson Objectives:

- Become familiar with the process of projecting sales and earnings growth.
- Become familiar with how to determine whether a stock is reasonably priced.
- Identify three ways to achieve return on stocks.
- Identify ways investors can manage risk in picking individual stocks.

Looking to the Future

Once we've determined the company in question is likely a high-quality one worth studying further, we next project sales and earnings growth into the future. A company's future growth is a pivotal point in a stock study!

Projecting Future Sales and Earnings Growth—Why Do We Do This?

These projections are part of the building blocks we use to forecast a potential high price and low price for a company's stock in the next five years. Using that information will help us determine if the stock is selling at a reasonable price.

As fundamental investors, we know that in the short term, the market may not reward the company for its excellence. But over the long term, we trust that it will. So it's the long-term projections five years out we care about.

Projecting Sales Growth

We start by projecting sales growth five years out because we need this for building our earnings projection over that same period of time. The projected sales growth rate drives the earnings growth rate five years into the future, which ultimately drives the future stock price.

Strength and Consistency of Historical Sales Growth Rates

One of the things we rely on heavily when making this projection is the strength and consistency of historical sales growth. History is a powerful teacher for beginning and experienced investors alike.

What this means is we will take the historical sales growth rate into consideration to start with when deciding on future growth rate projections. This is a reasonable place to start since company management has demonstrated its ability to successfully operate at those levels.

Projecting Earnings Growth

We then project earnings growth in light of the sales projection. We'll consider the company's history of earnings growth and any goals it has stated. We can also access analyst reports, analysts' consensus estimates and other data points to assist us in making a well-thought-out and reasonable projection.

When we’re finished, we 'll use our earnings growth rate projection to arrive at an estimate of earnings per share five years from now.

For example: If we have projected growth of 15% a year, and the earnings per share at our starting point is $1, five years from now the earnings per share will be $2.

There are two things to keep in mind regarding projections:

- It’s prudent to be conservative. A firm might have increased earnings 25% annually over the past 10 years, but such performance is extremely difficult to maintain.
- Earnings advances can outpace sales growth for only so long. Over the long term, they usually settle in at the rate of revenue growth.

Checking Valuation

How do you determine if a stock is reasonably priced?

Once we've projected the EPS five years from now we're ready to take the next steps that will enable us to answer our second question.

Is the stock reasonably priced?

Price-Earnings Ratio

Our first step is to evaluate the stock's high and low price-earnings ratios (P/E) over the past several years. The P/E, the stock's price divided by the company's earnings per share (EPS), is how much the market is willing to pay for $1 of a company's earnings; it's the most common way to measure how expensive a company's stock is.

Estimate Future Average High and Low P/E

Next, we forecast the likely average high and low P/Es over the next five years. We will use the historical high and low P/Es to help us make these forecasts. Historical valuations can help us in this process, however it is important to note that P/Es often go through unpredictable periods of expansion and contraction as industries go in and out of favor on Wall Street.

Estimate Potential High Price

Next, we're ready to estimate a potential high price for our stock. It's a matter of simple math: The high point of EPS — what we forecast the EPS to be five years from now — is multiplied by the forecasted average high P/E to come up with a potential high price. For example, if we predict EPS will be $2 in five years and the average high P/E will be 30, our predicted high price will be $60.

Estimate Potential Low Price

Our next step is to estimate a low price for our stock. After projecting the average low P/E, we can multiply it by the expected low EPS to come up with a potential low price. Since we've determined this is a growth company, we usually can use the most recent 12 months' EPS as the low point for earnings.

