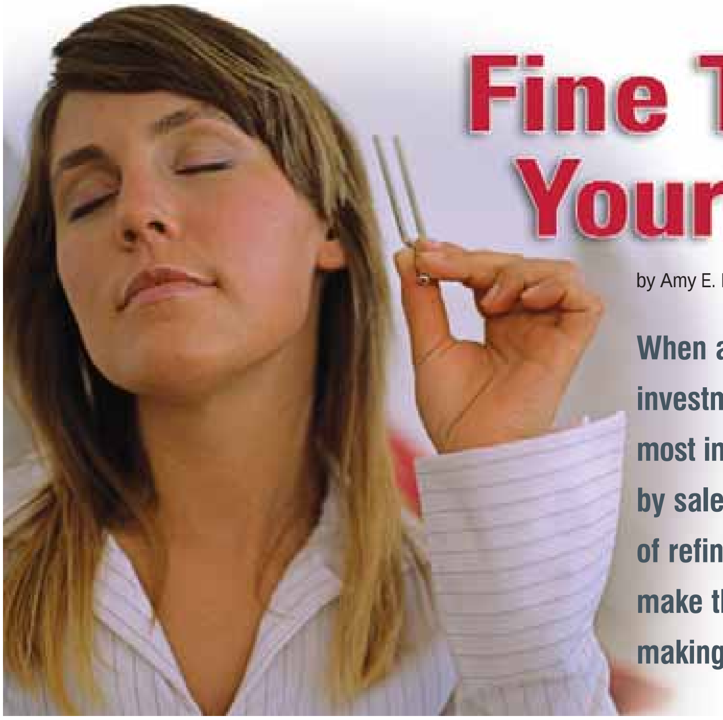

Fine Tuning Your Forecasts

by Amy E. Buttell

When analyzing a stock for possible investment, company earnings are one of the most important factors. Earnings growth is driven by sales growth, but you have numerous ways of refining your earnings estimates not only to make them more accurate but also to avoid making investment mistakes.

There are several techniques you can use to enhance your analysis of a company's sales, earnings, pre-tax profit margins, return on equity and valuation, which in the BetterInvesting community is the proverbial 80 percent of what you need to know to determine a stock's return possibilities over the next five years. We'll outline some of these methods in this article. Not every individual investor or investment club uses all of any of these techniques; still, a look at the options can strengthen your approach to estimating earnings and stock analysis as a whole.

Recent Versus Long-Term Growth

Although long-term growth trends are generally the best way to assess a company's past growth and potential for future growth, recent growth trends are important, especially in a market as volatile as the one in 2008.

Companies that boast strong trends in earnings, sales and pre-tax profit margins during the past five or 10 years could be in trouble today given the turmoil in the financial system. So before investing in a particular company, isolate trends from the past year or two and check up on recent news to make sure that long-term trends aren't overshadowing traumatic recent events and trends.

Organic Versus Acquisition Growth

Many investors prefer organic growth to expansion by acquisition. Organic growth is generated by current operations, while growth by acquisition is generated by simply buying up other companies.

"When analyzing growth by acquisition, you have to look at the company doing the acquiring and whether those acquisitions are material to the company's operations," says Mark Robertson, founder and general partner of Manifest Investing and a frequent speaker at BetterInvesting events. "With a huge company like Johnson & Johnson (ticker: JNJ), for example, most acquisitions won't have a major impact on company earnings because the company is so big. But larger acquisitions can be very disruptive, as we have seen with companies such as Pfizer (PFE). And acquisitions just wreck the trend analysis on the Stock Selection Guide." *(Companies are mentioned in this article for educational purposes only. No investment recommendation is intended.)*

Steven Rogé, a portfolio manager at R.W. Rogé & Company in Bohemia, N.Y., sees growth by acquisition as a potentially dangerous strategy, especially for companies that are known as serial acquirers. "Companies may have trouble integrating acquisitions into their core businesses and also may not be putting their capital to the best use by waiting for the best opportunity," he says. "A lot of them are more focused on building an empire because they want to get paid more, so they keep increasing the size of the company as a goal in and of itself."

A company's quarterly and annual Securities and Exchange Commission filings — the 10-Qs and 10-Ks — are the best source of information about a company's organic and acquisition-related growth. Most companies post these documents in the investor relations section of their websites.

Filings are also available in the EDGAR database, which you can access from the SEC's website. The commission also provides a tutorial for the search engine. In the publicly filed documents, look for a section titled something like Management's Discussion and Analysis of Financial Condition and Results of Operations. Many analyst reports also discuss sources of growth.

Companies that wisely acquire other companies at a good price and that are a good strategic fit are a different story, Rogé says, citing Warren Buffett's Berkshire Hathaway as a company that waits for the best opportunities rather than pursuing whatever's out there.

