

ADDITIONAL THOUGHTS AND REPOSSES ON "WHY THE TORTOISE SOMETIMES WINS"

During the session there were several questions asked that were answered. I thought providing fuller answers might help understanding. So here are a few additional thoughts in response to some questions asked – Avi

[Note the questions were edited to eliminate typos and to clarify the question, but the intent of the question was not altered.]

Q: Can you clarify what you mean by P/E expansion?

A: P/E expansion is simply the P/E Ratio expanding or increasing. The reason this is important is that our stock price is the result of multiplying the company's Earnings Per Share (EPS) times the P/E Ratio.

Normally EPS goes up, but we should think about what happens even if it does not. If Earnings Per Share stays the same, our stock price can go up if the P/E Ratio goes higher. For example, let us say that our EPS is \$1 per share and we buy the company at \$10 per share, the multiple of the EPS or P/E Ratio is 10 ($\$1 \times 10 = \10). Assuming the EPS doesn't move, but market sentiment about the future causes investors to be willing to pay a P/E Ratio of 15, our stock now becomes worth \$15 ($\$1 \text{ EPS} \times 15 \text{ P/E Ratio}$), so our stock price has gone up simply because P/E expanded.

In the real world it doesn't happen in a vacuum, normally if EPS are not increasing it is unlikely the company will get much P/E expansion because the P/E Ratio is based on market expectation for the future. If the future is not looking any better, then in theory the P/E Ratio should not change, well at least not go higher.

Think of P/E expansion of an added booster for our stock price.

Q: What factors trigger PE expansion for slow growing EPS?

A: P/E expansion reflects how many times the Earnings Per Share our stock price is selling at. It is driven by market sentiment reflected in how much the market is willing to pay for each dollar of the company's EPS. It can be driven by many things, among them rumors (such as a new product, a large customer, a possible merger, or acquisition). It is also driven by how the company performs vs. other competitors, and the market and the economy. It truly reflects what the market thinks about the company. It does however go up and down within what we sometimes refer to as the signature P/E. We calculate this by averaging the prior 5 years of P/E to give us a good picture of the normal range. The P/E tends to move up and down within that range depending on how the market feels about that company at any given moment. Our goal is to purchase when the P/E is below the average of the High and Low signature P/E.

If you look at a Tortoise, they tend to have a pretty stable P/E range, and you will see that each year it approaches the top of the range and each year it approaches the bottom of the range. It moves up and down within the range during the year. Our goal is to buy the Tortoises when they are nearer to the bottom of range, which gives us room for P/E expansion as the stock P/E ratio moves back up to nearer the top of the P/E range.

Q: Where does reinvestment of dividends come into the Total Return?

A: Dividend reinvestment does not change our Total Return because we calculate the payment of that dividend into our return on the company.

If you think about it, dividend reinvestment is the equivalent of you receiving a dividend and then using it to buy additional shares of the company. Whether you buy more shares of a company or use your dividends to buy more shares of a company, you have increased your ownership, which then compounds the earnings on those dividends by essentially acquiring more shares that are earning that same Total Return.

Q: On one of his tables, one column was projected Total Return and how to identify small return companies x bigger return ones.

AP: I believe the table you may be referring to is the Excel spreadsheet showing the club portfolio on slides 31 and 32. Or it may be the Toolkit Offense Report on Slide 33.

Neither of those reports show the projected Earnings Per Share growth rate, however they do show the Projected Total Return for each company.

*We do not normally consider a company small or large based on the company's projected **Total Return**. We do that based on sales growth, although many sort companies based on "market cap" or market capitalization.*

What we do with Projected Total Return is determine whether it is sufficient for our investment purposes. BetterInvesting targets a 15% compounded annual rate of return. At approximately 15% our investment would double every 5 years.

There has been much discussion regarding the 15% and there are proponents who suggest that the goal should be to outperform the market by a certain percentage, because the market goes through periods where it performs better and periods where it performs worse.

Q: If the p/e expansion doubles the P/E would you sell like LaFarge?

A: I do not think doubling or going up any specific percentage is the operative here. I believe we look at the company's P/E history and as it gets nearer to its historic average high P/E our potential for further expansion decreases. That affects our ability to get future price appreciation. So, I think the goal is to look to sell when the P/E gets exceedingly high based on the company's P/E history, not when the P/E goes up a certain percentage, such as doubling.

Q: He said Total Return comes from price appreciation + dividends. Can he detail that formula a little more?

