

## Topics on Stock Trading (part 3)

### How to Evaluate the Quality of EPS

EPS manipulation might be the second oldest profession, but there is a relatively easy way for investors to protect themselves. This article will show you how to evaluate the quality of any kind of EPS, whether it's GAAP, pro forma, or otherwise.

#### Overview

The evaluation of earnings per share should be a relatively straightforward process, but thanks to the magic of accounting, it has become a game of smoke and mirrors, accompanied by constantly mutating versions that seem to have come out of Alice in Wonderland. Instead of Tweedle-dee and Tweedle-dum we have pro forma EPS and EBITDA. And, despite rumors to the contrary, the whisper number - the cheshire cat of Wall Street - continues to exist as guidance.

To be fair, this situation cannot be totally blamed on management. Wall Street deserves as much blame due to its myopic focus on the near-term and knee-jerk reactions to one-cent misses. A forecast is always only a guess - nothing more, nothing less - but Wall Street often forgets this. This, however, does create opportunities for investors who can evaluate the quality of earnings over the long run and take advantage of market overreactions.

#### EPS Quality

High-quality EPS means that the number is a relatively true representation of what the company actually earned (i.e. cash generated). I use the word 'relatively' because while evaluating EPS cuts through a lot of the accounting gimmicks, it does not totally eliminate the risk that the financial statements are misrepresented. While it is becoming harder to manipulate the statement of cash flows, it can still be done.

A low-quality EPS number does not accurately portray what the company earned. GAAP EPS (earnings reported according to generally accepted accounting principals) may meet the letter of the law but may not truly reflect the earnings of the company. Sometimes GAAP requirements may be to blame for this discrepancy; other times it is due to choices made by management. In either case, a reported number that does not portray the real earnings of the company can mislead investors into making bad investment decisions.

#### How to Evaluate the Quality of EPS

The best way to evaluate quality is to compare operating cash flow per share to reported EPS. While this is an easy calculation to make, the required information is often not provided until months after results are announced, when the company files its 10-K or 10-Q with the SEC.

To determine earnings quality, I rely on operating cash flow. The company can show a positive earnings on the income statement while also bearing a negative cash flow. This is not a good situation to be in for a long time, because it means that the company has to borrow money to keep operating. And at some point, the bank will stop lending and want to be repaid. A negative cash flow also indicates that there is a fundamental operating problem: either inventory is not selling or receivables are not getting collected. 'Cash is king' is one of the few real truisms on Wall Street, and companies that don't generate cash are not around for long. Want proof? Just look at how many of the dotcom wonders survived!

If operating cash flow per share (operating cash flow divided by the number of shares used to calculate EPS) is greater than reported EPS, earnings are of a high quality because the company is generating more cash than is reported on the income statement. Reported (GAAP) earnings, therefore, understate the profitability of the company.

If operating cash flow per share is less than reported EPS, it means that the company is generating less cash than is represented by reported EPS. In this case, EPS is of low quality because it does not reflect the negative operating results of the company and overstates what I feel are the true (cash) operating results.

#### An Example

Let's say that Behemoth Software (BS for short) reported that its GAAP EPS was \$1.00. Assume that this number was derived by following GAAP and that management did not fudge its books. And assume further that this number indicates an impressive growth rate of 20%. In most markets, investors would buy this stock.

However, if BS's operating cash flow per share were a negative \$0.50, it would indicate that the company really lost \$0.50 of cash per share versus the

reported \$1.00. This means that there was a gap of \$1.50 between the GAAP EPS and actual cash per share generated by operations. A red flag should alert investors that they need to do more research to determine the cause and duration of the shortfall. The \$0.50 negative cash flow per share would have to be financed in some way, such as borrowing from a bank, issuing stock, or selling assets. These activities would be reflected in another section of the cash flow statement.

If BS's operating cash flow per share were \$1.50, this would indicate that reported EPS was of high quality because actual cash that BS generated was \$0.50 more than was reported under GAAP. A company that can consistently generate growing operating cash flows that are greater than GAAP earnings may be a rarity, but it is generally a very good investment.

#### Trends Are Also Important

Because a negative cash flow may not necessarily be illegitimate, investors should analyze the trend of both reported EPS and operating cash flow per share (or net income and operating cash flow) in relation to industry trends. It is possible that an entire industry may generate negative operating cash flow due to cyclical causes. Operating cash flows may be negative also because of the company's need to invest in marketing, information systems and R&D. In these cases, the company is sacrificing near-term profitability for longer-term growth.

Evaluating trends will also help you spot the worst case scenario, which occurs when a company reports increasingly negative operating cash flow and increasing GAAP EPS. As discussed above, there may be legitimate reasons for this discrepancy (economic cycles, need to invest for future growth), but if the company is to survive, the discrepancy cannot last long. The appearance of growing GAAP EPS even though the company is actually losing money can mislead investors. This is why investors should evaluate the legitimacy of a growing GAAP by analyzing the trend in debt levels, times interest earned, days sales outstanding and inventory turnover.

#### The Bottom Line

Without question, cash is king on Wall Street, and companies that generate a growing stream of operating cash flow per share are better investments than companies that post increased GAAP EPS growth and negative operating cash flow per share. The ideal situation occurs when operating cash flow per share exceeds GAAP EPS. The worst situation occurs when a company is constantly using cash (causing a negative operating cash flow) while showing positive GAAP EPS. Luckily, it is relatively easy for investors to evaluate the situation.

#### Cyclical Versus Non-Cyclical Stocks

Investors cannot control the cycles of the economy, but they can adjust their investing practices with its ebbs and flows. Adjusting to economic transitions requires an understanding of how industries are characterized by their relationship to the economy. It's important for you to know the fundamental difference between cyclical and non-cyclical companies so that you can distinguish between sectors that are affected by economic changes and those that are more immune. Here we look at the industries that reside within these categories, and identify where it's best to put your money when the economy starts to decline.

#### What Does Cyclical and Non-Cyclical Mean?

These terms, cyclical and non-cyclical, refer to how highly correlated a company's share price is to economic fluctuations. Non-cyclical stocks repeatedly outperform the market when economic growth slows, while cyclical companies are highly correlated to the economy. The non-cyclical securities, also called defensive stocks, experience profit regardless of economic gyrations because they produce or distribute goods and services we always need: food, power, water and gas. The sales of companies with cyclical stocks, on the other hand, depend on whether or not the economy is strong; sales will thrive when people have extra income to spend on luxuries, and they'll decline when the economy slumps.

