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John Price, PhD

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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ISBN 978-0-470-60438-0 (hardback); ISBN 978-0-470-91097-9 (ebk);
ISBN 978-0-470-91098-6 (ebk); ISBN 978-0-470-91099-3 (ebk)

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

Acknowledgments

When I read the acknowledgments in other books I often think how fortunate the authors were to have had so many people help with their books. Now I find myself in the same privileged position. There have been many people who have played important roles at all stages of this book.

I am enormously grateful to Warren Buffett. Without his investing expertise coupled with the generous way that he answers questions at the annual meeting of Berkshire Hathaway and other times, this book would not even have gotten started. It is still clear in my mind the palpable excitement in the auditorium when my wife, Sandy, and I attended our first annual meeting of Berkshire Hathaway. Despite the fact that there were around 14,000 attendees, I had the feeling that he was talking to his family. His good humor, common sense, and integrity supported his wise words on investing in the stock market.

Next I am grateful to Roger Lowenstein, the author of *Buffett: The Making of an American Capitalist* (Random House, 1996). This excellent biography was life-changing for me. Lowenstein laid out Buffett's history with just enough information on his methods to whet my appetite for more. As an investor I was impressed by Buffett's stock market success. But as a mathematician and scientist I was even more impressed by the consistency of his results, outperforming the market almost every year for over four decades. This was far more than anything that could be expected by chance. I wanted to know how he did it. How did he achieve such success year after year over decades? I immediately put aside all my research and consulting on derivatives and risk management to focus on understanding Warren Buffett. At that moment I felt that my background as a research mathematician, computer programmer, educator, and writer came together. I read everything by Buffett and about him that I could get my hands on. He became my research project.

Approaching topics from a research perspective is natural for me since it forms the greater part of the two parts of my career, academic and business. Starting with the academic, I would like to thank Robert Edwards, my Ph.D. adviser. Robert generously read everything I wrote as I struggled toward understanding what was meant by research mathematics and to explain my ideas and results with more clarity and precision. Robert's guidance and encouragement went far beyond the usual role of a thesis adviser.

This was the start of my academic career, and I thank all of my colleagues at universities around the world where I have spent time in teaching or research positions. My happiest memories range from the solitude of my office, poring over books and manuscripts, to discussions in the common room, to time spent browsing through the dusty book and journal stacks in the libraries. Also I loved teaching the big first-year classes: They brought out the performer in me. In terms of research, I have been fortunate to work with leading people including (in alphabetical order) Gavin Brown, Michael Cowling, Tony Dooley, Alessandro (Sandro) Figà-Talamanca, Garth Gaudry, Ed Hewitt, Valery Kholodnyi, Henry Landau, John McMullen, Sid Morris, Larry Shepp, Alladi Sitaram, and Terry Speed. Apart from the publications we have written together in mathematics, physics, and finance, I have learned so much from these people. More generally, I am grateful to my colleagues at a range of universities including the Australian National University, Maharishi University of Management, University of Genoa, University of Maryland, University of Milan, University of New South Wales, University of Sheffield, and University of Washington (Seattle).

It is a pleasure to thank Ralph McKay, who in 1987 started an innovative company called Option Technology. It aimed at applying the newly developed methods of risk analysis using options to help importers and exporters manage their foreign exchange risk and developers manage their interest rate risk. I am grateful to Ralph for plucking me out of academia to join his company as head of research. Much of my time was spent working out pricing formulas for all sorts of exotic derivatives including barrier, compound, look-back, and many more. Some years later, part of this work grew into a research monograph written with Valery Kholodnyi called *Foreign Exchange Option Symmetry* (World Scientific, 1998).

After Option Technology it was a complete change of pace with a move to Maharishi University of Management in Fairfield, Iowa, as

head of the Department of Mathematics. This is where I was handed the biography of Buffett by Lowenstein, mentioned earlier. It was the ideal place to dive into Buffett's methods: There were interested international faculty members to bounce ideas off, an intellectual and experiential framework provided by Maharishi to understand new approaches to knowledge, many enthusiastic investors to attend the workshops that I started to give, and a comfortable drive to Omaha, Nebraska, to attend annual meetings of Berkshire Hathaway.