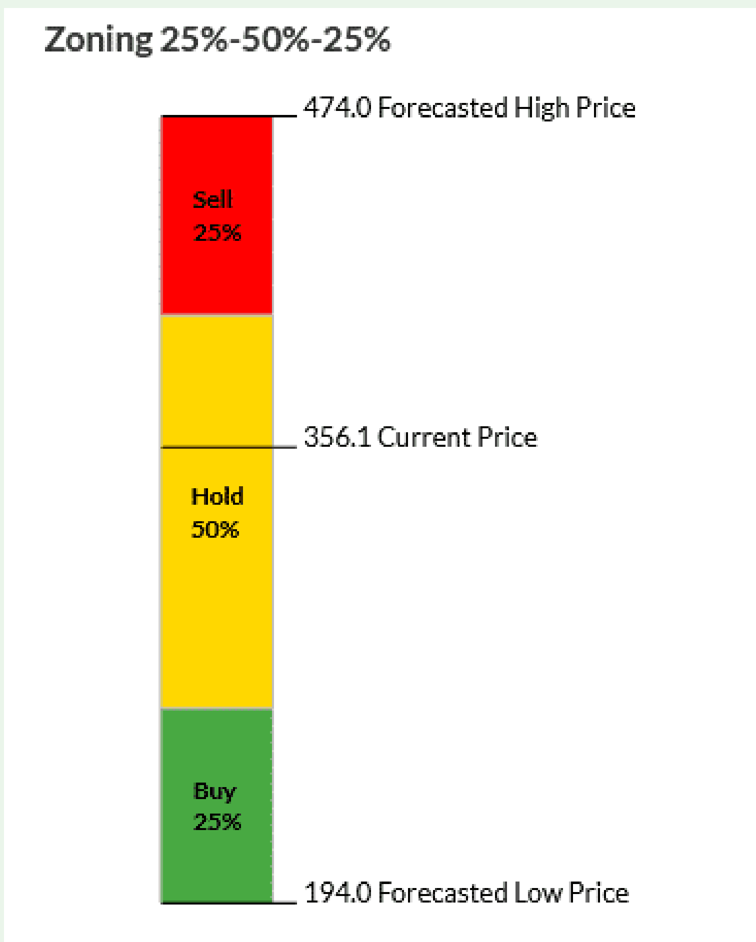
We now have a range of estimated stock prices for the forseeable future.

Return Expectations

With the stock's potential price range from low to high now in hand, we're ready to see whether this stock could provide a suitable return.

Our SSG divides the range between the potential low and high price into three zones: Buy, Hold and Sell. The lowest 25 percent of the range is the Buy zone, and the upper-most 25 percent is the Sell zone. We then lay in the current price of the stock to see which zone the current price falls within.

In our example, we see the current price of the stock falls within the hold zone and if we purchased the stock at the current price, we would very likely be overpaying for the stock. This would not be a reasonable price to pay for this stock.



There are three ways to achieve a return on stocks...

1. through dividends;
2. through the market increasing the stock's price in concert with the earnings growth;
3. through the stock's price rising because the market believes the P/E should be higher.

We aim for our stock portfolio to return 15% annually on average over the next five years, or a doubling of return. That's an aggressive target, but the idea isn't to be disappointed if we fail to meet it. It's to maintain our focus on seeking high-quality growth stocks that are generally growing faster than the overall economy and inflation combined.

Managing Risk

Investors can manage their risk in picking individual stocks by following some simple rules:

1. Require that the company have at least five years of financial history. Younger firms haven't developed enough of a track record for assessing management performance.
2. Study only companies that have proven they can make money. Someone who invests in a company that has never reported earnings is speculating, not investing.
3. Understand the possible risk and reward of owning a stock.
4. Diversify your portfolio. Even if you've done your homework on every holding using all the information you need to make an informed decision, you'll still make mistakes. If you have a good-size basket of stocks, however, you'll also have some stocks that perform much better than expected.

Key Idea Review

Q) Besides investing in high-quality growth stocks and diversifying your portfolio, what other principles can help you build wealth over the long term?

A) Let's review the first two BetterInvesting principles:
B)

- **Invest a set amount of money regularly.** Do so regardless of the swings in the market.
- **Reinvest all earnings.** By reinvesting all your dividends and profits from the sale of stock, you'll fully leverage the power of compounding.

Conclusion

The type of analysis we've outlined in this course provides a lot of fundamental information investors need to determine whether a stock is a suitable investment - but not everything. Learning to use the Stock Selection Guide, reading annual reports, listening to conference calls and viewing company presentations will help you form a fuller picture of the company.

In today's unpredictable, volatile market, fundamental analysis is even more important than usual. But for an investor using a simple, straightforward methodology that focuses on the long term, these are also times of great opportunity.

Take the next step and learn the BetterInvesting stock selection methodology in its entirety by viewing the Intro to the SSG stock selection program found in the Video Learning Library at https://www.betterinvesting.org/members/learning-center/video-learning-library.