#### The Concept

The difference between cyclical and non-cyclical industries is simply the difference between necessity and luxury. There are certain items we can't live without and won't likely cut back on even when times are tough. The stocks of companies producing these things are non-cyclical and are "defended" against the effects of economic downturn, providing great places to invest when the economic outlook is sour. For example, household non-durable goods - a fancy term for the things you use up quickly around the house - such as toothpaste, soap, shampoo and dish detergent may not seem like essentials, but you can't really sacrifice them. Most people don't feel they can wait until next year to lather up with soap in the shower.

Contrast this to the new car you've had your eye on. Although it's more exciting to buy a new car than soap, you are more likely to postpone the car for a year or two if your finances feel the effects of an economic slump. Another good example of a cyclical industry is fine dining. When things are good people are more inclined to take the family out for an expensive meal; macaroni and cheese, on the other hand, has to suffice when finances are depressed. Other examples of cyclical industries are manufacturing, the steel industry, travel and construction - the sectors that produce things we can live without when money is tight. These are exactly the types of industries you want to avoid when the economy turns sour.

#### Charting a Cyclical vs. Non-Cyclical Company

Below is a chart showing the performance of a highly cyclical company, the Ford Motor Co. (blue line), and a classic non-cyclical company, Florida Public Utilities Co. (red line). This chart clearly demonstrates how each company's share price reacts to downturns in the economy.

Notice that the downturn in the economy from 2000 to 2002 drastically reduced Ford's share price, whereas the growth of Florida Public Utilities' share price hardly batted an eye at the slowdown.

#### Non-Cyclical Industries - Safety in Turbulent Times

Let's look more closely at examples of non-cyclical industries so that you know where to start looking when a recession is on the horizon.

##### Utilities

An excellent example of a non-cyclical industry is utilities, which can help investors avoid losses when highly cyclical companies are suffering. For instance, selling your Caterpillar stock and buying a share in, say, Minnesota Power Inc. is a type of maneuver that investors have used for years during economic downturns. If times become tough, there's not much money for building projects, so construction companies are less likely to purchase heavy machinery. But, no matter what, people's top priority will always be to have power and heat for themselves and their families. By providing a service that is consistently used, utility companies grow conservatively and do not fluctuate dramatically - these companies provide safety, but this also means they are not going to skyrocket when the economy experiences growth.

##### Household Non-Durables

As we mentioned before, people will always need certain essentials around the house. From deodorant to bleach, we can't really sacrifice the things that keep us and our living spaces clean. For this reason, companies such as Procter & Gamble, Colgate-Palmolive and the Gillette Co. are all attractive investment choices when the economy is in the dumps.

##### Tobacco

It is easy to see why tobacco companies are considered non-cyclical: it's hard for smokers to stop smoking, even during a recession. So a company such as British American Tobacco will exhibit more stability during these times. Even though tobacco is considered a "sin" industry and may be unethical for some investors, it does have the characteristics of a non-cyclical sector.

#### Conclusion

Learning how to predict economic cycles is not within the scope of this article, but simply realizing that different industries respond differently to economic fluctuations can help keep your money safe. When the economy cools off, the cyclical companies will be hit the hardest, so seek out stable companies that produce things you can't live without.

#### Move over P/E, Make Way for the PEG

It is common practice for investors to use the price-to-earnings ratio (P/E ratio) to determine if a company is over or undervalued. There are, however, many extreme cases of stocks trading at 10,000 or more times their earnings - these kinds of situations affect the ratio's accuracy for assessing a company. The companies with a high P/E ratio are typically startup companies with little or no revenues; however, a high P/E does not necessarily mean the stock isn't a good buy for the long term.

Let's take a closer look at what the P/E ratio tells us:

$P/E \text{ Ratio} = \text{Market Value per Share}$

Earnings per Share (EPS)

There are two primary components here, the market value (price) of the stock and the earnings of the company.

Earnings are very important to consider. After all, earnings represent profits, for what every business strives. Earnings are calculated by taking the hard figures into account: revenue, cost of goods sold (COGS), salaries, rent, etc. These are all important to the livelihood of a company. If the company isn't using its resources effectively it will not have positive earnings, and problems will eventually arise.

Besides earnings, there are other factors that affect the value of a stock. For example:

- Brand - The name of a product or company has value. Brands such as McDonald's, Microsoft and General Motors are worth billions.
- Human Capital - Now more than ever, a company's employees and their expertise are thought to add value to the company. It's about time!
- Expectations - The stock market is forward looking. You buy a stock because of high expectations for strong profits, not because of past achievements.
- Barriers To Entry - For a company to be successful in the long run, it must have strategies to keep competitors from entering the industry. Coca-Cola, for example, has built a very extensive distribution channel--anybody can make pop, but getting that product to the market like Coke does, is very costly.

All these factors will affect a company's earnings growth rate. Because the P/E ratio uses past earnings, it gives a less accurate reflection of these growth potentials.

The relationship between the price/earnings ratio and earnings growth tells a much more complete story than the P/E on its own. This is called the PEG ratio and is formulated as:

$PEG \text{ Ratio} = \text{Price/Earnings Ratio}$

Annual EPS Growth\*

\*The number used for annual growth rate can vary. It can be forward (predicted growth) or trailing, and either a one- to five-year time span. Check with the source providing the PEG ratio to see what kind of number they use.

Looking at the value of PEG of companies is just like looking at the P/E ratio: a lower PEG means that the stock is more undervalued.

Let's demonstrate the PEG ratio with an example. Say you are interested in buying stock in one of two companies. The first is a networking company with 50% annual growth in net income and a P/E ratio of 100. The second company is in the beer business. It has lower earnings growth at 24% and its P/E ratio is also relatively low at 12.

Many justify the stock valuations of tech companies by relying on the assumption that these companies have enormous growth potential. Can we do the same in our example?

