

# **7 STEPS** **TO UNDERSTANDING** **THE STOCK MARKET**



# 7 Steps to Understanding the Stock Market

## *The Investing for Beginners 101 Guide*

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## Welcome to my Free Guide!

In a market driven by emotions like **fear** and **greed**, I present to investors a simple numbers-based approach to consistently picking good stocks. I'm an electrical engineer at a Fortune 500 company with a fiery passion for numbers and value investing.



I've developed the *Investing for Beginners 101* guide to give those who know nothing

about the stock market, to give them all the tools they need to make smart investing decisions.

Easy to follow and full of value, I've created the course for people of all ages to be able to understand, **leaving out all the Wall Street jargon**. Young investors have such an advantage if they just start now, and I hope to motivate as many people as I can to follow this path to wealth.

My investing strategy centers on value investing and is heavily influenced by Benjamin Graham, Warren Buffett, and investing podcasts and books.

Instead of attempting to reinvent the wheel, my 7 Steps to Understanding the Stock Market guide integrates **proven and successful** investing strategies.

I don't have a billion dollar portfolio, I'm not a wildly successful hedge fund manager, and I even don't have decades of experience. But I do take my research very seriously and have innovated on everything I've learned. Enjoy.

# Contents

<b>Step 1 to Understanding the Stock Market .....</b>	<b>5</b>
<b>The Rule of 72 Exercise .....</b>	<b>7</b>
<b>Step 2/7: How the Stock Market Works .....</b>	<b>8</b>
<b>Step 3/7: The BEST Stock Strategy and Buying Your First Stock.....</b>	<b>14</b>
<b>Step 4/7: How To Calculate P/E Ratio.....</b>	<b>21</b>
<b>Step 5/7: The Single Two Factors Most Correlated To Success.....</b>	<b>25</b>
<b>Step 6/7: Cashing In With A Dividend Is A Necessity.....</b>	<b>30</b>
<b>Step 7/7: The Best Way To Avoid Risk &amp; Putting It All Together.....</b>	<b>36</b>

# Investing for Beginners 101: 7 Steps to Understanding the Stock Market

Welcome to this easy 7 step guide to understanding the stock market, *Investing for Beginners 101*. I've created the easy to follow Investing for Beginners guide to simplify the learning process for entering the stock market. By leaving out all the confusing **Wall Street jargon** and explaining things in simple terms, Investing for Beginners 101 is the perfect solution for those willing to learn.

Before we get started, here is a breakdown of the 7 categories for the [first official Investing for Beginners guide](#).

1. [Why to Invest?](#)
2. [How the Stock Market Works](#)
3. [BEST Stock Strategy; Buying Your First Stock](#)
4. [How to Calculate the Most Used Valuation](#)
5. [The Single Two Ratios Correlated to Success](#)
6. [Cashing In With a Dividend Is a Necessity](#)
7. [The Best Way to Avoid Risk, and Putting it all](#)

[Together!](#)

## Why is investing so important?

Let's imagine a life without investing first. You work 9-5 for a boss **all your life**, maybe get a couple of raises, a promotion, have a nice house, car, and kids. You go on vacation once a year, eat out regularly, and attempt to enjoy the finer things in life as best you can.

Now since you haven't invested, you get old, become unattractive for hiring, and live with a measly social security allowance for the rest of your life. You might've made good money when you were young, but now you have **nothing to show** for your lifetime of work.

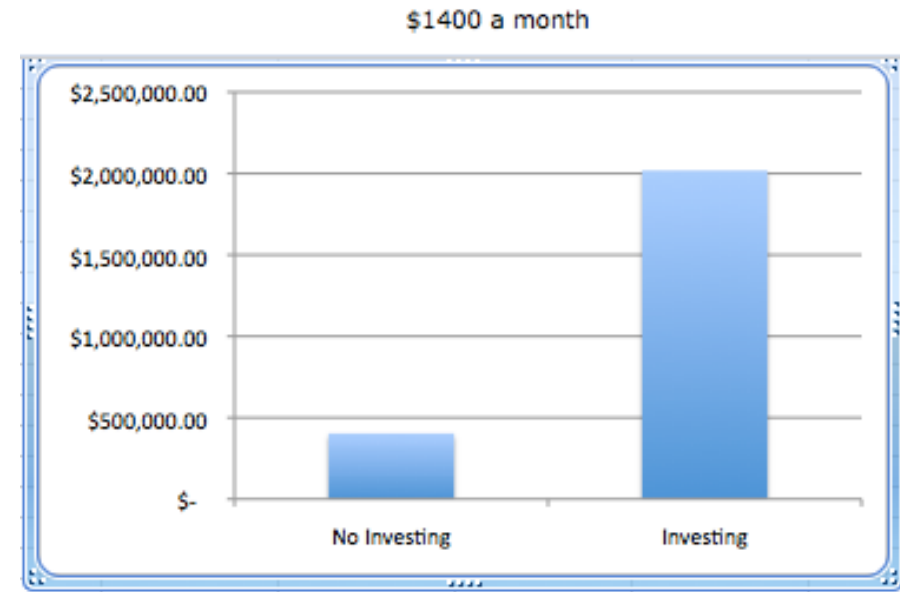
Now let's say you did save some money for retirement, but again this money wasn't invested and won't be invested. Let's even stay optimistic and assume you saved **\$1400** a month for 26 years. This would leave you with **\$403,200** to live on, which on a \$60,000 a year lifestyle would only last you 6.72 years. You're retiring at 65 only to go broke at 71 and you've been a good saver all your life. Well then what's the point of saving, you may

