

**Part A—Using Value Line for an Overview of the Company and Industry**

There are thousands of publicly traded companies in the US and thousands more overseas. There is something to like about most of them. Still, when one is putting in the effort to research and buy individual stocks it makes sense to be highly selective and buy only the very best. Simply going through steps 1–3 in this handout would have saved most investors most of the money they lost in the dot.com bust.

Value Line, S&P and Morningstar are the three most reputable independent research providers. Of the three, Value Line hard copy is generally the best place to start your assessment of a new stock since it is found in most libraries. Further, the Value Line format makes it easy to quickly compare your stock to others in an industry and scan through tons of data to see if you have a pitiful dog or a potential winner. If Value Line does not cover the stock, you can move on to S&P and Morningstar looking for the same data outlined here. If a stock passes your first screening through Value Line, you may want to get a little more detail by checking out the other two providers.

**Step 1. Find your company in the Value Line index and find its industry and company page.**

What is your company's **name**? \_\_\_\_\_

What is your company's **ticker symbol**? \_\_\_\_\_

In what **industry** is your company? \_\_\_\_\_

In what **sector** is your company?

- |   |  |  |
|---|--|--|
| <input type="checkbox"/> Consumer Staples | <input type="checkbox"/> Telecom           | <input type="checkbox"/> Basic Materials |
| <input type="checkbox"/> Finance          | <input type="checkbox"/> Consumer Cyclical | <input type="checkbox"/> Industrial      |
| <input type="checkbox"/> Healthcare       | <input type="checkbox"/> Energy            | <input type="checkbox"/> Technology      |
| <input type="checkbox"/> Utilities        |  |  |

Read the section marked "**Business**": what does your company do? \_\_\_\_\_

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## Step 2. How profitable is your company?

A company's **net profit margin** is one of the most important measures of profitability. If a company has net profits of 25% it means that 25 cents out of every dollar of sales remain even after the company pays for raw materials, salaries, research and marketing, taxes and borrowing costs. In general, a bigger net margin number is better, but it's also important that a company be consistent and is able to stay fairly profitable even during the inevitable business downturns. A 25% net margin is generally a better thing to have than a 5% net profit margin, but great companies can be built even with a 5% net margin if management is very smart.





a. Look for the net profit margin line. Is your company losing money? (Profit margin NM)

Yes   No



b. If your company is profitable, what are your company's net profit margins...

...this year? \_\_\_\_\_ ...last year? \_\_\_\_\_ ...next year? \_\_\_\_\_




c. Has the net profit margin been:

- Improving? 
- Deteriorating? 
- Bouncing all over the place? 
- Pretty consistent over time? 

d. Flip back to the Industry page and look at the lower left hand box. Find industry average "net profit margin" line and compare it to your company. Is your company...

- More profitable than average? 
- Less? 
- About the same?

e. Flip through the individual company profiles focusing only on the net profit margin line.

- Is your company one of the most profitable in the industry? 
- And/or have its profits been among the most consistent? 
- Or have profits been showing very dramatic improvement? 

If you can't answer yes to one of the questions in e) you should already be feeling uneasy about this stock. **If it is not making any money now and has had more than one year of losing money STOP RIGHT HERE and leave this stock to gamblers.** If you are interested in this particular industry, be sure to flag the most profitable companies in the group for further study.

### Step 3. How well managed is your company?

**Return on Shareholders' Equity (ROE)** is an excellent measure of overall management skill. ROE is affected by the company's profit margins and its ability to use debt and assets wisely. A company with a high ROE of 20% returns 20 cents in a year for every dollar originally invested, reflecting either exceptional profitability or very careful use of assets. Low ROEs, below 10%, usually reflect several years of no profits or big, overly ambitious acquisitions that involved big expenses—not the sort of thing you want to see. It's important to note that a company can have fairly low profit margins (say 5%), but if it is well managed and consistently profitable, it can attain very high returns on equity over time and can be a VERY good investment. Avoid companies with NMF on the ROE line—they are destroying shareholder value through poor management.

a. Look for the Return on Shr. (shareholder's) Equity line. What is your company's ROE for...

...this year? \_\_\_\_\_ ...last year? \_\_\_\_\_ ...next year? \_\_\_\_\_

b. Has the Return on Shr. Equity been:

- Improving? 😊
- Deteriorating? 🚩
- Bouncing all over the place? 🚩
- Pretty consistent over time? 😊

c. Flip back to the Industry page and look at the lower left hand box. Find industry average "Return on Shr. Equity" line and compare it to your company. Is your company's return to shareholders

- Better than average? 😊
- Less? 🚩
- About the same?

d. Flip through the individual company profiles focusing only on the Return on Shareholder's Equity line.