Networking Company:

$P/E \text{ ratio (100) divided by the annual earnings growth rate (50)} = \text{PEG ratio of 2}$

Beer Company:

P/E ratio (12) divided by the annual earnings growth rate (24) = PEG ratio of .5

The PEG ratio shows us the sexier high-tech company, compared to the beer company, doesn't have the growth rate to justify its higher P/E.

Take Microsoft as another example. At time of writing it had a P/E of 37 and an expected earnings growth next year of 9.6%, this gives us a PEG 3.86. The S&P 500 has a P/E of 24 and an earnings growth of 14%, this produces a PEG of 1.71. Judging by the PEG ratio, Microsoft is significantly pricier than the S&P 500.

Investors are getting pickier. Many have abandoned the P/E ratio, not because it is worthless, but because they desire more information about a stock's potential. We've realized that the P/E doesn't tell us everything we need to know. Using the P/E along with current growth rates produces the more informative PEG ratio, a great indicator of a stock's potential value.

#### The Importance of a Profit/Loss Plan

Who needs a profit/loss plan? Isn't investing only about buying low and selling high? It would be nice to always buy at the bottom and sell at the top, but it is nearly impossible to do so consistently. Furthermore, investors are only human: emotions that sway our judgment it is in our nature to hate losing. Taking a loss on a stock, therefore, is not only detrimental to our pocketbooks, but it also hurts our egos. Time and time again investors take profits by selling an investment that has appreciated, but hold onto declining stocks in the hope of a rebound; oftentimes these investments shrivel to a fraction of their previous worth. So how can an investor avoid this type of outcome? One solution is to learn to be a disciplined investor and to adopt a profit/loss plan. In this article, we'll go over this strategy and show you how to use it to stay in the black.

#### What Is a Profit/Loss Plan?

This plan is a step that many retail investors (and professionals) often overlook. The profit/loss plan is a set of limits that determines the maximum loss or gain an investor will take on a stock. Containing losses is a very important part of investing, so the profit/loss plan is crucial to a sound strategy.

We all make stock-picking mistakes and most of us have lost money in the stock market - what sets the great investors apart is their ability to recognize their bad choices and use what they've learned to make up for them later. A profit/loss plan helps you recognize your mistakes by allowing you to separate your emotions from investing. If you aren't too zealous about your gains and you see them purely as a means of increasing your cash flows (rather than your ego), you will have a much easier time letting go of your losses and, therefore, controlling them.

#### Devising Your Plan

Devising a plan may be more difficult than you'd expect. First, you'll need to set the maximum gain you will accept and the maximum loss you will tolerate for your investments, but these maximums and minimums shouldn't necessarily be the same for every stock. For example, a blue chip stock is more unlikely to rise or fall by 10% within any given year as compared to a small-cap growth stock, which will exhibit more volatility. In other words, you must analyze each stock individually to estimate how much it is likely to move in either direction.

Some investors use technical or fundamental analysis or a combination of both to determine appropriate limits for gains and losses. (For an introduction to "technical analysis", see the article [Charting Your Way to Better Returns](#).) Another way to devise your limits is by modeling your plan on the performance of a designated benchmark such as an index or even on the past performance of your own portfolio.

Another factor you must consider when devising your profit/loss plan is your risk tolerance, which depends on many factors such as your personality, your time frame and your available capital. Typically, people who are risk averse will have tighter boundaries than those of people who don't mind risk. Risk lovers will try to profit as much as possible from a rising stock, but a more conservative investor may sell the stock early on in its rise to eliminate the risk of losses, which would occur if the stock took a quick downward dive. If you prefer to shy away from risks, a profit/loss plan of 10% each way may not be suitable or even realistic for you. On the other hand, if you are willing to take on the added risks associated with potential profits, then a 10% profit/loss might be more appropriate.

#### Carrying Out Your Plan

Once you've decided on your numbers, whether conservative or aggressive, you have to put the plan into action with as few hitches as possible. Remember, this plan has a double requirement: you have to sell your stocks (1) if they fall to a certain level and (2) if they rise to a certain level.

Now, brokers will not let you enter two different sell orders for the same security so you need to figure out which one you'd rather enter first. It may be wisest to enter orders that first protect your downside: many wise investors use the stop-loss order, which instructs your broker to buy or sell a stock once it has reached a certain price. The stop loss ensures that you won't get burned on a down market, especially if you aren't able to watch it every second. When you enter in your order with your broker, set the stop price at your maximum loss percentage and then sit and wait. If the price ends up appreciating to your upper boundary, just change the price of your stop loss order, which will then activate the immediate sale of your stock.

### Staying Disciplined

Once you have your profit/loss strategy in place, you will have to remember that the whole idea of the plan is to establish strict guidelines for when to sell. Sure, it hurts to see a stock continue to rise once you have sold it, but it is often better to sell on the way up than to wait until you have to dump the stock while the price is collapsing after its peak. Jack Kennedy once said, "Only a fool holds out for the top dollar."

### Conclusion

Keep in mind that our example figures are generalizations. Devising your plan requires detailed research, analysis, self-assessment and a realistic outlook. Setting a profit limit at 100% (double your money) doesn't make sense if you invest in low-risk companies that grow steadily at 15% per year.

Here are some things to remember:

- A stock that declines 50% means you will need to double your money to get back to even. Controlling losses is the key to sound investing.
- Making mistakes is human nature. Once you realize this, you will find it easier to move on.
- Buying a stock and holding onto it for a very long time doesn't mean you will make money. A buy and hold strategy will work only if you pick the right companies.

The most important part of devising a profit/loss plan is sticking to it!

What Is the "Chinese Wall"?

The term "Chinese Wall" has been used in headlines, but why and what does it mean? This article will define that term, give a little history about it, and discuss why it appears in the news.

The question of analyst objectivity is a big issue, especially in regards to how analysts treat their firm's investment-banking clients and individual ("retail") investors. In other words, if an analyst's employer has a commitment to bring a stock to the market, how objective can that analyst be? Won't they tend to promote the stock in order to get the big bucks?

These are good questions, but the issue is not new. Following the crash of 1929, the government sought to provide a separation between investment bankers and brokerage firms in order to avoid the conflict of interest between objective analysis and the desire to have a successful stock offering. These regulations became known as the "Chinese Wall" because they were meant to create a barrier as effective as the Great Wall of China between the two operations. Most investment/brokerage firms even re-located departments to different floors. This issue received more attention in the wake of dotcom fallout perhaps as people were seeking a scapegoat.

