



smartwomansecurities

Date

How to Find Investment Ideas

Speaker
Position
Company

Announcements

- Please enter any SWS related announcements here.



Company and Financial Analysis

- **Week 4:**
 - Finding investment ideas
 - Company and industry trends
 - Understanding the business
- **Week 5:**
 - Discussing financials
 - How to understand financial statements
- **Week 6:**
 - Important financial metrics
 - How to calculate financial ratios
 - How to understand what financial ratios mean
- **Week 7:**
 - Putting it all together for an investment recommendation



Tonight's Agenda

- Market Update
- Finding Investment Ideas
- Company Trends
- Industry Trends
- Understanding the Business



This Week's Seminar

- **After this, you should be able to:**
 - Brainstorm trends and look to see how past trends affected certain stocks or certain industries
 - Be able to create a list of “interest” stocks within industries to research more in-depth
 - Research these “interest” stocks deeper to understand their core business model
 - Have a list of good companies that you believe MAY be good investments (pending sound financial review... to be covered next seminar)



Market Update

- Have speaker comment on what happened in the markets for past week.
- We encourage speakers to create a slide of important occurrences (see next slide for example).



Market Update Example Slide

- S&P200 gained 2.3% on the week; DJIA was up 2.1% while the NASDAQ was up 2.9% as investors seemed less concerned about risks in the credit markets
- There were mixed technology results as Apple & Microsoft posted solid positive Q3 earnings; rising concerns about semiconductor valuations
- Merrill Lynch wrote down \$7.9b in losses from subprime losses, although the stock rallied on reports that CEO Stan O'Neal would be ousted
- Bank of America announced 3,000 job cuts in the corporate & investment banking division
- Crude oil futures climbed above \$92; some analysts expect it to surpass \$100



Finding Investment Ideas



Picking Stocks

- So you've opened an investment account: now, what stocks do you invest in?
- One approach would be to put your money in a mutual fund or index fund, and most likely make the returns of the market
- OR, you could try to beat the market on your own, by doing the research and picking stocks that you think are strong buys
 - With this approach, some things to ask yourself:
 - Time horizon of investment
 - Risk
 - Type of stock (growth, income, value, etc.)



How to Begin?

- How do you begin thinking about which stocks are good investments?
- How much of “what you know” can translate into a good stock pick?
 - Like everything else, we recommend looking at trends in the macro marketplace and within industries
 - o One of Lynch’s picks was L’eggs, because his wife saw an emerging trend where women wanted to buy high-quality pantyhose in convenient places



What Drives a Stock?

- You want to buy a stock that you think will have a higher price in one year
- A simplified view of stock prices
 - Stock price = Earnings Per Share (EPS) x Price/Earnings Ratio (P/E)
 - o Earnings Per Share = Company Earnings / Number of Shares Outstanding
 - Company Earnings = Revenue – Expenses
 - Shares Outstanding = Number of claims on the company's earnings
 - EPS thus means how much each shareholder “owns” of the company's earnings
 - o Price/Earnings Ratio = Stock Price/Company Earnings
 - Stock Price = Price at which the stock is trading
 - Company Earnings = Revenue – Expenses
 - P/E is what you should pay for a given level of earnings



Earnings Per Share and P/E

- EPS is how much the company is making and P/E is what you should pay for that
- Google (GOOG) stock price of \$625 = EPS of \$15.28 x P/E of 41x
- EPS is a function of revenues & expenses >> this is where trends can help you find ideas
- P/E is a function of earnings growth and of investor sentiment >> this is typically more difficult to get right
- We'll spend more time in coming classes on how to determine future EPS and the P/E ratio



Company Trends



Apple (AAPL)

- The first iPod came out in October 2001
 - If you bought \$5,000 of AAPL in October 2001 when you bought that first iPod and sold it in January 2008, you would have made \$120,650 profit (gain of +2413%)
 - But, even if you missed the stock idea the first time around and didn't invest \$5000 until January of 2006 and sold in January of 2008, you still would have made \$8557 (gain of 172%)