ask? Now let me show you the same numbers but add investing into the equation.

Again, let's say you saved \$1400 a month for 26 years. BUT, this money was invested continuously as part of a long-term investment plan, solid in the fundamentals you learned from *Investing for Beginners 101*. Now, including dividends in long-term stock market investments, I can confidently and conservatively say that you can average a 10% annual return on these investments.

The same **\$1400** a month compounded annually at 10% turns your net worth into **\$2,017,670.19** in 26 years! But the story gets even better. With this large sum of money at your retirement, again conservatively assuming a 3% yield on your dividends, you can collect \$60,530 a year to live on WITHOUT reducing your saved amount.

See the graph to the right to get a visual picture of the staggering difference.



### Answer: Compounding Interest

By letting the power of compounding interest assist you in saving, you leverage the resources available in the market and slowly build wealth over time. It's not some mystified secret or get-rich-quick shortcut; this is a **time tested** method to become wealthy and be financially independent, and it's how billionaires like Warren Buffett have done it all their life.

For those who don't want to think about tomorrow, I can't help you. But tomorrow will come, it always does. Would you rather spend the rest of your life with no plan, dependent on others and unsure of your future? Or would you rather be making progress towards a goal, living with purpose and anticipating the fruits of your labor you know you will be reaping for years after you sow?

The choice is yours, and only **YOU** will feel the consequences of that choice.

## The Rule of 72 Exercise

The Rule of 72 is a simple way to quickly calculate how long it will take for an investment to double, based on compounding interest.

As I referred to in the previous section, compounding interest works its wonders by earning interest on capital, than earning interest on the interest of that capital, thus multiplying the amount of money able to be

saved each and every year thereafter.

We want the ability to calculate how much interest we could earn on an average investment in order to plan sufficiently and create goals for that investment plan.

The equation for calculating how long it takes an investment to double is as follows:

$$[ 72 / (\text{interest \%}) ] = \# \text{ of years to double}$$

So, for our previous example of 10% compounded annually, it takes our money 7.2 years to double.

$$72 / 10 = 7.2 \text{ years}$$

In a period of 26 years, our money doubles 3.6 times. When adding in the monthly additions, this is how \$1,400 a month becomes \$2,017,670.19.

The best way to learn is by doing. Work on this exercise and then read the answer in the next exercise section. How long until your money doubles at 12% annually?

## Step 2/7: How the Stock Market Works

The saying goes that knowing is half the battle, and the same is true with investing in the stock market. By yearning to educate yourself about how to invest and build wealth, you are already halfway to your goal.

My job as your teacher is to build a foundation of educational wisdom that can be broadly used to earn money and understand any stock market strategy presented to you. I hope this guide is as entertaining and easy to follow as can be.

In order to understand investing, you must understand how the general principles behind the stock market work. Before I started researching and reading about investing, the only things I knew about the stock market were what I saw on TV or heard on the news, and it was never positive.

## Stock Market is Overdramatized

I remember hearing about the disaster of the Facebook IPO (initial public opening, when the stock is first able to be bought by the public), the failures of Freddie and Fannie Mae and how stocks tumbled afterwards, and the great dot com bubble that burst in 2000.

With each stock market crash or failure, there are lots of emotional stories about everyday people losing everything they had or big, greedy corporate leaders succumbing to the fall of their empire.

Because of my limited knowledge of the stock market, I pictured it as full of Gordon Gekko businessmen types (from Wall Street: Money Never Sleeps) with money spilling out of their ears and lives full of fast action and New York speed trading. Hollywood depicts Wall Street as this extreme roller coaster ride where fortunes are won and lost every instant, when in reality this isn't the case. Yes, the stock market has **ups and downs**, there is risk involved, and some people do get burned



badly, but the majority of successful investors take very boring and safe strategies straight to success, because they understand the basic principles and are educated on how to stay out of risky investments.