Historically, Wall Street analysts have been paid a combination of a base salary, a percentage based upon trading volume in the stocks that they cover, and a percentage of any investment banking deals with which they are involved. These packages are generally structured to reward good stock picking; however, the potential for ethical conflict is greatest in investment-banking deals.

Ideally, investment bankers involve the firm's analyst early in the process in order to get their opinion of the deal. The analyst will have a better understanding of the client company's industry and is generally better able to determine the viability of the deal. If the analyst does not think that the client company has the fundamental strength to be public, the bankers should drop the deal and move on. If the analyst thinks that the client company has a good business plan and profit potential, the company should go to the Street to raise funds to grow and contribute to the economy.

Generally speaking, we analysts (Reg FD Disclosure: I am a practicing analyst) try to find good investment ideas because we can only succeed if we build a reputation as a good stock picker and forecaster. The cliché that "analysts are only as good as their last idea" is very true. I call this the "invisible hand theory of research" because the desire for long-term success in this industry guides the analyst to focus on finding good stocks rather than to promote the stock du jour.

Henry Blodgett and Mary Meeker typify the dotcom market, and they were involved in the largest deals and got the most airtime. In their defense, I think they tried to rationalize an irrational market. They saw that the market was paying for "new paradigm" stocks and tried to find a way to apply rational valuation techniques to irrational prices.

Were they wrong in what they did? One could argue the following:

- Based on "normal" markets and analytical thought, many of the dotcoms should never have gone public.
- The Street is to blame because they were the ones who "sold" us those bad stocks.
- They should be punished.

But this is based on 20/20 hindsight and ignores the fact that many of us were constantly challenging the "new paradigm" consensus and knew it would just be a matter of time. But we did not get on CNBC as much as the other talking heads because our story was not as "newsworthy."

Despite periodic excesses, the system works. Analysts perform a very crucial role in the markets: transforming data into information for investors to use in their decision making process. We like reading footnotes in company filings and asking management "Colombo-style" questions. We relish in the challenge of finding the next big stock and hope to be paid fairly for our efforts. We know that we are only as good as our last idea and will not consciously jeopardize our reputations.

As in most sectors of life, however, the system functions within the parameters of the current environment, and environments change with time. Excesses do occur, but are generally not recognized as such until after the fact.

I think the current debate is healthy and will be productive if for no other reason than to increase the awareness of the individual investor. "Caveat investor" will be the buzzword for 2001.

Types Of EPS

Gertrude Stein said, "A rose is a rose is a rose," but the same cannot be said about earnings per share (EPS).

While the math may be simple, there are many varieties of EPS being used these days, and investors must understand what each one represents if they're to make informed investment decisions. For example, the EPS announced by the company may differ significantly from what is reported in the financial statements and in the headlines. As a result, a stock may appear over- or undervalued depending on the EPS being used. This article will define some of the varieties of EPS and discuss their pros and cons.

By definition, EPS is net income divided by the number of shares outstanding; however, both the numerator and denominator can change depending on how you define "earnings" and "shares outstanding". Because there are so many ways to define earnings, we will first tackle shares outstanding.

Shares Outstanding

Shares outstanding can be classified as either primary (primary EPS) or fully diluted (diluted EPS).

Primary EPS is calculated using the number of shares that have been issued and held by investors. These are the shares that are currently in the market and can be traded.

Diluted EPS entails a complex calculation that determines how many shares would be outstanding if all exercisable warrants, options, etc. were converted into shares at a point in time, generally the end of a quarter. We prefer diluted EPS because it is a more conservative number that calculates EPS as if all possible shares were issued and outstanding. The number of diluted shares can change as share prices fluctuate (as options fall into/out of the money), but generally the Street assumes the number is fixed as stated in the 10-Q or 10-K.

Companies report both primary and diluted EPS, and the focus is generally on diluted EPS, but investors should not assume this is always the case.

Sometimes, diluted and primary EPS are the same because the company does not have any "in-the-money" options, warrants or convertible bonds outstanding. Companies can discuss either, so investors need to be sure which is being used.

#### Earnings

As has been evident in recent headlines, EPS can be whatever the company wants it to be, depending on assumptions and accounting policies. Corporate spin-doctors focus media attention on the number the company wants in the news, which may or may not be the EPS reported in documents filed with the Securities & Exchange Commission (SEC). Based on a set of assumptions, a company can report a high EPS, which reduces the P/E multiple and makes the stock look undervalued. The EPS reported in the 10Q, however, can result in a much lower EPS and an overvalued stock on a P/E basis. This is why it is critical for investors to read carefully and know what type of earnings is being used in the EPS calculation.

We will focus on five types of EPS and define them in the context of the type of "earnings" being used.

#### Reported EPS (or GAAP EPS)

We define reported EPS as the number derived from generally accepted accounting principles (GAAP), which are reported in SEC filings. The company derives these earnings according to the accounting guidelines used. (Note: A discussion of how a company can manipulate EPS under GAAP is beyond the scope of this article, but investors should remember that it is possible. Our focus is on how earnings can be distorted even if there is no intent to manipulate results.)

A company's reported earnings can be distorted by GAAP. For example, a one-time gain from the sale of machinery or a subsidiary could be considered as operating income under GAAP and cause EPS to spike. Also, a company could classify a large lump of normal operating expenses as an "unusual charge" which can boost EPS because the "unusual charge" is excluded from calculations. Investors need to read the footnotes in order to decide what factors should be included in "normal" earnings and make adjustments in their own calculations.

#### Ongoing EPS

This EPS is calculated based upon normalized or ongoing net income and excludes anything that is an unusual one-time event. The goal is to find the stream of earnings from core operations which can be used to forecast future EPS. This can mean excluding a large one-time gain from the sale of equipment as well as an unusual expense. Attempts to determine an EPS using this methodology is also called "pro forma" EPS.