Capitalizing on Trends

- Why was APPL a good stock pick back in Oct. 2001?
 - Cheap; right after the tech bubble
 - Introduced an innovative new product that became a hot commodity (iPod)
 - Became the “it” product of the new millennium
 - EPS grew from \$0.00 to \$3.00 from 2001 to 2007
 - In 2007: success of the iPhone (AAPL jumped from \$120 to \$140 in a month after the launch, or +17%)



Starbucks (SBUX)

- SBUX was founded in 1971 but really took off as a brand in recent years
 - If you had bought \$5,000 worth of SBUX at its IPO in 1992 and sold it in July 2007, you would have made \$184,100 (+3782%)



Capitalizing on Trends

- **Why has SBUX's stock been huge?**
 - Took a familiar product and built a brand around it
 - Targeted a specific demographic (white-collar & high income)
 - Transformed a commodity (coffee) into multiple drinks with fancy-sounding names
 - The Starbucks “experience”
 - EPS grew from \$0.28 to \$0.87 (+300%) from 2001-2007



New York Times (NYT)

- Trends can go in the opposite direction too
 - A \$5,000 investment in the New York Times in September 2003 would only be worth about \$1,700 in September 2008 (-66%)



Predicting Trends

- Predicting Trends = Predict Earnings (EPS)
- Remember: $\text{stock price} = \text{EPS} \times \text{P/E}$
- EPS is a function of:
 - Revenue – expenses = earnings (much more on this next week)
 - o Revenue growth: how long will people be willing to buy Crocs? Will people own more than one pair?
 - o Are there other trends of which you are aware?
 - o Costs >> can't really figure out via trends, we'll address this next week
- Finding trends:
 - Reading the newspaper, being aware of the world around you, noticing things in your own life, knowing the basics of the economy, GUT FEELING ... just know that sometimes you will be wrong!