What was needed now was some way of thoroughly testing the methods that I read about and those I was developing. This led to the development of Valuesoft, a collection of investing functions that operate within Excel. Once loaded, the functions become part of Excel and can be used and manipulated in the same way as the standard functions that come with the software. I am grateful to my son Matthew for helping me overcome a few programming hurdles in getting this up and running. Now I had a framework for testing functions with data for specific companies or with multiyear data from thousands of companies in commercial databases. I quickly began to add valuation functions to Valuesoft, a process that continues to the present time.

Next I would like to thank Ken Barrett. At the time Ken was an owner of Alliance Investment Services and he was the first financial professional to look at what I had developed. He said that it was what he had been looking for but had never found in the large number of presentations and workshops he had attended. It was his encouragement that spurred me to keep going. Later it was a pleasure to be associated with Alliance and to work with Ken, as well as with Brad Martyn, Scott Stanley, and Paul Begley.

From the United States I came back to the University of New South Wales. For five years I was head of a double degree program where students graduated in both finance and mathematics. This was a wonderful time since I had the opportunity to supervise the final theses of about 30 students. Topics ranged from trading methods through to some of the valuation methods described in this book. Around this time Andrew Bird formed Aspect Financial, which became Aspect Huntley and later Morningstar (Australia). I would like to thank Andrew for his support and the opportunity to consult for his company in its formative years.

I would also like to thank Margie Baldock. In 2000 Margie contacted me and said that she loved Valuesoft but wanted it automated

and coupled with its own databases. With her creative background in marketing, the two of us, with my wife, Sandy, formed a company and this was the start of the Conscious Investor[®] investment software. We were fortunate in getting the programming expertise of Paul Shields, who took my code for key functions in Valuesoft and programmed them into a systematic, user-friendly setting which we called Conscious Investor. The package consists of three steps: scanning individual sectors or the whole market, reviewing companies in more depth, and finally calculating the likely profit. I also want to thank Bretton Day and especially Felipe Rodriguez for financial support that made the whole project viable. A few years later Felipe, Sandy, and I bought Margie's share of the business.

Since those early days, Conscious Investor has evolved with more features including an expert system to describe and interpret in plain English the main features and significance of key charts for individual companies, through to automatic margins of safety when calculating the likely profit from an investment. Other people I would like to thank for helping make Conscious Investor successful are Laura Courtney, Adam Dominik, Mary Huynh, Rajiv Jacob, Saurabh Shukla, and Kean Wong. I also want to thank Bill Clark for his marketing expertise and patience in working with me to clarify what I was trying to achieve. On the research side, I thank Clive Wong, Wayne Thong, and Xiao Xu, who were my research assistants at different times. I am grateful to Ed Kelly who, when he was at Trinity College in Dublin, carried out the first independent research on Conscious Investor. Over the years data for Conscious Investor has been supplied by Morningstar. In this area I have had a lot of help from a number of people at Morningstar including Elise Isaacson, Anna Nordseth, and Thu Pham (in the U.S.), as well as Andrew Doherty, Darryn Springett, and Jamie Wickham (in Australia). Thank you for your support and prompt replies to my questions.

At the start of 2009, Conscious Investor became part of Teaminvest. I particularly want to thank Teaminvest's Howard Coleman for recognizing the strengths of Conscious Investor and making it part of his vision for a truly unique package for serious investors. Howard's ability to analyze companies from a business perspective, to describe the factors that are crucial for their success, and to list their future risks was an eye-opener for me. It reminded me of what I had been told about the way Buffett could, in a short telephone call, give valuable insights to the managers of Berkshire's businesses.

In most cases, these were initially their own businesses that they had been running successfully for years. Also I want to thank Mark Moreland of Teaminvest for his marketing energy and drive.