#### Pro Forma EPS

The words "pro forma" indicate that assumptions were used to derive whatever number is being discussed. Different from reported EPS, pro forma EPS generally excludes some expenses/income that were used in calculating reported earnings. For example, if a company sold a large division, it could, in reporting historical results, exclude the expenses and revenues associated with that unit. This allows for more of an "apples-to-apples" comparison.

Another example of pro forma is a company choosing to exclude some expenses because management feels that the expenses are non-recurring and distort the company's "true" earnings. Non-recurring expenses, however, seem to appear with increasing regularity these days. This raises questions as to whether management knows what it is doing or is trying to build a "rainy day fund" to smooth EPS.

#### Headline EPS

The headline EPS is the EPS number that is highlighted in the company's press release and picked up in the media. Sometimes it is the pro forma number, but it could also be an EPS number that has been calculated by the analyst/pundit that is discussing the company. Generally, soundbites do not provide enough information to determine which EPS number is being used.

#### Cash EPS

Cash EPS is operating cash flow (not EBITDA) divided by diluted shares outstanding. We think cash EPS is more important than other EPS numbers because it is a "purer" number. Cash EPS is better because operating cash flow cannot be manipulated as easily as net income and represents real cash earned, calculated by including changes in key asset categories such as receivables and inventories. For example, a company with reported EPS of \$0.50 and cash EPS of \$1.00 is preferable to a firm with reported EPS of \$1.00 and cash EPS of \$0.50. Although there are many factors to consider in evaluating these two hypothetical stocks, the company with cash is generally in better financial shape.

Other EPS numbers have overshadowed cash EPS, but we expect it to get more attention because of the new GAAP rule (FAS 142), which allows companies to stop amortizing goodwill. Companies may start talking about "cash EPS" in order to differentiate between pre-FAS 142 and post-FAS 142 results; however, this version of "cash EPS" is more like EBITDA per share and does not factor-in changes in receivables and inventory. Consequently, I think it is not as good as operating-cash-flow EPS, but is better in certain cases than other forms of EPS.

## The Bottom Line

Caveat investor (investor beware)! There are many types of EPS being used, and investors need to know what the EPS represents and determine if it is a valid representation of the company's earnings. A stock may look like a great value because it has a low P/E, but that ratio may be based on assumptions with which you may not agree.

## The Media as a Lagging Indicator

Have you ever noticed how often today's headlines are really yesterday's news? By the time an event reaches the national consciousness through the media filter, it's almost over. For example:

- In 1987, the movie *Wall Street*, starring Michael Douglas and Charlie Sheen, was a hit just months before the crash.
- 1987 was never called a "crash" until late 1988, after the market had already started to rally.
- Jeff Bezos was *Time's* "Man of the Year" in December 1999 - the following year, the dotcom bubble burst.
- *The*, a short-lived TV show about a baby-boomer brokerage firm, aired November to December 2000 - just before the 2001 meltdown.

### Why Is This Important?

In the next few weeks, the media will be filled with so-called news about the recession. Regardless of the fact that this economy has been in a recession since August, the data to "prove" it will not be released until October. While this is old news to the people who have been laid off, it will mark the turning point. Once the media finally uses the "R" word, the economy will probably already be on the mend, so investors should act on buying opportunities.

Another interesting aspect of the media as a lagging indicator is that once a company is featured on the cover of a magazine or in a book, it is time to sell - even though there are exceptions, this is often the case. For example, most of the companies highlighted in *In Search of Excellence* subsequently under-perform. Al Dunlap and Donald Trump had their day in the spotlight, but they had subsequent challenges.

### What This Means for Investors

It also means that to be a successful investor, you need to look for investment ideas where others are not, and you need to buy when others are not. While there is a risk in being first, there is also a risk in being a follower. Being early may mean you have to wait longer than expected for the market to "discover" your stock, but if you have done your homework, value investors just need to wait. Momentum investors like to jump on the bandwagon after it's already started, but their ride may be short, and the momentum may carry them over the cliff.

There are many stocks with solid fundamentals and great investment potential, but the challenge is to find them. Wall Street remains focused on the mega-cap stocks that are mostly yesterday's news and have little left to offer. Luckily, investors can use the Internet to do their own research instead of blindly following Wall Street's recommendations. Thanks to Reg FD, conference calls and other information are now available to individual investors. But investors must learn how to differentiate between hype and analysis and steer clear of misinformation and outright fraud.

### Helpful Resources

Fortunately, there are many websites that not only educate investors, but also offer helpful information and analysis. Here are some of my favorites (besides Investopedia, of course):

- [researchstock.com](http://researchstock.com) (\*) - Provides in-depth research on small-cap stocks that are not being followed by Wall Street.
- [charthelp](http://charthelp.com) - Provides information on technical analysis.
- [bigcharts](http://bigcharts.com) - Current news, charts and decent info on analyst coverage.
- [multex](http://multex.com) - Wall Street research reports (pay per view).
- [sec.gov](http://sec.gov) - EDGAR provides access to financial statements.
- [AIMR.org](http://AIMR.org) - Provides information on analyst objectivity and the rules/regulations that Chartered Financial Analysts follow.
- [Nasdaq](http://Nasdaq.com) - Lots of data

### New Accounting Rules Could Roil The Markets

FAS 142 is the accounting rule introduced in 2001 that changed how companies treat goodwill. To avoid making bad investment decisions, investors must be aware of this rule's impact on reported earnings. This accounting rule change impacts earnings in two major ways, both of which could give uninformed investors a wrong signal:

1. It generates a one-time boost to EPS that could fool the market into thinking it represents a change in the fundamentals.

2. It provides an incentive to write-off goodwill during the next few quarters, which will further depress weak earnings.

Previously, companies were required to amortize goodwill over a long time (40 years), and this non-cash expense reduced reported (GAAP) EPS. FAS 142 eliminates amortization and institutes an annual impairment test. This article will briefly review the potential impact of these changes on reported earnings. We expect the changes to start impacting earnings by the end of 2001.

#### EPS Impact: A Potential False Positive

The new accounting change will provide a one-time boost to a company's EPS, which may be misinterpreted by the market as an improvement in the long-term earnings potential of the company, causing the market to move the stock higher. There is also the possibility that the market may react like it does when a company announces a stock split, bidding the shares higher although no change occurs in the fundamental earning power of the company. One Wall Street analyst recently estimated that this change could boost software firms' EPS by 114%.