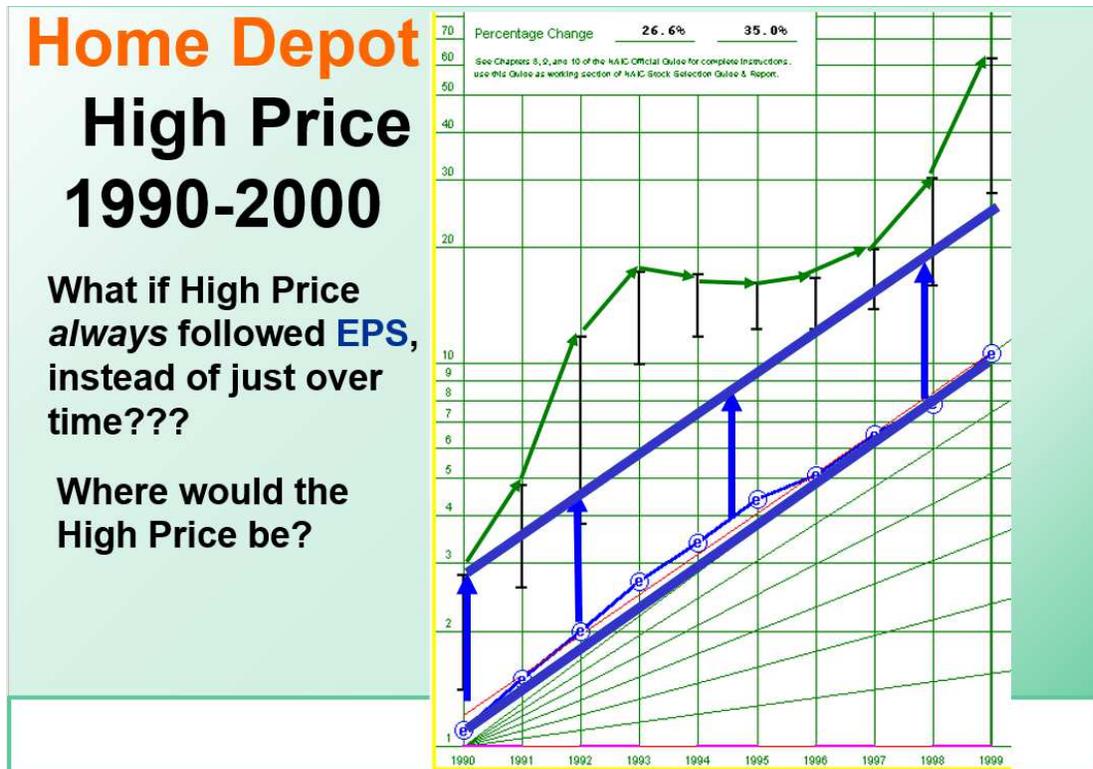
A: Mathematically calculating compounded annual return is complicated. Rather than lay out the formula, I choose to let software do the number crunching for me.

We get our return on our investment from two places: the price going up and from the dividends the company pays us when we hold the stock.

So simplistically: Total Return = Price Appreciation plus Dividends

Q: When the PE is high, one would think of selling. But, what kind of analysis do you do to see if the earnings will "grow into" the higher PE?

A: I think a graphic from another one of my presentations might help here.



If you look at the 4th year from the left, you can see that the High Price (the green arrowed line) moved way ahead of the bottom blue line (EPS growth). That means the P/E expanded a great deal.

My question is, if you look at what happened for the next 3 or 4 years, the price went almost nowhere while it waited for the EPS to catch up. So yes, the EPS should eventually catch up to where the P/E was, but that essentially makes to P/E lower at the same price. [If the price remains the same, and if the EPS is higher, the P/E is lower – if a stock sells for \$20 and EPS is one dollar the P/E is 20. If the stock price stays at \$20 but the EPS catches up and goes to \$2, your P/E ratio has dropped to 10. That is P/E contraction.]

My question is that if you know the price has gotten ahead of the EPS, why would you hold the company that will likely not appreciate until the EPS catches up? Wouldn't it be better to sell, and replace it with something that will increase in value? If it is a great company, keep an eye on it and buy it back in once the EPS catches up and there is once again room for price appreciation.

In Home Depot's case, you would have held the company 3 or 4 years without the price really going up. Do you want to keep a company with that little return in your portfolio when you can use the money elsewhere for 4 years and put it into something that will increase your portfolio's value?

Q: Where in the SSG do we find Projected Total Return percentage?

A: As I mentioned we do not. The SSG looks at the Total Return we expect over a 5 year period and converts it to an annual amount, the Compound Annual Rate of Return, which can be found at the very end of the SSG in the 5-Year Potential section.