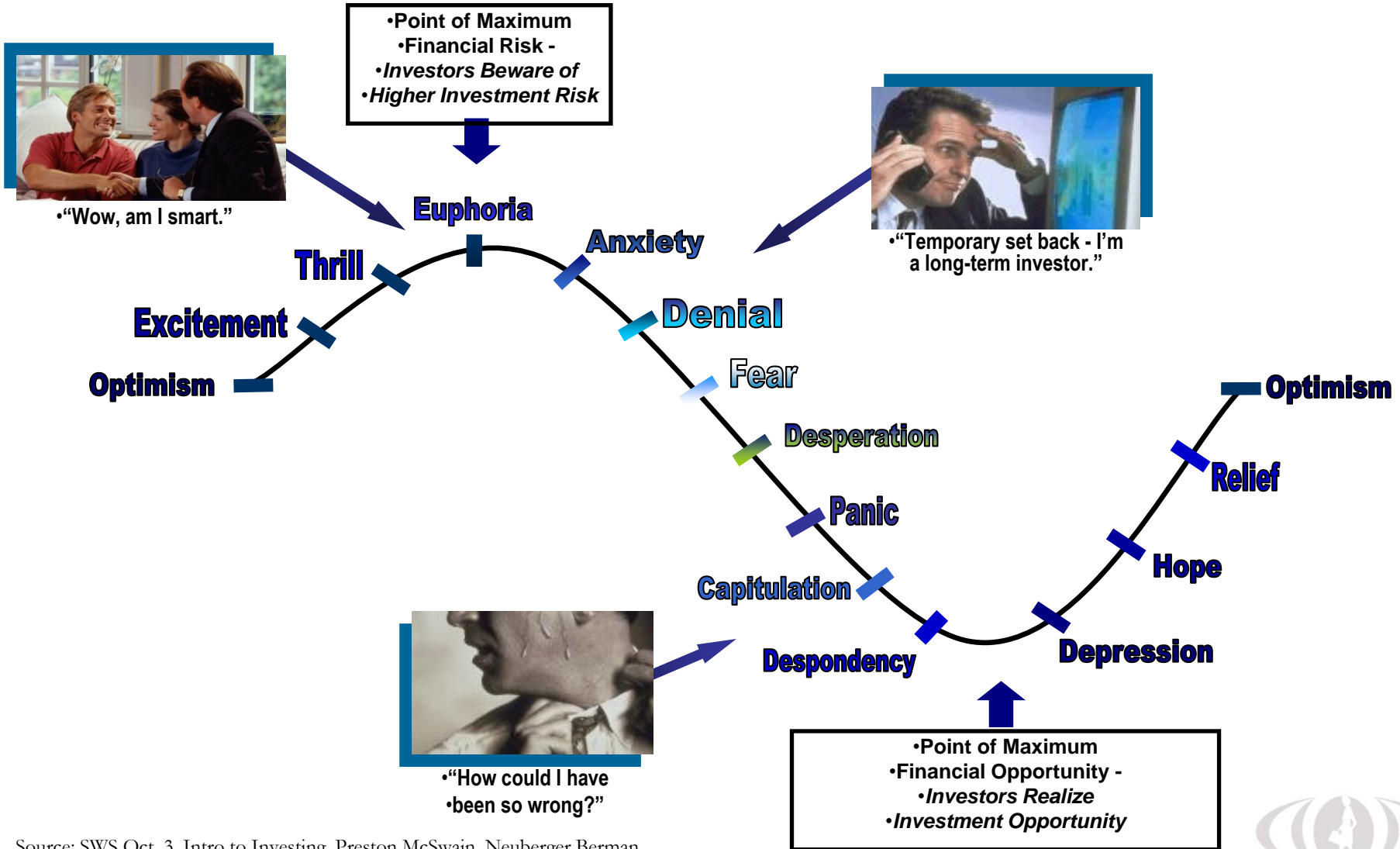


It's Hard to Predict Trends

- Ideally you want to foresee trends, not jump on the bandwagon
 - You may jump on the bandwagon too late
 - If you bought SBUX in January 2007 you would've seen your investment lose 57% of its value as of September 2008.
 - Sometimes you have to wait it out and be patient
 - Between October 2001 and April 2003, AAPL was actually down 17%
 - Sometimes you may ride a trend to the top and then see it come crashing down (tech bubble)
 - The lesson: not only should you know when to buy, you also have to know when to sell



Don't Invest with Emotions



Trends are Still Predictions

- If you are a really good investor, you are going to be WRONG 40% of the time.
- Trends you predict may not materialize because the company will not perform well or consumers will change their minds
 - If America is more health conscious, why is WFMI's stock price getting killed?



Notes on Company Trends

- While trends may seem to favor “growth” stocks, trends can also highlight undervalued companies
 - For instance, macro trends like food inflation (price of butter was up 70% in 2007) and typically supermarkets can do well in that scenario
 - You can then conduct analysis on the company’s financials in order to determine it is undervalued
- Your investing time horizon matters when looking at trends
 - A “trend” doesn’t have to be new in order for it to give you good stock ideas, but jumping on a trend after it’s been “discovered” won’t give you the highest returns
 - o Then again, jumping on a trend before it’s discovered necessitates that it gets discovered. Risk vs. return again!
 - If you’re investing for 30 years from now, you probably won’t have to worry too much about a health food craze...unless you think it will continue for 30 years



Trends are a Good Start

- So while trends are important, there are many other factors to consider as well
- The attributes of a company matter as well, especially in the long run
 - Quality of the company >> Porter's 5 forces
 - Quality of management >> they're the ones making operational decisions!
 - Sound operational strategy
 - Financials
 - Valuation >> P/E, P/B, EV/EBITDA (more to come next week!)
- And you must have the foresight to stick with your stock... if the market sees a trend, it's already too late



Industry Trends



Industry Trends

- Recognizing trends within industries can help us whittle down the list of companies or industries we wish to learn more about
- Oftentimes, trends fall within industries, not just across the economy
- Let's take a quick look at these two industries:
 - Healthcare
 - Technology
- We will go over these today, but just keep in mind that there are many other important industries out there

NOTE: "Sectors" are breakdowns within an industry. For example, you can speak about the "retail sector" within Consumer