Various people have read different versions and chapters of the manuscript. I thank you all for the time and care you have put into this. In many cases your suggestions have been the difference between a confused description and a readable explanation. In particular I thank Pauline Clemens, Charles Mizrahi, Ralph Rasmussen, Tom Rickenbacker, and Mark Riordan. Charles and I have had many conversations over the years which I have highly valued. His book *Getting Started in Value Investing* (John Wiley & Sons, 2007) is an excellent way to do just that, to get started in value investing. I also thank Charles for introducing me to Debra Englander, executive editor at Wiley. It has been a pleasure to work with Debby, as well as with Adrianna Johnson, Kelly O'Connor, and Claire Wesley, also at Wiley. Robert Miles is another person with whom I have had enjoyable "Buffett" conversations and dinners over the years. I particularly enjoyed his book *The Warren Buffett CEO* (John Wiley & Sons, 2003). I also thank Jim Brownlee for his support.

Finally, it is a huge pleasure to thank Sandy. Not only is she my wife, but she is also my best friend and confidant. She has always been completely supportive of everything that I have wanted to do and without her I have no doubt that I would not have gotten to the stage of writing a book. Even on the technical level her support for this book has been way beyond any marriage vows. For instance, with little background in investing and the stock market, she read every word that I wrote and made pertinent suggestions on content as well as style. Many times she pulled me up and prodded me to explain more clearly what I was talking about. Thank you, Sandy.

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Introduction

The stock market is an extraordinary outcome of human ingenuity. Buying shares on the stock market gives you ownership of parts of some of the world's greatest companies. For under a hundred dollars you can buy a piece of Microsoft or Intel, companies that have revolutionized the way we do business and, indeed, most parts of our lives. You can buy a piece of Wal-Mart or Costco, companies that have changed the way millions of people shop. Or, in a different direction, you can buy shares in new sustainable energy companies such as Suntech in solar energy or Vestas Wind Systems in wind energy, companies that are shifting how we see our relationship with our environment.

As a shareholder you have ownership rights such as voting for directors, receiving dividends, and sharing in the proceeds of a corporate liquidation. But as an investor the key goal is to choose stocks that will be profitable. This is the focus of this book: showing how to be a successful investor by determining the real value of stocks. This will be done through a careful analysis of quantitative methods of equity evaluation to determine whether an investment will make money or not. Putting it simply, we are going to examine what separates wealth winners from mere speculative hopefuls.

Successful investing depends on knowing what to buy and when to do it. Then it depends on knowing when to hold and when to sell. The problem is *how* to do this. We often talk about the stock market in terms of a human psyche with a mind of its own: euphoric highs, depressing lows, tedious doldrums. And it is hard not to think of it this way. For example, from 1975 to 1985, on average the U.S. stock market reflected around 50 percent of the value of the underlying assets, according to U.S. Treasury tables. This means that a very large investor, by buying all the stock of companies traded on U.S. markets, could get the lot for about half the price of what the overall market

was worth. Such an investor would be getting everything for 50 cents on the dollar. Then the market started climbing until in 2000 it was close to twice the value of the underlying assets. Next it crashed to undervalued levels in 2008 but has now crept up until it is slightly overvalued once again in early 2010.

Another example of the bipolar nature of the stock market is the price of Berkshire Hathaway, the company run by legendary investor Warren Buffett. Since he has been in charge of the company there have been four occasions when the price has dropped by around 50 percent. The first three times were in 1974, in 1987, and in 1998. Each time, like a punch-drunk fighter, it picked itself up off the canvas and headed for record highs. Consider the fact that Buffett bought his first shares in the business for \$7.50 on Wednesday, December 12, 1962, and on Tuesday, December 11, 2007, almost exactly 45 years later, they reached \$151,650, an all-time high. This is an average return of 24.65 percent per year. After that the price tumbled to a low of \$70,050 on Thursday, March 5, 2009. Within six months it was back over \$100,000, and by March 2010 it was over \$125,000, so the chances are that the price will move to record highs once again. These massive price swings have little if anything to do with the underlying business. Every year the company, under the astute leadership of Buffett, continues to invest its capital in a wide range of quality businesses either via the stock market or through direct purchase of private companies. Except on two occasions, every year the equity of the business on a per-share basis has gone up, a remarkable record. However, if you only looked at the share price, you would conclude that the business was continually alternating between periods of wild success and dismal failure.