### Reality: The Market Fluctuates

I feel like I must give the reader some perspective to the reality of the stock market, so you can understand that the big flashy news headlines and TV specials are extremely overdramatized. The S&P 500 is a list of the top 500 stocks in the U.S., and is widely accepted as the benchmark for all stock investments; analysts consistently compare performance to that of the S&P 500. The S&P 500 is an index that you can think of that is similar to the DOW, which only has 30 companies. Now, the worst one day loss for the S&P 500 in 2008 was only **-9.03%**. In total for the year, the S&P 500 lost **-38.49%**, which was the worst year the index has ever had.

If you think about these numbers for a little

bit, anyone can clearly derive that investors lost less than half their worth during that year. But as you can see from the graph below, the S&P quickly **recovered** lost ground after the '08 fall.

In fact, periods of time where the price falls are common. An important aspect of investing is knowing that stock prices do fluctuate up and down but when held over long periods of time, the chances of capital gains exponentially increases.



## Reality: Media Covers the Extreme

As you can see, the majority of investors aren't in fact losing their shirts and the media is choosing to cover extreme cases of people losing money in the stock market, simply because they make for good stories and good TV. Those who did lose all their money weren't diversified in their investments, bought stock in companies that were over leveraged, borrowed money to purchase stocks, or a combination of all three.

For those investors who didn't sell their stocks in 2008, which would've been the worst time to bail out of your stocks, the market recovered and the "devastating losses" didn't affect their portfolio. Therein lies the importance of long-term investing and riding out the storms. Since its inception in 1957, the S&P 500 has returned on average 10.83% annually, when dividends are automatically reinvested.

For those who need a reminder on how powerful a compounding 10% return can be, recall my \$2 million example. In 40 years, this amount becomes \$8,179,114!

## Smart Investors Don't Listen to Noise

So *Investing for Beginners* fans, please don't forget that a stock is meant to be a long-term investment. It will pay you dividends that over time will compound and multiply, and if invested in a good company the share price will appreciate substantially as well. As financial guru Dave Ramsey simply puts it, "The only people who get hurt riding a roller coaster are the ones that jump off." Once you gain the confidence to have convictions in your investments - knowing that they will recover when hit badly - you will easily be able to avoid selling your stocks at the **worst possible time**, when the market has a temporary crash and it seems like everyone else around you is doing it.

Before I introduce the more in-depth topics of this guide, I feel I must explain how I derived these categories and why they are relevant to you. While the Value Trap Indicator I teach is my own original invention, the fundamental ideas and ratios are all well known and widely used by millions of investors around the world and countless investing gurus and authors. In fact, if you get around to reading enough investing and stock market books you'll realize they are almost all the same, and many of the various ways institutional investors evaluate a stock run parallel to other strategies.

Understanding this fact helps bring greater understanding to the process and you can feel confident in these metrics because a quick Google search will confirm their validity. I am not reinventing the wheel; instead I am utilizing my obsessive passion for investing research and presenting the most important concepts in an easy to follow guide not yet found on the web. For those who complete the guide and advance as investors, my Value Trap Indicator can be accurately implemented for a very profitable stock picking strategy.

Step 3 will uncover the **BEST** stock strategy you will ever learn, and will show you that buying stock is easy. The first step to swimming is first **getting your feet wet**.

Once you climb that obstacle of learning how to transfer money into your investment account and easily buy a stock, you will find the confidence to continue educating yourself about investing to then make the right decisions with some real money.



## The BEST Stock Strategy and Buying Your First Stock

For Part 3 of this guide, I will show you the absolute best strategy you should always use when investing and will help you overcome the biggest hurdle beginning investors face: buying your first stock. Buying just 1 share of your favorite company when buying your first stock is like taking your **first step into the market**.

I can't stress enough how important buying your first stock is, as you can read and read until your eyes turn blue but you won't start to see progress towards your results until you **take action**. Trust me - a guy who has been there already - buying your first stock gives you a sense of **empowerment** and excitement at being part of the stock market.

Before going over buying your first stock, I am going to reveal the absolute best stock strategy you can use and one that most wealthy investors use. It is called:

## Dollar Cost Averaging

What do investing greats have to say about dollar cost averaging? The godfather of value investing and Warren Buffett's mentor Benjamin Graham wrote in his book *The Intelligent Investor* that dollar cost averaging, "Enables you to put a fixed amount of money into an investment at regular intervals ... You buy more - **whether** the markets have gone (or are about to go up), down, or sideways." Warren Buffett called this book, "By far the best book on investing ever written," and it is the resource many investors refer to for guidance.

