WORLD'S SIMPLEST STOCK VALUATION MEASURE

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Here’s the world simplest stock valuation measure:

Growth Rate/2 + 8 = PE Ratio

Let me emphasize that this is simply a quick-and-dirty valuation tool and it shouldn’t be used as a precise measure of a stock’s value. But when I’m first looking at a stock and want to see roughly how it’s priced, this is what I’ll use.

For example, let’s look at **Pfizer (PFE)**. Wall Street expects the company to earn $2.34 per share next year. They also see the company’s 5-year growth rate at 2.79%. If we take half the growth rate and add 8, that gives us a fair value P/E Ratio of 9.40. Multiplying that by the $2.34 estimate gives us a fair price for Pfizer of $21.98. The current price for Pfizer is $22.98, so it’s about fairly priced.

Let’s look at **IBM (IBM)** which has a higher growth rate. Wall Street sees IBM earning $16.61 next year. They peg the five-year growth rate at 10.58%. Our formula gives us a fair value multiple of 13.29, and that multiplied by $16.61 works out to a value of $220.75. IBM is currently at $201.71.

I like to find stocks that are going for more than 30% below our fair value. As I said, that’s just one tool I use to find bargain stocks.

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Equity Versus Assets

I wanted to discuss an important topic that's often misunderstood by investors, and that's the difference between equity and assets.

When new investors look at the list of things to invest in, they tend to see it as a giant list of similar options; stocks, bonds, commodities, forex, real estate and so on. But this blurs an important point which is that stocks are unique. There's no other class quite like them.

All other assets are *things*. They just sit there. If you buy some gold and leave it alone, in 50 years it will still be there, just sitting there. There are income-producing assets like bonds and real estate, which makes them a little better than commodities. But still, they're just things. They can neither think nor create.

Equity, on the other hand, is wholly different. It's a legal entity by which people can come together and employ said assets to make goods and services for people. It's almost analogous to looking at the difference between a pile of car parts and a fully assembled car. The business works to make a profit, and it keeps investing those profits in the business to make still more profits.

Some trader right now is investing in, say, copper. I wish them well. But remember that copper has no independent value. By itself, it's just an element. Not to get too philosophical, but copper's entire value is based on what it can do for us. What are the goods and services it can enhance? For that to happen, copper needs to pass though the hands of a business.

This is why long-term studies of what's been the best investment usually have stocks at the top, followed by bonds and real estate followed by commodities. When you're investing in a company, you're really investing in human ingenuity—the way that people can come together and figure out how to make something useful from those assets.

Real estate, for example, is a nice investment. I hope everyone owns their own home. But in the long run, real estate will never, ever, ever, ever outpace stocks. Never. This isn't just my opinion, it's reality. It won't happen because it can't happen.

A house is simply an asset. No matter how hard it tries, it will never be anything more than an asset. A house does its job by just sitting there. But a stock is different. A stock is part ownership in a corporation. A corporation is people using assets to create wealth. This ain't just a matter of definitions.

You can buy a share of stock of a company that can buy a house. A house can't invest in a corporation. You can form a corporation and issue stock. With the proceeds, you can do cool things, like…buy a house and rent it for profit. After a while, you'll have enough money to buy another house.

Then another and another. Soon, you'll have a nice stable of houses. That's what businesses do—they grow. If they don't grow, they're replaced by businesses that do. It's that simple, and a house can never do that.

Why Return-On-Equity Is So Important

Here's a post for new investors or a helpful reminder for more experienced investors.

When you're looking at a company, the single-most important number is return-on-equity. Forget head-and-shoulders, forget bear traps and double bottoms, forget volume, forget stochastics.

Return-on-equity tells you more than anything else about how well a company is performing. It's the best measure of efficiency, bar none. In short, ROE tells us how much we get for how much we got.

ROE can be deconstucted down into three parts (warning, math ahead). Profits margins, asset turnover and leverage. Think of it this way:

Profit margin is profits divided by sales.

Asset turnover is sales divided by assets.

Leverage is assets (stuff you have) divided by equity (stuff you own).

If we multiply them it will look like this:

(Profits) (Sales) (Assets)
——– X ——– X ——– = ROE
(Sales) (Assets) (Equity)

I pass the graphics savings on to you.

The mathematically inclined will see that the two "sales" and two "assets" cancel each other out. And we're left with profits divided by equity, or return-on-equity.