It is our job to look behind these manic-depressive swings of the overall market and individual companies where prices seem to oscillate between astronomical highs and pitiless lows. For example, what is it that drives the share price of Berkshire Hathaway upward over the years despite the short-term volatility? In a nutshell, it is the strength of the underlying business. For a start, when a company announces strong improvements in its sales and earnings, generally its price goes up. If it announces the opposite, generally its price goes down. More importantly, over a longer time frame, the prices of successful businesses tend to rise and the prices of poorly performing businesses tend to fall, the speed and sizes of these rises and falls depending on the degree of success or otherwise of the business.

Many years ago, Benjamin Graham, often referred to as the dean of Wall Street, said it clearly: “In the short term the market is a voting machine, in the long term it is a weighing machine.”

What is it weighing? Value. And value and the valuation of equities are what this book is about. It is all about how to weigh or measure the value of stocks. If we can’t measure value, then we cannot tell if any stock that we purchase is likely to be profitable. We are left to be kicked around by the market’s whims and uncertainties. This is particularly true at the present time since, according to George Soros, we are experiencing the “the worst financial crisis since the 1930s.” Yet history shows that it was during times of past turbulence and uncertainty that many astute investors made their greatest profits.

After making a purchase of shares in a company, it takes time to be sure that it was profitable and, hence, that it represented value. If the price goes up over our time frame we can look back and say that when we made the purchase the price we paid was good value. If the price goes down, we say the opposite. The problem facing every investor is to be able to determine at the time of the purchase whether the investment is likely to be profitable or not, and not wait until the price has actually gone up or down. This is done by measuring the real value of the equity when the purchase is being considered.

Like most important areas in life, this measurement of value is both a science and an art. It is both objective and subjective. As a science, measurement of value involves careful calculations using specific financial inputs based on approved and audited financial statements. The outcome is usually referred to as *intrinsic value*, which is taken as the true worth of the equity independent of investor and market opinions. The measurement of real value comes by comparing this intrinsic value with the actual price. If the intrinsic value is high compared to the price, then we are encouraged to go ahead with the purchase. Otherwise we would be wise to leave it alone.

At the same time, measurement of value is an art because there are actually dozens of ways of measuring intrinsic value, each with its own set of inputs. Often the outcomes for the same stock are hugely different so that which method to use and the levels of the inputs are judgments to be made. In this book each valuation method is followed by a clear list of its strengths and weaknesses so that you can make an informed choice if you wish to use that method. Just as importantly, you can be aware of what to watch out for when reading

a report on a company that discusses its value using a particular valuation method.

The fundamental assumption of value is that over time, the price of a stock will move toward its true worth or intrinsic value. Just like a swarm of mosquitoes appear to be flying randomly, but overall unerringly move toward an uncovered arm, so the millions of investors drive the stock price, by a series of persistent up and down nudges, toward its value. The difference is that for mosquitoes the time frame is minutes, while for the stock market it can be months and even years.

In fact, this tendency of prices leads to a second assumption, namely that stocks that are more undervalued will initially rise in price more quickly than those that are less undervalued. In other words, they will have a higher rate of return. This means that we have two core questions when making investment decisions: How much is it really worth? And, if it is undervalued, is the market price substantially below the true worth? These questions, particularly the first one, are the focus of the methods covered in Chapters 6 to 10 and then again in Chapter 12.