- Is your company one of the best in the industry? 😊
- And/or have its returns been among the most consistent? 😊
- Or have they been showing very dramatic improvement? 😊

#### Step 4 How shareholder-friendly is your company's management?

**Dividends** are key for shareholders in large companies—don't buy a big company's stock unless the company has a policy of paying a generous dividend and making those dividends grow! Management can also reward shareholders by using cash to buy back a company's shares on the open market, thus helping to support the stock price. It's okay for small companies not to pay a dividend.

Does your company pay a dividend? (Box in lower left hand corner, at bottom)  Yes 😊  
How much per share per year? \_\_\_\_\_

How fast have dividends been growing (Value Line box in middle of left hand column labeled Annual Rates, the line labeled Dividends)...

...over the last 5 years? \_\_\_\_\_ ...the last 10 years? \_\_\_\_\_

What is the dividend yield for the stock? (Top line, right hand side. Yield= annual dividends per share divided by price per share) \_\_\_\_\_

How does the dividend yield compare with other stocks in the industry?

- Higher? 😊
- Lower?
- About average?


Has the company been **buying back its own shares**?  Yes 😊  
(Look at shares outstanding line to see if the number is getting smaller)







#### Step 5 Study the long-term stock chart for your company

**Stock charts** have two major functions for normal investors:




1. Charts tell you what the market thinks about a stock. Each chart tells the story of how traders and the investment community react on a day-to-day basis to news about the company, the industry and its competitors.
2. Charts can keep you out of big trouble by warning you if a stock is cyclical, or has had a big move upward (making it potentially overpriced) or is being actively sold by big institutions (often for a very good reason!).

Stock charts help you listen to the market—and wise investors do. When a stock chart shows a big move—in whatever direction—pay attention, the market is telling you there is a story there. It's up to you to find out what that story is, and whether you believe it, before you buy. I like to start with the charts before I get caught up in the details of analysis—it helps keep me unbiased and focused on the big picture of how I can make money with this particular stock.

- Study the long-term (10 year) stock chart on your company's Value Line page. Has the stock had a lot of drastic up and down moves over the years? If so, it may be very cyclical or be a 'traders' stock. Be very careful! 

- Did the stock have a big peak early on and then a big crash? If so, has it formed a new flat ‘base’?  Could be a buying opportunity, but investors once burned are twice cautious and the stock will often need years to recover.
- Has the stock been going nowhere for many years? (This can be a great opportunity if there is a catalyst for positive change.) 
- Has the stock been moving up **gradually** and smoothly over many years? If so, it’s probably a well-managed company and a Wall Street favorite. Could be a great stock to learn about and buy on pullbacks. 
- Has the stock been drifting down for years making a series of lower lows, and lower highs? Be careful—you’ll need to understand why investors are losing interest in this stock before you buy! 
- Has the stock moved up very sharply over the last year or so? Be careful: stocks that move up sharply have a tendency to ‘correct’ downward just as fast! 
- Has the stock has formed a new plateau after a long move up? Many excellent stocks pause for a year or two and then take off again if business is still good. This can be an ideal buy moment—be prepared to work extra fast on your research and make a move fairly quickly. 

Flip through all the company pages in the industry group you are studying.

- Has your company’s stock been more volatile than most, with more ups and down? 
- Or is your company a ‘steady Eddie’, with a long fairly smooth stock pattern? 
- Has your company had the biggest price move in the group? If so it’s probably not wise to jump in now, even if it’s a good company. Better to wait and watch for a better opportunity. 

You now have a basic picture of how a company’s stock has performed over the short term—and over the course of several years. Take a quick look at your notes above and at the charts and highlight any observations you think may be critical.

**STOP HERE!** If the company is reasonably profitable and has a decent (not too volatile) stock chart it’s time to do a little more research. If not, ditch your company and put your research time into another stock, preferably one that is one of the best in its industry group.

## Step 6 Is the business growing?

On the Value Line page, find the box on the left labeled “Annual Rates”. This box summarizes growth for five key measures of financial performance: sales, cash flow, earnings, dividends and book value. Stock investors make money because companies grow, enabling them to pay more dividends. Investors also make money as the company’s sales, profits, book value (a measure of assets) and cash flow grow, signaling a strong business that warrants an increase in the stock price. Dramatic changes in growth rates (up or down) always affect a stock’s price. There is no “best” growth rate, but if a company is not showing some growth in most of these metrics then the stock’s total return (dividends + stock price gains) will be disappointing.

**Sales** are the most fundamental form of grow and reflect new products, expansion into new markets and the ability to raise prices.

