The Investment Letter

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Decoding Financial Alpha, Beta Soup

Investing can be a complicated endeavor. Even so-called 'experts' can't agree on whether a particular security is a good or bad investment. This makes sense in a way, considering every transaction has a buyer and a seller who have obviously differing views and criteria.

To make matters worse, the various terms, formulas and abbreviations that are common jargon sometimes can sound Greek, and they often are (alpha, beta, delta, gamma). All this only serves to further confuse the layperson.

While we cannot eliminate all the complexities and confusion that surrounds financial lingo, we can, hopefully, demystify some of the more common terms you're likely to come across while researching a stock.

We hope you'll find our explanations of some of the most common terms, and how they relate to our investment selection process, useful. Perhaps they will help you better understand the terminology and maybe even make you a better, more informed investor.

Valuations

When purchasing a stock, bond or any investment for that matter, what you pay for it has to likely represent a good value to you - or else why buy it? Too often, investors get caught up in the price of a stock but miss the value of it. Think of a grocery store where two identical items are priced the same, the only difference is that one package is larger and contains more units of the product. In this case, despite the price being the same, the value, or cost per unit, is clearly different.

Buying stocks is similar in this respect. It is insufficient to say that a stock trading at $60/share is cheaper than one trading at $100/share without further review. That's why a large part of our investment process focuses on valuing securities so that we can buy quality companies and hold them for the long term but do so at reasonable prices.

Some of the valuation criteria we use are Price to Earnings (P/E), Price to Book (P/B), Price to Cash Flow (P/CF) and Price to Sales (P/S). We'll do our best to explain some of these ratios and why they are important below.

Price to Earnings (P/E)

One of the most common ratios in investment analysis is the P/E ratio. The P/E ratio is simply the price of the stock divided by the earnings per share of the stock.

For example, a stock that trades at $100/share and has $5 of earnings per share would have a P/E of 20. Another way of thinking about this is the stock trades at 20 times earnings. Or you are paying $20.00 for every dollar of earnings.

A higher P/E is a sign of a more expensive company, while a lower P/E can mean a relative bargain of an investment. Of course, there are good reasons why a company may have a higher or lower P/E ratio. For example a company with excellent

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growth prospects may command a higher price, while one that is struggling may look like a relative bargain on a P/E basis, and for good reason.

Understanding what P/E means is a great first step, but being able to interpret the ratio and compare P/E ratios among different companies is even better. As with most purchases, cheaper is better, but this doesn't take into account factors such as quality, volatility and many other measures.

In the case of securities analysis, P/E ratio alone is never sufficient to make any buy or sell decisions. Many other factors come into play in order to fully understand a company and it's valuation, but a P/E ratio is a great and popular starting point!

Price to Book (P/B)

Price to Book is another way of determining the valuation of a stock, similar to P/E. P/B can vary significantly from industry to industry so when comparing two companies it's best not to draw too many conclusions from vastly different firms.

As the name implies, the Price to Book ratio compares the current price per share of a stock to its book value per share. Book value is simply the current, adjusted value of physical assets of the firm. In accounting terms this would be the property, plant and equipment of the company. You can think of book value as the liquidation price of the company.

Of all valuation metrics discussed here, many financial theorists consider the Price to Book ratio to be the most discriminating in identifying over- and underpriced securities. For best results, though, it should still be considered in conjunction with other valuation metrics.

Price to Cash Flow (P/CF)

Much like P/E and P/B, discussed above, Price to Cash Flow (P/CF) compares the price of a security to how much cash flow the firm generates.

Cash flow is an important measure for investors as it considers the amount of cash a company generates after meeting operating expenses. It's best to think of it in terms of what's left after all the bills are paid.

The remaining cash can then be applied to other uses, like paying dividends or buying back shares for example, which are both beneficial to investors.

Theoretically, all else being equal, a lower P/CF ratio is preferred over a higher one. Differences in what is considered low, medium or high vary somewhat by industry and market conditions so care should be taken to consider this ratio in a broader context.

Price to Sales (P/S)

The Price to Sales ratio is calculated by dividing the price per share of a stock by the sales per share of the same company. P/S is usually backward looking, often reported as trailing twelve months (TTM) but can be forward looking using sales estimates as well, although this introduces more uncertainty.

A lower P/S ratio is typically preferred to a higher one, although profitability is not taken into consideration, so even with an attractive Price to Sales ratio a company may still be an unattractive investment. P/S measures the cost of purchasing a dollar worth of sales of the target company.

One major limiting factor of this valuation metric is the way a company's debt can influence the outcome. This ratio is best for comparing very similar companies in the same industry with similar capital (debt/equity ratio) structures.

Valuation is a key component in how Investment Counsel evaluates stocks. Given the importance of not overpaying, we use all of the already mentioned financial ratios, as well as others, in estimating whether a potential investment is fairly priced or not.

Yield

We've focused so far on valuation, which is a critical component of evaluating a stock. Valuation metrics, however, are not the only thing to consider. Most equity investors are also interested in the Yield of their investment.

Many stocks pay a dividend, which is simply a return of cash to investors. The amount of the dividend as a percentage of the stock price is what is referred to as the Yield of a security.

If we consider a fictional company that trades at $100/share and pays an annual dividend of $3.25 back to shareholders every year, it would have an annual Yield of 3.25%.

Yield is used to measure return of cash to investors and is particularly useful for investors seeking current income from their holdings.

Companies that pay a dividend, particularly an attractive one, are typically sound financially and can afford to part with cash. Conversely, a high dividend can be a sign that a company doesn't have attractive growth prospects and therefore returning cash to shareholders is a better use of excess cash.

Companies that are in more stable, mature industries, like Utilities for example, typically pay a higher dividend or yield. Companies that are still growing and have projects that are expected to have attractive returns will usually opt to not pay a dividend (or only pay a modest one) to allow them to reinvest in the business. Technology stocks would typically fall into this category.

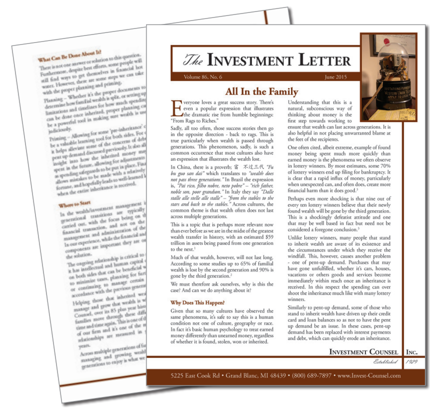
When evaluating a stock for possible purchase or even casually perusing the investment news it helps to have a solid understanding of the most commonly used financial terms.

We hope that we've helped demystify some of the terminology, with the full understanding that there are far too many terms to ever truly cover all of them in these pages.

Furthermore, the investment industry continues to create new terms to further confuse and confound investors. Remember, new terms and phrases will come and go, but the basics of investing: buying quality companies at fair and attractive prices and holding them for the long-term is something that has and will continue to work regardless of what you call it.

Investment Counsel News

Inside the Office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All In the Family

Our newsletter has been in print since 1929. If there is a specific month and year that is special to you, we'd be happy to send you a reprint from that time period.

Outside the Office

Dorothy and her husband Kirk again visited the sand dunes at Silver Lake. This is a picture of them doing wheelies in their sandrail!