The preceding discussion leads, however, to an even more fundamental question for investors, namely: What rate of return can I confidently expect to get? In the end, this is the all-important question for making investment decisions. Even if a stock is undervalued by 50 percent, it is no use as an investment if we do not have confidence at the outset about the growth of its price. For example, the fact that it is highly undervalued does not tell us when, or indeed if, the price will move upward in our time frame. The stock may continue to stay undervalued by 50 percent for years. As investors we want to know at the time of our purchase whether we are going to make money or not, and how much we are likely to make. In other words, what is our anticipated rate of return? This means that we don't even need to calculate intrinsic value provided we can calculate the expected rate of return. Methods are presented in Chapters 11 and 13 that go straight to such calculations.

The major stock markets around the world are maelstroms of activity. Every day, untold numbers of transactions are made by hundreds of thousands of people involving thousands of companies. With an online brokerage account and a basic home computer, it can be done with a few key strokes and mouse clicks. On one hand, are the parents at home with children on their knees, the office workers in

their work cubicles, and the tradespeople on their Internet phones, all squeezing in a few transactions whenever they get the chance. On the other hand, there are the investment professionals sitting in front of banks of computer monitors, shifting millions of dollars, often in great spurts of activity. In every case, the goal is the same: to increase the net worth of their portfolios or the portfolios of their clients.

What does differ is the reasoning and strategy behind their decisions. These depend on many factors. The time element is one of them. For day traders, unless the price moves immediately in the way they want, they may well cut their losses and reverse the transaction. For savvy value investors it is the opposite: If the price of a stock goes down after they make a purchase, they are likely to buy even more. As an investor, rather than a trader, we want to find stocks that, compared to their market price, are undervalued according to clear criteria. In the opposite direction, if the price of a stock is substantially above its value, then it may be time to sell since it is likely that the price will drop.

There are two basic problems with the value approach, both related to the fact, stated previously, that there are many ways of calculating value. The first problem is that on an initial analysis all the methods can seem very plausible. In most cases, if the average investor and, I suspect, the majority of professionals were presented with any one of the methods with its accompanying rationale, they would accept it as the method to use. However, as stated earlier, the different approaches can give hugely varying results, in some cases differing by hundreds of percent. Even within some of the methods, just small changes in the way they are applied can result in impossibly large variations.

The second problem is that the methods all have different assumptions and requirements. Some methods apply in certain situations while other methods apply in quite different situations. To try to apply a single method in all situations invariably leads to misleading results. Unfortunately, investors and analysts are usually only familiar with a single method and keep applying it in every case. It may be a valuation method they were taught in a formal course, or it may be something they picked up from a book, web site, or software package. The point is, along with most areas of life, it is just not true that one size fits all. (Charlie Munger, Warren Buffett's longtime friend and vice-chairman of Berkshire Hathaway, is fond of saying that to a person with a hammer everything looks like a nail.)

Important as they are, these are still technical problems. There is an even bigger problem associated with valuation methods, what I call *mathematical intimidation*. There is a tendency for many people to accept as correct anything that comes from a mathematical formula. Normal common sense and discrimination seem to be put on hold at the sight of mathematical symbols placed in a formula. Even if the symbols and formulas are hidden in computer programs, there is still the tendency not to question the outcome. As we will see, this is particularly true for the discounted cash flow and dividend discount methods with their impractical use of infinite forecasts. These methods are not even scientific because their key assumptions cannot be tested.

What Is This Book About?

With this in mind, the purpose of this book is to provide details of all the major equity valuation methods. Each method comes with a description of its motivation and justification, together with a list of its assumptions, so that it is clear which situations it can be applied to and which should be skipped over. Also, the strengths and weaknesses of each method are listed to make it easier to choose between competing methods. Which methods to use and how to apply them are not just theoretical problems. They impact decisions involving hundreds of millions of dollars for institutional investors. But for individual investors the stakes are often higher. Getting it right may mean the difference between a comfortable retirement and a struggle to make ends meet.