Healthcare Trends

- Pharmaceuticals, biotechnology, drug manufacturers/distributors, managed care, hospitals, medical devices, contract research organizations, etc.
- Trends:
 - Strong growth characteristics: 9% of GDP in 1980 and 15% of GDP now
 - o Healthcare spending is expected to steadily continue for the upcoming 5-10 years at least
 - \$5,444 per capita spending in 2002 in US, 50% higher than next closest country
 - Aging population, longer life spans, desire to be active and healthy later into life
 - Large-cap pharmaceuticals acquiring smaller biotechs for potential drugs
 - Consolidation among managed care providers (e.g. UnitedHealth's recent acquisition of Sierra Health to expand into Nevada market)
 - Government is a growing “buyer” of healthcare (Medicaid & Medicare), so there is increasing pricing pressure in the healthcare sector
- Merck (MRK) to Johnson & Johnson (JNJ) to Community Health Systems (CYH), to Boston Scientific (BSX) to Novartis (NVS) to Genentech (DNA) to Medtronic (MDT) to UnitedHealth (UNH)



Technology Trends

- Information technology, software, hardware, communications, computers, electronics, Internet, scientific instruments, semiconductors, wireless, devices, etc.
- Trends:
 - The tech bubble burst in 2000, but the industry has been slowly recovering since then
 - Technology is more volatile than most; big new “trends” may just follow what the new generation decides is interesting: social networking, video on cell phones, etc.
 - However, the tech space is made up of a couple big players and a lot of small players; finding the next big breakthrough is, while risky, potentially very lucrative.
- Companies include: Motorola (MOT) to Google (GOOG) to Dell (DELL) to NetLogic Microsystems (NETL) to Texas Instruments (TXN) to Microsoft (MSFT) to Cisco (CSCO) to Logitech (LOGI) to Electronic Arts (ERTS)



Note on Industries

- We study industries to serve as a benchmark in which to compare stocks
 - Especially with financial metrics
- However, there are many stocks that go across these industry groups. Therefore, some industry trends may not apply to them, or may only affect a small part of their business.
 - For example, General Electric (GE) sells refrigerators but also owns NBC Universal
 - o We will talk about this more next week
- Then, in order to see what trends may affect which stocks, we must understand the company's business...



Learning more about industries

- **Yahoo! Industry List:**
 - <http://biz.yahoo.com/ic/index.html>
 - 10Ks of industry bell-weather (IBM, XOM, etc)
- **SWS resources**
 - Research Teams



Trends in 2008

- Questions to ask:
 - Are these emerging trends? Or have they already been discovered by the market (and reflected in the stock price)?
 - How long and with what probability will these trends continue?
 - Do they fit within a specific industry (ie. healthcare or technology or consumer)?



Understanding the Business



Understanding the Business

- Now you have a list of stocks that you are potentially interested in investing
- These may be across a variety of industries
- Let's whittle this list down some more...
 - Studying up on the company
 - Porter's Five Forces
 - Lastly... is it a Lynch stock?
 - o Obviously this is not a prerequisite for a good investment... but it may be interesting to look at nonetheless



Researching the Company

- Visit its website, read blogs, find research reports (if available). Do as much as you can to understand the core business
- Listen to conference calls to learn about current trends and issues
 - Earnings.com
- Read its financial reports
 - Annual report, quarterly report, focus on Management Discussion and Analysis (MD&A) section as this will describe their strategy
- Know their management
 - Get to know the management ... read their bios
 - Understand what the industry thinks about them
- Visit the company, use its products, visit its stores



Porter's Five Forces Analysis

- Porter's Five Forces are a way to understand the competitive position of a company or an industry.
- Warren Buffett likes to invest in industries that have a “moat” around them or in other words, they have a strong position that competitors cannot easily penetrate
- Five Forces
 - Rivalry
 - Barriers to Entry
 - Threat of Substitutes
 - Supplier Power
 - Buyer Power