- How fast has your company been growing sales over the last five years? \_\_\_\_\_
- Ten years? \_\_\_\_\_
- How fast are sales expected to grow in the future? \_\_\_\_\_

**Earnings** growth is just as important as sales growth, after all, if the new products don’t make money, what’s the point?

- How fast has your company been growing earnings over the last five years? \_\_\_\_\_
- Ten years? \_\_\_\_\_
- How fast are earnings expected to grow in the future? \_\_\_\_\_

## Step 7 Is the stock overpriced?

Some people think that a stock priced at \$5 is cheap and a stock priced at \$50 is expensive, but that’s not the right way to think about stock value. A key measure is the **price to earnings ratio or P/E ratio** (find it in the middle of the top line on your Value Line sheet, in bold). The P/E ratio is usually calculated by dividing the share price by the current earnings per share. *There is no ‘right’ P/E, but there are definitely wrong P/Es. During the dot-com boom there were barely profitable companies selling at over 100 times earnings per share—historically prices like this have never, ever been justified.* In fact P/E ratios above 50x current earnings per share are a red flag. (Current earnings = 2 most recent quarter’s earnings + 2 upcoming estimated quarters). It generally pays to be patient and buy a stock only after it’s price has dipped below this level. In general, though, P/E ratios are relative: faster growing companies, and companies with good track records often carry above average P/Es for many years and that’s just fine.

What is the P/E ratio on your stock? \_\_\_\_\_

Is your stock more or less expensive than most stocks in the market? The box just to the right of the P/E ratio box shows the relative P/E—if it’s less than 1.0, then your stock’s P/E is lower than the market average. **It’s unusual for a good company to sell at a discount to the market, but it happens and can be a great buying opportunity.** What is the relative P/E for your company? \_\_\_\_\_

### Step 8 How large is your company?

Market Capitalization: \$ \_\_\_\_\_ bil = Large (>\$10b) Medium (\$1b–\$10b) Small (<\$1b)

All things considered, small companies can generally grow more quickly than large companies, but large companies typically give investors a smoother ride—plus they often have the resources to weather the inevitable business downturns, exploit major new opportunities, such as expansion into international markets, and still pay dividends to shareholders. Further, understanding the growth cycle of corporations helps you appreciate the numbers you’ve been studying—one can forgive small companies for being less consistent in profitability and more volatile as stocks because when they are doing well life (and stock appreciation) is so very sweet. Conversely, one can forgive a large company for having a lower growth rate for the sake of a nice steady dividend.

### Step 9 How strong is your company?

Value Line rates a company’s financial strength with a letter grade A to F, reflecting how much debt the company has relative to assets and cash income. What is your company’s financial strength rating (lower righthand corner)? \_\_\_\_\_  Is it above B+? 😊  Is it below B? 🚩

Stop here. Count up the number of Red Flags (\_\_\_\_\_) and the number of Gold Smiles (\_\_\_\_\_). **Are there more Red Flags than Gold Smiles?**  Yes  No **Forget this company—or wait and watch for a better price.** If there are lots of Gold Smiles your company may be a very good buy—it’s time to move on to Part B to help you to think through your decision to buy stock in the company.

## Part B—Why Should I Buy This Stock?

“A share of stock is not a lottery ticket; it’s part ownership in a business.”—Peter Lynch

You can learn a great deal about your company’s business from Value Line. A visit to the company’s web site is also in order to help you understand the company better. Finally, you need to think clearly about what kind of company you are buying and whether it fits your portfolio. Every portfolio should have a mix of large companies and small companies, as well as broad representation in different industry groups. Investors who just buy a stock because they “like the story” wind up buying too many of the same kind of companies (i.e., all health care, or all technology) and throwing their portfolios out of balance. Understanding why you bought the stock to begin with will also help you make decisions on when to sell—for example, if you bought stock in a small fast-growing company because you expect its stock price to go up quickly, then it makes sense to take some profits after the stock has appreciated 50% in three months! And conversely if your big old steady-Eddy stock is not going up, but keeps paying a dividend, then why sell it? After all, you bought it for dividend growth in the first place!

The checklists below, adapted from Peter Lynch’s bestseller *One Up on Wall Street*, can give you some helpful ways to think about your company. Use the checklists to guide you as you study the company web site, and read comments on the company in Value Line, Morningstar, and financial news sources such as the *Wall Street Journal*. Listen to management talking to analysts on the quarterly conference calls (available on most web sites). Notice the kinds of questions that the analysts are asking and how well management fields questions. If, on balance, there seem to be more gold smile positives than red flags, figure out whether the stock fills a particular role in your portfolio. If it does, go ahead and take a deep breath and buy a little. Watch, read and learn for a few months and if you are still happy with the company, buy more.