In reality, however, a company's fundamentals, real earnings potential and cash flows remain unchanged regardless of the new rules. FAS 142 can be viewed as a rule change that occurs in the middle of the game. But because companies are not required to restate historical results, the change will potentially result in significant EPS growth in the first quarter after adoption of the rule. During the next three quarters, while EPS growth will be exaggerated when it is compared to the same quarter of the prior year, sequential EPS growth will fall back to lower ("normal") levels.

After the dismal earnings reported in this year, this sudden acceleration of EPS growth may generate a knee-jerk reaction in the market, causing these shares to rise. Under this scenario, uninformed investors may get caught up in the excitement and could lose money as they chase what they think is strong earnings growth.

Ironically, the companies that may experience the greatest EPS "growth" from this change are the old dotcom darlings. Internet and telco companies whose earnings have evaporated could post significant EPS growth as they eliminate the amortization of the huge amounts of goodwill they accumulated during the heady days when all-stock mergers were done at outrageous multiples. Hopefully these companies will resist the temptation to use this as an opportunity to generate renewed interest in their tired shares.

#### Impairment Hell: Another Blow to Already Weak Earnings

The one-time charge offs that may be forthcoming during the next two quarters will further depress already weak earnings. FAS 142 requires companies to evaluate goodwill annually in light of expected value (an impairment test). It also requires companies to charge off goodwill if it is impaired (i.e. the appraised value is less than the value recorded on the books).

Companies have a year after adoption of FAS 142 to perform the impairment test and charge off impaired goodwill, but the rule provides incentives to bite the bullet during the first fiscal quarter after adoption:

- If the charge is made in the company's first fiscal quarter, no restatement is required and the charge is treated as an extraordinary item (does not impact net income because it is recorded below the net income line).
- Charge-offs made after the first quarter of the fiscal year will require restatement of preceding financial statements.
- Charges made after the first year will be treated as operating expenses and will reduce net income.

Consequently, it behooves a company to bite the bullet and take the charge in their first quarter in an attempt to avoid a hit to earnings and the cost of restatements.

Another factor that could accelerate impairment charge-offs is that current market valuations are significantly below the prices paid for the acquisitions a few years ago. The opportunity to "clean house" at the start of the new year, as well as complying with the new rules, could result in very large charge-offs.

A current example of this impairment risk is Enron. In its 10Q filing on 11/19/01, Enron disclosed that it "might be forced to take a \$700 million pre-tax charge to earnings...due to a drop in the value of some of its assets" (The Wall Street Journal, Nov 21, 2001, page A4). While FAS 142 is not specifically cited as the sole reason for the write-off, and we have not been able to contact management for a clarification, this does sound like an "impairment event".

How the market will react to this additional bad news is unknown, but we see two possible outcomes. On one hand, the combination of dismal economic data, weak earnings and FAS 142 charge-offs could result in a grand sell-off as investors perform their year-end tax selling. On the other hand, the news that companies are cleaning house may provide some good news for bulls in a very bearish market.

#### The Impact of FAS 142 Should Be Felt During the Next Earnings Season

The impact of FAS 142 should be revealed as companies report year-end results next spring. While most of the larger companies have fiscal years that are calendar years, there are a number of companies with non-calendar fiscal years that will report FAS 142 results later this year and early 2002. This should provide a good indication of how FAS 142 will impact results and how the market will react.

#### The Bottom Line

Artificially inflated earnings growth and large asset charge-offs could negate each other as well as cause stock volatility. In any event, investors will need to dig even deeper into financial statements to fully understand a stock's long-term earning potential. Investors should also guard themselves against being fooled by an inefficient market and those companies that will do whatever it takes to generate spin for their shares.

#### Theme Investing: Mega-Trends and Market Psychology

Investing has always been a little like surfing. Successful investors spot key investment themes (waves) and ride them to profits. Sometimes the waves are shorter and smaller than we had expected. Other times the wave takes on a mind of its own and falls under its own weight. The hardest but most profitable thing to do is to be the lone rider of a wave that others have abandoned for the "next best thing", and then wait for them to catch up. The key is to know when to get on and when to get off. Previous examples of trend investing include defense stocks during the second World War, oil stocks in the '70s, and of course, the dotcoms.

#### Spotting the Trends

How do you spot the next wave? You need to step back from the daily noise of the market and look at the long term - we're talking years, not weeks. You need to look for the long-term forces that will propel some stocks and draw money from other sectors. In the early- and mid-1990s the focus was on demographic trends and the graying of the baby boomers. In the second half of the 1990s, it was the Internet.

Demographics and the Internet also illustrate how long-term trends fall in and out of favor. Both seemed to peter out eventually. The profit potential of investing in companies that benefit from the graying of the baby boomers was the focus of many investors at one time, but it was overshadowed by the Internet, obscured by market psychology that tends to focus on the current hot theme.

The events of September 11th, for example, caused a major reallocation of money into sectors that benefit from rebuilding our infrastructure and making our society safer from attack. Prior to September 11th, the market was focused on telco inventory corrections and old dotcom names; the market lacked any new ideas to sell to investors. After the attacks, the spotlight turned to security and defense stocks. While many of these previously unnoticed stocks had potential, many did not have any. A blind rush to buy any stock with a "security theme" could have resulted in another bubble.

Funds moved out of the old favorites into new hot sectors. These significant changes in investment policy represented a reaction to a key event, much like the reallocation that occurred in mid-1990 as investors were drawn to the promise of Internet stocks. The demand for increased security represented a long-term structural and psychological change that provided a potential boost for stocks in that sector. The effects on insurance, airlines and brokerages reflected near-term concerns for profits as institutional investors raised cash to reallocate funds to security stocks. Other long-term trends remained intact, but market psychology tends to focus the Street's attention on one or two sectors at any one time.

There are three key things to remember:

1. Differentiate between knee-jerk reactions and fundamental structural changes.
2. Don't sell to avoid short-term losses. If you have decided that a sector/stock is a good long-term buy, don't try to avoid a short-term loss with panic selling. If a sector is falling, individual investors will not get the best prices, so it is better to stay put. You have a better chance of getting the stock cheap by buying when everyone else is selling.
3. Stick with your game plan, but be vigilant for major structural changes. Demographic stocks may be a better buy today because we are all six years

older, but a smarter investment would be airport security stocks with solid fundamentals. You, of course, need to do your homework before investing.