Sustainable Growth

Sustainable growth is the highest growth rate a company can maintain without borrowing more money. Calculate this by multiplying a company's return on equity (how well management employs investment dollars) by 1 minus the company's dividend payout ratio. When examining a company's sustainable growth rate, you have to be careful about how you break down ROE, because a higher debt level can make this number look better than it actually is.

"You have to dissect ROE numbers to see what effect profit margins, asset turnover and debt have on ROE," says Stephen Horan, Ph.D., Chartered Financial Analyst, head of private wealth at the CFA Institute in Charlottesville, Va. "Is it good ROE or is it dangerous ROE — ROE fed by too much debt?"

Industry Growth

When examining earnings growth, Lynn Ostrem, a member of the Crow River Investment Club in the Minneapolis area who teaches classes on stock analysis and investment club topics, uses sites such as Yahoo! Finance, MSN Money, Hoover's and Reuters to dig deeper into the company's industry.

"I want to know where my company fits into its industry," she says. "What I'm looking for is the best of the breed — a terrific company in a terrific industry. Looking at industry growth rates can tell you what the future drivers of growth will be for the industry and the company because you want to know where the growth is coming from."

BetterInvesting's online SSG tool, accessible through the website's homepage, also allows you to compare a company's fundamentals with those of its peers.

Cash Flow

Many analysts like to study a company's cash flow. Free cash flow is the operating cash flow minus capital expenditures. It's a way to measure the amount of cash a company generates after subtracting money used to maintain or expand the company's asset base.

Discounted cash flow, or DCF, analysis examines a company's free cash flow, projecting future cash flows then discounting them back to a present value. This somewhat advanced but popular technique is useful in analyzing whether a company's stock presents an attractive value at its current price.

Many analysts employ this technique because cash is less susceptible to manipulation than earnings and sales. Because cash going in and out of a business is a reliable indicator of a company's ability to sustain sales and earnings, examining cash flow growth is a conservative way to gauge earnings.

Rogé uses DCF analysis as a cornerstone of his analysis. "One thing we do with our discounted cash flow analysis which may be unique out there is that we use average free cash flow over a full economic cycle — boom to recession — to really get at a core earnings rate of what the company can earn," he says. From there, he tries to project long-term growth in free cash flow.

The trick with DCF analysis is coming up with a model that will factor in all the inputs influencing a company's cash flow in the future. This is an onerous task that's "computationally intensive," Horan says. Fortunately, ready-made DCF analysis is available at Morningstar. Ostrem uses Morningstar's analysis as a conservative check on her projections because its DCF methodology is particularly conservative.

Analysts' Projections: Pro and Con

When refining earnings projections, Robertson relies on analysts' consensus estimates (ACE) for the next two years. By incorporating such forward-looking data into his estimates, he can get a better handle on what's happening with a company right now and in the near-term future. "The most dramatic example we've seen recently is with homebuilders and financials," he says.

"Going back two years, there was nothing wrong on the Stock Selection Guide with the (earnings and sales) trend lines, but looking forward two years dramatically impacted the long-term trend negatively," he adds. These projections showed that financials and homebuilders were experiencing downturns before such information turned up in actual earnings. Robertson prefers the ACE data at Yahoo! Finance.

Peter Gore, a CFA and Certified Financial Planner with Gore & Golub Financial Advisors in Williamsburg, Va., uses ACE as a backstop to his own projections to see whether he's in the ballpark, but he believes their usefulness is limited.

"There has been so much research showing that analysts are myopic in their projections," he says. "There is doubt as to whether they really reflect the true earnings potential of a corporation.

"In the short term, they're typically correct because a lot of information about the short term is available from the companies themselves. But in the long term, to successfully forecast earnings you really have to build out projections based on trends within the various markets of a company's product mix, and it's not easy to do that successfully."

Horan prefers to find the analysts that are most successful at following a particular industry, as those analysts' longer-term projections are the most likely to be accurate and also actually move the market. You can find these analysts by closely following the news on your company. Generally, sites such as Google Finance post news when influential analysts report on a company or about stock price movements that are influenced by analyst reports.

Core Earnings

There are earnings and there are earnings. Core, or operating, earnings, are the profits derived from ongoing company operations. Some believe they're the best indicator of a company's true earnings capacity.

"In my background in international finance with a large food service company, I learned that the major thing to focus on is the quality of the earnings," Gore says. "Basically, you need to figure out how repeatable that earnings stream is. You look at operations and the company's divisions from the top down and figure out what's driving sales."

Companies report several varieties of earnings. Analysts such as Gore focus on those that strip out one-time gains and losses and other factors that aren't material — relevant, in other words — to ongoing earnings. When examining a company's income statement and accompanying earnings news release, therefore, it's best to ignore so-called pro forma earnings or whatever earnings per share numbers management chooses to highlight, because these are most likely to present the company in the most favorable light.