(Profits) (~~Sales~~) (~~Assets~~)
——– X ——– X ——– = ROE
(~~Sales~~) (~~Assets~~) (Equity)

See, easy.

The beauty of ROE is that it works for every company. You can compare General Electric to a lemonade stand. A company like Wal-Mart may have a teeny profit margin (around 3.5% last year), but incredible asset turnover. Wal-Mart is really just one big inventory control machine.

A financial company like JPMorgan has 12 times more assets than equity, but it generates less than a penny of revenue for each dollar of assets.

Everything here balances out. If you want to borrow more to increase your leverage, your interest costs will hurt your profit margin. Or, you can increase your asset turnover by lowering your margins. There's no way to shortcut except by doing better business.

For ease of explanation, I'm simplifying this but there are two other ways to bump up your ROE. One is by lowering your taxes and the other is by lowering your borrowing costs. Typically, however, companies aren't in control of these variables.

Investing Is a Bottom-Up Activity

The longer I've worked as an investor, the more I've come to realize that successful investing is a **bottom-up process**. By bottom-up, I mean it starts with the very basics of a company (its products and markets) and gradually works upwards from there (i.e., balance sheet, cash flow, valuation ratios).

The problem is that most people are strongly averse to this approach. I don't know exactly why, but there's a natural propensity to view the investing world top-down. This clouds nearly every investment discussion. Heck, I'm guilty of it myself.

Here's how it works. An investment discussion (particularly in the media) invariably starts with the Federal Reserve and the macro economy. Then it works its way down to partisan politics: the budget, taxes and the debt. Throw in a discussion of EMH and how bad hedge funds are (curiously, we're never told the flip side of EMH—that it's impossible *to lose* to the market consistently before fees), and maybe touch on CAPE. Then if we're lucky, one or two comments about Apple. And we're done.

This is a huge disservice to readers, and almost none of it matters to being a good investor. The skill set one needs to be a shrewd stock picker doesn't involve complex math or defending your political party. Rather, it's closer to that possessed by an investigative reporter or a private eye. Don't laugh. Whenever I'm in a department store, I've gotten in the habit of asking the kid behind the counter, "What's popular?" He'll tell you. In fact, he'll tell you a lot. Just by doing this, you can learn a lot more than what a stock screener will tell you.

Look, I love financial ratios as much as anyone, but the information they give you is very limited. I've long called the Balance Sheet the overlooked cute sister of the 10-Q report, but even that only says so much. Here's an important generality in corporate finance: a good company isn't usually transformed into a bad one by taking on too much debt. Sure, it's possible, and certainly it has happened before. But what really happens is that companies take on too much debt precisely because they're bad. They have a growing need to mask their deficiencies.

A few years ago, I stumbled across **Nicholas Financial (NICK)**. I've probably written about this stock more than any other. NICK isn't followed by any analyst. It rarely generates news. I visited a branch office and later called up the CFO. He patiently answered my many questions. With a little bit of work, I probably knew more about them than anyone outside HQ.

I remember when NICK dropped below $1.64 per share five years ago. It's really hard to believe in efficient markets when your stock is trading at one-fifth book value and roughly one times earnings for the year after next. The market was offering me dollars for dimes, and I bought them. (NICK just agreed to be bought out at $16 per share.) Inflation, Obamacare, the euro—none of that mattered. To be fair, the Fed's low rates played a role in helping NICK, but connecting that policy to being a NICK bull would be a stretch.

I also have a growing distrust and outright aversion to the tiresome bull-bear debate (Barry Ritholtz has led the charge on this for years). It's a fun parlor game, but again, how does it help investors? Not much.

Another favorite game of the top-down view is to find a sector that ought to be big in the future. I know! Green Energy! Robotics! Biotech! China! Chinese robots producing green energy biotech!!

A basic fact about business is that money can be made just about anywhere. Your objective shouldn't be finding the next so-and-so. You should try to find superior ROE. No top-down approach would lead anyone to **Danaher (DHR)**, but it's been one of the best-performing stocks of the last few decades. Their stable of businesses is pretty ordinary. That's what they do, and they do it well.

My advice to investors is to grant yourself a healthy distance from those who view investing from 30,000 feet. It's easy to wave your hand and say everything's overpriced and the Dow could go to 1,000. Instead, if you're interested in a company, start at the ground level and found out why it's successful.

Personal Finance 101

It's easy to laugh at the comic books put out by the Fed.