There is also an underlying theme in the book, which is really the path to the fundamental goal mentioned earlier of calculating the expected rate of return. This theme starts with the idea that intrinsic value or true worth on its own has no practical value for investors. It requires price to put it into action. And once you have included price, you are including, either directly or indirectly, price ratios such as price-to-earnings, price-to-free-cash-flow, or price-to-dividends ratios. (In fact, in the standard discount methods, you actually require forecasts of infinite strings of such ratios.) Now it becomes clear that you never had to actually calculate intrinsic value as a stand-alone dollar amount in the first place. This puts you in the fortunate position of recognizing that you can use one of a handful

of key price ratios to calculate directly the actual rate of return that you can confidently expect.

In the introduction to the early editions of the best-seller *A Brief History of Time*, author Stephen Hawking wrote that he was told that every equation he put in the book would halve the sales. He resolved to have none but ended up with a single equation. The bad news is that I have sprinkled equations throughout the book, particularly the later chapters. After all, if we are going to talk about the intrinsic value of stocks, then we need a formula to work this out. This will enable those with a mathematical bent to have a clear and concise description of the methods. The good news is that you can hop over the equations as all the methods are also described in words. Moreover, most of the equations are consigned to appendixes. In addition, the methods are presented in such a way that the calculations are a natural consequence of the features and logic of the method. In other words, by understanding what is trying to be achieved with a certain method, we are led automatically to the calculations, rather than the calculations driving the method.

The first three chapters set up what we mean by *value*. The first chapter looks at the concept of intrinsic value, particularly in monetary terms as it applies to the stock market. What is intrinsic value? Does it really exist? What are the ways of measuring it? Chapter 2 covers the price-setting mechanisms and influences in the stock market. It also describes the difference between pure price theories and fundamental data theories. Briefly, pure price theories such as the efficient market hypothesis and technical analysis describe price movements with reference to the price itself. In contrast, fundamental data theories, the focus of this book, describe price movements as a longer-term response to the fundamental data of the underlying businesses or equities. Chapter 3 brings together Chapter 1 on intrinsic value and Chapter 2 on price, and introduces real value as a combination of intrinsic value and price. In broad terms, the greater the intrinsic value compared to price, the greater the real value.

Chapter 4 is an introduction to accounting and the roles of the four financial statements (balance sheet, income statement, cash flow statement, and equity statement) in providing the data for the valuation methods. I even include a brief discussion of off-balance-sheet obligations. Chapter 5 uses the data in the financial statements to describe the key financial ratios as part of the process of analyzing

and filtering companies. The valuation methods themselves start in Chapter 6. For those who want to get straight into the actual methods, this is the place to start.

Most of the valuation methods are presented in three parts. The first part is a general description with minimal use of technical language. The descriptions list the type of data that is needed, including whether it can be taken straight from financial statements issued by the company or whether estimates are needed such as forecasts of the growth of earnings. As well, the type of output is clearly described. For example, in some cases the output is the direct statement of the intrinsic value of the stock. This needs to be compared with the current price to decide on what action, if any, should be taken. In other cases, rather than dollar value, the output indicates whether it is likely to be a profitable time to buy in terms of the expected return. A third case displays the outcome as the length of time that will be required for the earnings or dividends to cover the original outlay. The second part of the description of each method is more technical, giving either the specifics of the formula behind the method or, for the more complex methods, an outline of the formula. The final part of the description of each method is the list of strengths and weaknesses previously mentioned.

Who Is This Book For?

The book is intended for all investors, from those just getting started in the stock market to experienced professionals. For experienced investors, I hope the book will provide a fresh look at any valuation methods that you are already using. Many of you may want to go straight to the chapters on the particular methods that you use. Hopefully they will also provide new variations of these methods, as well as encouraging you to consider including other methods in your approach. For other investors, as explained earlier, Chapters 1 to 5 provide an introduction to all the tools and ideas needed to understand, measure, and use the idea of value in the stock market. From Chapter 6 onward, the book will provide you with an overview of all the main methods so that, as you get started, you will have more confidence in what you are doing.

My father, who built hundreds of houses during his life, always told me to make sure that I had the right tools and materials before starting on a job. Don't just rush in. This is even truer in the stock