Rivalry

- Rivalry – discusses the competitiveness of the industry and markets in which the company is located. Rivalry within that industry will be higher when there are:
 - A large number of firms – companies have to compete for the same finite customers and resources
 - High fixed costs – companies have to produce at capacity to attain lowest production costs and highest profits, leading to high production levels and large quantities
 - High storage costs or highly perishable products – producers must sell goods as soon as possible, leading to market flooding and price cuts to induce consumers to buy
 - Low switching costs – customers can switch between products easily, leading to less brand loyalty
 - High exit barriers – high costs associated with abandoning a product will prevent a fast exit from the market, especially when products used to make product are specialized and difficult to resell



Barriers to Entry

- Barriers to Entry – characteristics within an industry that protect the high profit levels of firms and inhibit additional rival companies from entering the market.
 - Entry-detering pricing: when firms keep prices artificially low to minimize profits and to prevent potential entrants from entering the market
 - Government barriers – monopoly restrictions, natural utility monopolies
 - Patents and proprietary knowledge
 - Asset specificity
 - Restricted distribution channels
 - Customer brand loyalty and difficulty in brand switching



Threat of Substitutes

- Threat of Substitutes – a product's demand is affected by the price change of a substitute product or there is a product that could be easily substituted.
 - As more substitutes become available, the demand for a product becomes more elastic as customers have more alternatives and it constrains a company from raising prices
 - A substitute could be a direct competitor or a something that is just an alternative.
 - For example, substitutes for Coca-Cola could be other sodas, bottled water, or other drinks.



Buyer Power

- **Buyer Power:** the impact that customers have or can exert on a producing industry; when buyer power is strong, the buyer has more influence in setting the price and there are multiple suppliers.
- **Buyers are powerful if they:**
 - Are concentrated such that a few buyers have a significant market share
 - Purchase a significant proportion of output
 - Can threaten to buy products from a rival firm
- **Buyers are weak if:**
 - Producers can take over their own distribution and retailing and not need the buyer to do it
 - There are significant buyer switching costs (fees for breaking contracts early) or there is no substitute product to which the buyer can switch
 - They are fragmented such that no buyer has significant market share or ability to influence prices
 - Producers supply critical portions of buyers' input



Supplier Power

- **Supplier Power** – the impact that the supplier–buyer relationship has on the buying firm that purchases raw materials and inputs from another. Suppliers can influence costs by charging higher prices depending on their positioning.
- **Suppliers are powerful if:**
 - There is a credible forward integration threat by suppliers
 - Suppliers are concentrated and coordinate together
 - There are significant costs to switch suppliers
 - Customers are powerful and can influence which suppliers a firm chooses
- **Suppliers are weak if:**
 - There are many competitive suppliers and non holds a strong market share
 - The product delivered is standardized and can be supplied by many suppliers
 - They purchase commodity products
 - Purchasers are concentrated and can push back on suppliers
 - Customers are weak and cannot dictate which suppliers firms use



Lastly, is it a Lynch stock?

- **Lynch's tips:**
 - Invest in what you know
 - Understand the basic business
 - Keep it simple (“the simpler it is, the better I like it”)
- *“A stock is not a lottery ticket...it's part ownership of a business”*
- **Lynch's “perfect” stock**
 - Dull, depressing, disagreeable, no one follows it, has a niche market, and insiders are buyers or company is buying back shares
- **Stocks he'd “avoid”**
 - The hottest stock in the hottest industry, a company that “diworsifies”, the “whisper” stock



Seminar Recap

- Identifying trends are a way to come up with investment ideas.
- Trends can both be positive or negative for stocks, so it is important to spend
 - Be able to create a list of “interest” stocks within industries to research more in-depth
 - Research these “interest” stocks deeper to understand their core business model
 - Have a list of good companies that you believe MAY be good investments (pending sound financial review... to be covered next seminar)



Coming Up

- **Week 5:**
 - Discussing financials
 - How to understand financial reports and important ratios (and having the numbers tell you a story)
 - o Income Statement
 - o Balance Sheet
 - o Cash Flows
- **Week 6:**
 - Important financial metrics
 - How to calculate financial ratios
 - How to understand what financial ratios mean
- **Week 7:**
 - Putting it all together for an investment recommendation