### Step 1 Checklist of Positives 😊

- Company is the biggest and the best
- Stock pays a handsome and growing dividend
- Company is small but doing it better and taking market share
- Company has a breakthrough product or service
- Company has a clear strategy for growth
- Company occupies a special and protected niche
- Company does something boring, unpleasant or dangerous
- Stock has been going nowhere for years, but business is good
- Management owns lots of stock
- New management is taking over
- Fewer than seven analysts follow the stock
- There is little institutional ownership
- Company has a proven record of weathering downturns well
- Nobody can think of anything nice to say about company or industry

## Step 2 Checklist of Negatives ■

Wait for a better buying opportunity, take some profits if owned:

- Stock has run up tremendously in last year or two
- Stock has a current P/E of more than 50x earnings
- The media have discovered the company and are doing glowing stories

Avoid, consider selling if you own:

- Company is a slow grower or cyclical that refuses to pay a dividend
- Company faces huge, hard to quantify liabilities
- Company is a laggard with low margins, ROE and growth
- Company faces major new competition and can't possibly compete
- Company is dealing with deeply irrational, hostile regulatory environment
- Company is in a highly cyclical business and has no major competitive edge
- Company has had several quarters of losses and/or big write offs
- Company has recently made several BIG acquisitions
- Company has taken on a lot of debt (more than 40% debt/equity ratio)

Congratulations! If you've gotten this far and your company still has more pluses than minuses then you've probably got a stock that's a buy. But wait—even if it's a good stock, you need to figure out how it fits in your portfolio:

## Step 3 Portfolio Balancing Checklist

- I have no companies in my portfolio in that industry group
- I need more small to mid-sized, fast growing companies in my portfolio
- I need more large, stable dividend-paying stocks in my portfolio
- I need more foreign stocks in my portfolio
- It's a replacement for stock X which I recently sold
- It's a turn-around or contrarian stock and I don't have any of those
- I'm buying it for a quick trade:  
Take profits at the following price \_\_\_\_\_ (e.g., after a 30% gain);  
Cut losses at \_\_\_\_\_ (generally 7–15% of purchase price)

## Part C—Understanding Your Company in Depth

Warren Buffet, long-term investor *par excellence*, tries to understand the companies he invests in as well as if he were planning to buy the whole company. You should think this way, too. Over the years, you will come to know “your companies” like a manager or owner—and like any manager, your depth of understanding will let you ride through short term problems without too much anxiety, or take advantage of a short term problem to buy more shares, or understand when it’s time to get out! So here’s an outline of *some* of the things you should be trying to understand as you study your company using company sources, analyst reports and stories from the financial press. Try to write a short summary based on what you’ve read. You may not be able to answer all the questions right away, but over the course of several months you’ll fill in the gaps as your knowledge grows.

### Step 1. Understanding the Top Line: Sales

What does your company make or do that is special?

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List and describe the major products or services your company provides:

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If your company is a large one, what are its major divisions:

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What products/services/divisions are growing fastest and why?

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What market factors are driving growth in the company's key products?

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What risk factors threaten growth of major products?

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Does your company occupy a protected niche?

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If you company has lots of competitors how is it managing to compete?

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What international markets are important for your company?

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Which overseas markets are growing fastest? Why?

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Does your company face particular challenges overseas? How is it meeting them?

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How much experience does management have running overseas divisions?

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Has your company grown by acquisition? How good are they at integrating new businesses?

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Are the acquisitions in very similar businesses or are they very different? Do the acquisitions make sense to you?

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## Step 2 Understanding Profitability

What are the biggest expenses your company faces? How is your company managing costs?

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Are there changes in the business that will cause profitability to increase or decrease over the next few years? Describe.

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### Step 3 Understanding the Balance Sheet

Does your company have to spend a lot on new plants and equipment?

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Does your company have a lot of debt? What are management's plans for paying down the debt?

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How much cash does the company have? Is cash growing each year?

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Does the company have big liabilities, for example unfunded pension liabilities or product liability issues?

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**Mary Ellen McCarthy, Ph.D.****Responsible Investing**

This stock worksheet was developed by Mary Ellen McCarthy, founder of Responsible Investing. Mary Ellen is available for one-on-one or small group financial coaching designed to help you take charge of your own financial life. Coaching can help you:

- Learn how to use on-line resources
- Sharpen a particular stock-picking skill like chart-reading
- Review the stocks in your portfolio
- Check out a 'buy' idea
- Make educated mutual fund choices
- Balance or re-balance a portfolio
- Make the most of a retirement account

For more information on Responsible Investing's coaching services, or to schedule a free initial evaluation, call 617.277.6107 or visit [www.responsible-investing.net](http://www.responsible-investing.net).