Analysts who use cash flow growth and discounted cash flow analysis also use cash EPS in their analysis. To obtain this figure, divide operating cash flow by diluted shares outstanding.

Numerous stock data providers, including Standard & Poor's (BetterInvesting's data provider), offer their own version of operating earnings. The term *core earnings* is associated with S&P's version. S&P core earnings aren't part of the data feed to BetterInvesting members, but you can find these numbers on S&P company reports, which are often available free through your brokerage. Note that S&P doesn't provide core earnings for every company in its coverage universe.

A company's income statement will generally provide several different types of EPS, including basic and diluted. In your analysis, favor diluted earnings and any that come from continuing operations rather than those that include one-time items and discontinued operations.

Dividend Growth

Dividend growth charts the growth of a company's dividends over time. Horan doesn't place much emphasis on dividend growth in his analysis because this isn't necessarily related to the company's overall growth. Rather, the dividend policy is an "artificial decision by management," he says. "I'm more interested in whether a company's dividend policy makes sense for that particular company."

Horan believes that if a firm is in position to keep growing, it should reinvest all its capital to fund growth. "If there's an opportunity to fuel growth," he says, "you can put those funds to better use than by funding a dividend.

"If, on the other hand, a company is in a declining industry that has a hoard of cash with not a whole lot of options for reinvestment, a dividend would make sense."

Evaluating Retailers' Sales Ratios

Each industry has unique sales metrics that offer relevant clues to company performance. For retailers, whose stocks are popular choices in the BetterInvesting community, the most significant figures include same-store sales and square footage/store growth. Outside of sales, earnings and pre-tax profit margins, these two measurements provide important information about how a retailer is performing.

Same-store sales tracks units that have been operating for a year or more. The idea is to see how sales at those stores are growing compared with the same period a year earlier.

Stephen Horan, Ph.D., Chartered Financial Analyst and head of private wealth at the CFA Institute in Charlottesville, Va., believes same-store sales are an especially valuable metric for dissecting the strength of a retail operation's sales.

"Same-store sales shows the strength of a retailer's sales in terms of organic growth versus growth by expansion," he says. "Some retailers, like Starbucks (SBUX), have or had an explicitly stated strategy to saturate the market with new stores, but at a certain point that doesn't make sense." There can be so many new stores that they cannibalize the sales from existing ones, which isn't healthy growth.

Square footage/store growth divides a store's growth rate by its square footage. The more sales a store can extract from each square foot, the more efficient that particular store is at making sales. This ratio not only provides solid data on retail sales performance within a particular retailer, it also allows executives and analysts to benchmark retail sales against competing retailers.

A weakness in both measurements is that the performance of individual stores, whether new or existing, is affected by many factors, such as location, store layout, local competition and inventory. So if a retailer's management makes tactical mistakes in locating stores and providing them with inadequate inventory, for example, those statistics can be misleading.

That's one view. Others believe that companies with solid dividends that regularly increase their payout have confidence in their future. Dividends can also support a stock price when markets are volatile. In the current market environment, companies that are reaffirming their dividend policies are seeing positive effects on their stock price because so many companies, especially in the financial sector, are slashing or eliminating their dividends in an effort to bolster their balance sheets.

"Any company board that's boosting their dividend in these very uncertain times is expressing a strong degree of confidence in their own growth," says Charles Carlson, CFA, editor of the *DRIP Investor Newsletter*. "Companies don't like to cut their dividends, so an increase can be an important vote of confidence."

Carlson notes that a company generally likes to keep its dividend payout ratio — which is the percentage of earnings paid out to shareholders in dividends — consistent, so when earnings are increasing, the dividend will increase. Likewise, when a board votes to increase the dividend, it's a vote of confidence in the company's ability to increase earnings.

A number of well-known growth companies that have recently raised their dividends may be attractive candidates for investment in this environment. These include IBM (IBM), ExxonMobil (XOM), Pepsi (PEP) and Johnson & Johnson, Carlson adds. "Increasing a dividend can be seen as a leap of faith even if the company has confidence in its prospects," he says. "In a market environment as difficult as this one, it's easier to do nothing than to take the step of increasing a dividend."

Keeping Estimates in Perspective

For Ostrem, an earnings forecast is designed to help her get a handle on how much a particular company is likely to grow during the next five years. The closer she can get to a reliable estimate, the better. And the less likely she and her club are to be on the wrong end of either a company blowup or a firm's slow slide into mediocrity.

Websites of Interest

Google Finance
http://finance.google.com

Hoover's
www.hoovers.com

Morningstar
www.morningstar.com

MSN Money
http://moneycentral.msn.com/investor/home.asp

Reuters
www.reuters.com/finance/stocks

SEC's EDGAR tutorial
www.sec.gov/edgar/quickedgar.htm

SEC's EDGAR search engine
www.sec.gov/edgar/searchedgar/webusers.htm

Yahoo! Finance
http://finance.yahoo.com