## The Great Gap

Wall Street is myopically focused on a minority of large-cap stocks, leaving the majority of stocks under-followed and undervalued. Wall Street is focused on the big caps because that's where the investment banking (and big profits) are. Small/micro/nano-cap stocks (however you want to classify them) with solid fundamentals and great investment potential have been left to languish without a way to get their story to individual investors. Our research indicates that stocks in this under-followed sector are undervalued by 20-40%. The challenge for investors is to find reliable sources of information on these "undiscovered" stocks.

### Why Is Wall Street Focused on a Small Number of Big-Cap Stocks?

Wall Street has become focused on a very small number of big-cap stocks because that's where the money is and because mergers eliminated independent regional brokerage firms that used to support small-cap stocks. Investment banking now drives profitability, and the bigger deals have the biggest margins. At one time, trading desks generated reasonable profits, but regulatory changes and competition narrowed spreads to miniscule levels. As a consequence, brokerages make a market in only the most liquid stocks (which are also big-cap names) in order to generate enough volume to justify their existence. With every investment banker vying for the same deal, research coverage has become a lemmings' market with everybody following the same stocks.

Merger activity eliminated small regional brokerage firms that provided financial support to small-cap stocks. These regional brokerage houses provided investment banking, market-making, and research coverage to companies in their market area. This provided small-cap firms with access to capital and a growing shareholder base. As larger brokerage houses and banks acquired these smaller firms, however, their activities were redirected to the large-cap sector. Companies that do not meet a specific market cap or do not have the potential to yield a sizable investment banking deal are being dropped from coverage lists.

To prove this, we analyzed the Baseline database to compare market cap and analyst coverage (all data is as of Jan 5, 2001). Baseline has almost 10,400 stocks in its database and contains the stocks in all the major indexes as well as ones suggested by the Baseline subscribers who are analysts and portfolio managers. Because part of the database consists of stocks recommended by individual input, it also provides a perspective on what is deemed interesting by the users.

As shown in Figure 1, an average of less than two analysts cover each of the 4,890 stocks with less than \$500 million in market cap. In contrast, an average of 25 analysts cover each of the 10 companies with a market cap of \$200 billion or more.

### Figure 1

More noteworthy is the fact that of the 4,890 companies with under \$500 million in market cap, 32% (1,558) are not followed by anybody. Figure 2 shows how the lack of attention declines as market cap increases.

### Figure 2

Here is one final fact about the dearth of attention paid to micro/nano-cap stocks (under \$1 billion in market cap): of the 5,578 stocks with \$1 billion or less in market cap (about 54% of the total database), an amazing 53% have zero to one analysts following the stock.

### Figure 3

Believe it or not, the figures in this analysis are overstated, meaning that coverage is even less than presented. This overstatement is caused by situations in which an analyst maintains coverage but changes firms (duplicating analyst coverage) and/or assistants are included in the data (multiple analysts from one firm).

### Why Look at Small/Micro Cap Stocks?

If the pros are focusing on the big caps, why should you look elsewhere? The reason is value. Granted, some of the companies at this end of the food chain may not warrant any attention. But we have found many companies with solid fundamentals that are undervalued simply because investors are not aware of them. The table below contains a few examples of "undiscovered" stocks that were found to be extremely undervalued by the acquiring company.

This is the bottom line: there are numerous stocks that are undervalued just because they do not receive research coverage, but other companies are finding them and paying significant premiums for the stock.

To summarize, Wall Street is focused on a small number of stocks for the following reasons:

1. Trading margins have shrunk, forcing firms to trade only the more liquid (big-cap) stocks.
2. Investment banking drives profitability and the biggest profits lie with the biggest deals.
3. Mergers and acquisitions have eliminated small regional firms that used to support stocks as they grew from micro-cap to mid-cap.

This created an information gap between investors and the large number of good companies without research coverage. Bridging this gap are firms that provide fee-based research; however, there are also other players who are attempting to manipulate stocks by using promotional pieces disguised as professional research. Investors need to know how to differentiate between the good, the bad and the ugly.

### What Investors Need to Know

Investors must differentiate between substance and hype. Here, listed in order of importance, are some questions to ask to ensure you are reading professional fee-based research:

1. What is the nature of the relationship between the company and the analyst?

The nature of the relationship should be clearly disclosed in the report. A disclosure statement is required by SEC regulations and is usually found at the end of the report (and in small type). Information as to what, if anything, has been paid for the report is usually placed in the middle or end of the small type. If you cannot find a disclosure statement, beware. If the nature of the payment is not disclosed, and the report has not come from a known brokerage or investment-banking firm, beware.

### Compensation Structure

A fixed-fee relationship is preferable to one in which the analyst is paid in some form of equity (stock, warrants or stock options) and/or contains a bonus if the stock appreciates. The absence of an "equity kicker" significantly decreases the risk that the writer is hyping the stock to maximize his or her income. A fixed-fee relationship also indicates that the information source should be a more reliable source of information for the investor, at least during the term of the engagement. Generally, a fixed-fee relationship will require the research firm to cover at least a one year period and call for the issuance of quarterly reports on a timely basis. In contrast, "pump and dump" shops will write on a company only as long as it will take to achieve their schemes.

### Does Compensation Adversely Impact the Analyst's Objectivity?

Generally speaking, professional analysts are only as good as their last idea. To be successful, analysts must build their credibility one good stock at a time. This "invisible hand" forces professional analysts to focus their efforts on finding and promoting the best investment ideas and developing a reputation as being a source of good information.

Wall Street research used to be viewed as objective because there were no fees paid by the company being researched; however, now there is increasing debate as to how objective a Wall Street analyst can be. The reason for this is that analyst compensation packages generally consist of a base salary, a percentage of the investment banking deals in which they are involved, and a percentage of the trading volume generated by their research coverage. With this arrangement, it is no wonder that investors are beginning to question Wall Street's objectivity.