No, you didn't read that wrong. The New York Fed really does have a series of comics, and they're available both in free print versions and on its website. Included are such titles as "The Story of Banks," "The Story of the Federal Reserve System," "The Story of Foreign Trade," "The Story of Monetary Policy"—you get the idea.

Not all the materials are technical, of course. "A Kid's Guide to Money" attempts to teach budgeting to whatever generation is now replacing the Millennials in the long parade of evermore-entitled American self-seekers, while "Wishes and Rainbows" is more philosophical: A little girl finds the secret to raising colorful flowers in a black-and-white world. How to distribute them? Allow the market to dictate the price of scarce resources? Sell off the community's wealth to more-developed neighbors with superior technology? From each according to his abilities, to each according to his means?

Granted, the Fed is making the satirist's job pretty easy here. You don't need to be super-hip to take campy delight in the books' stodgy, unconsciously-patronizing-to-the-kids tone and cheesy graphics, which are pretty much what you'd expect from educational materials mandated by bureaucratic fiat. (Reading through them, you can almost hear the fluorescent lights humming in some grim federal building in the most forlorn corner of L'Enfant Plaza.) One activity book opens, "An old rock group called the Rolling Stones once sang…." Another features characters whose similarity to the stars of Hanna-Barbera's Scooby-Doo franchise is just this side of legally actionable. Still another features two not-fun videogames (here and here).

But quickly the laughs give way to chagrin. And a dawning sense of alarm.

Why alarm? Because what quickly becomes apparent is that for all their lameness, these materials are trying to address a real need. Specifically, the need for financial literacy, which, on the evidence of certain events in the housing and credit markets of not too long ago, would appear to be sorely lacking in today's America.

The Fed isn’t alone in throwing its hat into this educational ring. In 2011, Virginia’s public schools made a combined economics/financial-literacy class mandatory for graduation. Other states have similar requirements on the books. Meanwhile, many colleges now mandate that their charges take Personal Finance 101 immediately upon enrolling.

These curriculum changes may, of course, be motivated by whatever fad is now sweeping the graduate schools of Education and so filtering down to the state bureaucracies. But I prefer to reject such cynicism, however justified. I really want to believe that America’s public officials are indeed finally waking up to reality, that they recognize that in an increasingly post-pension world, a world where people are living longer and where Social Security cannot be relied upon to maintain one’s standard of living after retirement, the good citizens of the republic must, sad to say, learn to make intelligent decisions with their money. Nowadays this has become even more imperative, given that the country’s financial-services sector has become ever more aggressive—and ever more devious—in its strategies to separate folks from their hard-earned dollars.

Whatever the case, the teachers would appear to have their work cut out for them. A 2010 study by the University of Arizona found that college students all too frequently indulge in “risky coping strategies.” Among these “strategies”: postponing necessary health care and using one credit card to pay off another. Meanwhile, a financial-literacy workshop hosted by a community-outreach association in the Bronx tries to render its participants “work-ready.” Its activities include teaching 22-year-olds how to read their paychecks and explaining that check-cashing counters are frequently not the best option for those in need of funds. One attendee confessed she’d bought two pairs of headphones the day before the workshop, for reasons unclear even to herself. Several students were surprised to learn that credit cards are not a form of free money.

Astonishing, I know. But lest you come to the conclusion that such cluelessness could only flourish between East Tremont Avenue and the Bruckner Expressway, there is abundant evidence of its pervasiveness in all sectors of American society. Annamaria Lusardi, a Dartmouth economist who heads up the Financial Literacy center, has found that a majority of Americans do not understand the idea of compound interest.

And Broke, U.S.A., journalist Gary Rivlin's ground-level view of the Great Housing Scam of the 2000s, describes scores of people—rich, poor, and everything in between—who refinanced out of low-interest mortgages, or who thought they had signed fixed-rate agreements when they had really signed adjustable-rate ones.

When you combine this total lack of comprehension with Americans' ever-growing sense of entitlement—our sense that not being able to pay for the things we want should be no impediment to our buying them—you have a disturbing sense that our culture that is in deep trouble.

Maybe the Fed is onto something, after all.

"A Kid's Guide to Money," page 4:

"We all have a limited amount of money that we can use to buy things. Sure, it would be nice to have whatever we want whenever we want it, but because money is scarce, we have to make choices. When you make a choice, you give up one thing in exchange for another thing. This is how adult life works."

A sobering lesson. Would that we had learned it back in 2004.