So now this question emerges: how objective can fee-based research be when they are being paid directly by the company being analyzed? Our research has found that many users (buy-side, sell-side and individual investors) feel that fee-based research is more objective because the

compensation is fixed and not dependent upon investment banking deals or stock trades.

Our conclusion is that the best determination of objectivity is the quality of the research.

## 2. What is the Quality of the Research?

Readers need to judge the tone and content of a research report. A "report" that is full of promotional language and sparse on details is a hype piece and should not be used in making investment decisions. This is a type of fiction that talks about how the stock will "rocket" to new highs and how the author "guarantees" a huge return on your investment.

Beware if the word "guarantee" is used anywhere in a report - nothing is ever guaranteed.

### What an Objective Research Report Should Contain

A professional research report provides a balanced view by discussing a firm's competitive advantages, providing an overview of the prospects/challenges facing the company and the industry, analyzing operating results against a relevant peer group, and providing earnings estimates based upon clearly-stated assumptions. The "G" word (guarantee) is never used. The report does deal with assumptions and expectations with which the reader may disagree, but they are presented for consideration.

### Continuous Coverage

Due to the significant amount of time and effort required to initiate research coverage on a stock, the analyst is making a long-term commitment to following the company and the industry. Consequently, professional objective coverage usually means that the writer has a long-term commitment and will therefore be a reliable source of information for a long time. This is in contrast to others who will issue "reports" until they have achieved their pump and dump goals.

## 3. What Are the Author's Credentials?

The report should indicate the author's experience and background. A professional research report clearly identifies the writer and his or her contact information so that you can investigate the author and his/her firm. If not, beware.

Credentials may not always determine who is a better analyst, but they do indicate a person's desire to reach a certain level of competency. An analyst who has 20 years of experience but does not have an MBA could be a better stock picker than a newly minted MBA. But having an MBA or CFA generally indicates that the analyst has attained a certain level of knowledge.

The Chartered Financial Analyst, or CFA, designation is a key credential. The Charter is issued by CFA Institute, which is an international society of financial professionals. To achieve the designation, one must pass a series of three six-hour exams (held once a year) that tests your knowledge of ethics, government regulations, economics, accounting, stock and bond analysis, and portfolio management. Not having a CFA does not necessarily mean that the writer is not a competent analyst, and having a CFA does not necessarily make one an expert stock picker. But it does signify that the person has passed a series of difficult and demanding tests and has proven a mastery over a body of financial knowledge. More importantly, however, the CFA charter indicates its holder has a commitment to a high standard of ethical and professional standards.

## Summary

Fee-based research is a useful way to bridge the gap between companies and investors looking for new ideas and undervalued stocks; however, both parties must be aware of the differences between an objective research report and a hype piece designed to manipulate a stock's price. Likewise, under-followed companies need to find reputable independent research firms to reach the growing number of individual investors who are making their own investment decisions.

### What Is A Small Cap?

The meanings of "big cap" and "small cap" are generally understood by their names: big-cap stocks are shares of larger companies and small-cap stocks are shares of smaller companies. Labels like these, however, are often misleading. If you don't realize how big "small-cap" stocks have become, you'll miss some good investment opportunities.

Small-cap stocks are often cited as good investments due to their low valuations and potential to grow into big-cap stocks, but the definition of small

cap has changed over time. What was considered a big-cap stock in 1980 is a small-cap stock today. This article will define the "caps" and provide additional information that will help investors understand terms that are often taken for granted.

First, we need to define "cap", which refers to market capitalization and is calculated by multiplying the price of a stock by the number of shares outstanding. Generally speaking, this represents the market's estimate of the "value" of the company; however, it should be noted that while this is the common conception of market capitalization, to calculate the total market value of a company, you actually need to add the market value of any of the company's publicly traded bonds.

Big-cap stocks refer to the largest publicly traded companies like General Electric (NYSE: GE) and IBM (NYSE: IBM). These are also called the blue chip stocks. "Big" has also been believed to have less risk while "small" has implied more risk, but, as evidenced by Enron (NYSE: ENE), this is not a good assumption to make. It is true, however, that the bigger they are, the harder they fall.

The definition of big/large cap and small cap differ slightly between the brokerage houses and have changed over time. The differences between the brokerage definitions are relatively superficial and only matter for the companies that lie on the edges. The classification is important for borderline companies because mutual funds use it to determine which stocks to buy.

The current approximate definitions are as follows:

Big Cap - Market cap of \$10 billion and greater

Mid Cap - \$2 billion to \$10 billion

Small Cap - \$300 million to \$2 billion

Micro Cap - \$50 million to \$300 million

Nano Cap - Under \$50 million

These categories have increased over time along with the market indexes. In the early 1980s, a big-cap stock had a market cap of \$1 billion. Today that size is viewed as small. It remains to be seen if these definitions also deflate when the market does.

The big-cap stocks get most of Wall Street's attention because that is where the lucrative investment banking business is. These, however, represent a very small minority of publicly traded stocks. The majority of stocks are found in the smaller classifications, and this is where the values are. To prove this we examined Baseline's database of 10,721 stocks and found that 88% of the stocks were in the smaller classifications. Note the new category that shows how big "big" has become.

Mega Cap: 10 0.1% (over \$200 billion)

Big Cap: 374 3.5%

Mid Cap: 794 7.4%

Small Cap: 1888 17.6%

Micro Cap: 2015 18.8%

Nano Cap: 1699 15.8%

The big and small labels are also attached to the major stock exchanges and indexes, which also leads to confusion. The Dow Jones Industrial Index is viewed as consisting of only big-cap stocks while the Nasdaq is often viewed as being comprised of small-cap stocks. These perceptions were generally true prior to 1990, but have since changed. Since the tech boom, the market caps of the stock exchanges and indexes vary and overlap. The average market cap for the Dow, however, remains much larger than the average market cap for the Nasdaq 100.

## Conclusion

Here are some main points to keep in mind:

- Labels such as big and small are subjective, relative and change over time.
- Big does not always mean less risky, but the big caps are the stocks most closely followed by Wall Street analysts.
- This attention, however, generally means that there are no value plays in the big-cap arena.

EBITDA: The Good, the Bad, and the Ugly

EBITDA is one of those terms that is increasingly used, but

## About the Author

Source: <http://www.articletrader.com>