Dollar cost averaging is simply investing the same amount of money every month, year, or week, into the stock market with the effect of forcing the investor to buy more when stock prices are lower and buy less when stock prices are higher. By dollar cost averaging, the investor is always invested and will not be devastated by the losses that come with trying to time the market.

## Stay Away from the “Psychics”

In your investing life, beware the analysts who claim they know the exact time to buy low or sell high. In retrospect everyone believes they would've been able to predict the highs and lows of the market, but in reality it is impossible. Trying to profit from timing the market will **drive you nuts** and always leave you regretting your decisions. Most investors will sell too early and miss out on bigger gains or will sell because stocks have fallen significantly, which is the absolute worst time to sell. Or, investors will often feel good about their investments when they are doing well and will as a consequence buy a lot more at the time where stocks are very high already and there is very little upside.

Dollar cost averaging gives you the necessary, patient **discipline** you need to stay in the market for the long term and through the ups and downs. How does this strategy help you buy more when prices are low and buy less when prices are high? Take this simple example.

Say a stock's price is \$10 today and you are buying \$500 of stock a month in a dollar cost averaging strategy. So the first month you buy 50 shares of this stock. Let's say next month the price has dropped to \$5. Instead of getting pissed that the shares have fallen so much and cursing the world, the smart investor sees this as an opportunity to **buy more** stock at a discount. So, again you invest \$500 in month 2 knowing that you are in for the long term, and you end up buying 100 shares. Let's say in month 3 the price is still at \$5 and you are buying 100 more shares. Finally in month 4 the price recovers and is now at a whopping \$15.

Compare where'd you be if you had or hadn't dollar cost averaged. With dollar cost averaging, you have 250 shares of stock now worth \$15, and you are sitting pretty with some nice gains. Let's say you didn't use dollar cost averaging and you had invested all \$1500 at once. You'd have only 150 shares, and when the price dropped to \$5 you might've sold at the **worst possible time**, unable to stomach any more losses.

## Remember: Don't Try to Time the Market

While this might seem like an extreme example, you'd be surprised how often this happens to investors, which is the reason why many shun the market after being burned like this. Little do they know that a simple strategy such as dollar cost averaging reduces the possible downside and keeps you disciplined and invested long term.

If the price had instead gone up initially instead of down, yes investing all of it at the beginning might have been best in the short term for you now, but over many trades and years of investing, you'd find you're getting burned more often than you are gaining. Plus, how would you know when to sell? No one is able to predict the future no matter how much convincing talk you may hear, and the true answer is no one knows.

That's why it's important to stay long term invested and taking some profits along the

way, without getting greedy or attempting to sell at the highs or buy at the lows. Market timing will lead you to despair, and those who claim otherwise have yet to be burned by it but eventually will.

## Time for Action: Buying Your First Stock

Now that I've showed you why to invest, how the stock market works, and the best investing strategy you can use, my next recommendation is getting your feet wet and taking the first step towards taking control of your future by buying your first stock.

The best online broker I can recommend for buying your first stock is TradeKing, and let me tell you why.

Firstly, this broker is one of the few that doesn't have a minimum initial deposit when opening an investment account. Most investment brokers require at least \$500 to deposit, which doesn't help investors just trying to start out. I mean **who wants to pay**

**\$500** when buying your first stock?

Plus, the site has such low fees for buying your first stock and your next stocks, charging only **\$4.95** per trade compared to most at **\$6.95** or **\$9.95**.

TradeKing also ranked number 1 on comparebroker.com for accounts with no minimum and ranked number 2 on top 10 list online. I've made an easy picture guide to buy your first stock below. [Open a TradeKing account](#)

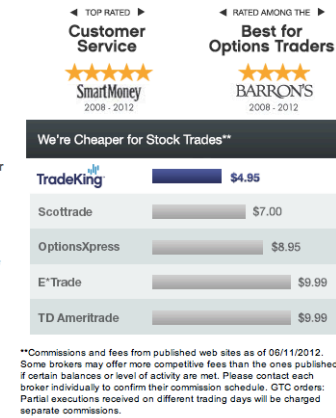
Please be aware that the process takes about 15 minutes to apply, and then 1-3 business days to get approved. Once that is completed, you are able to log in and buy your first stock!

Wealth building doesn't happen overnight, so this is a good opportunity to practice that newfound patience. On the first page, scroll down to open an account:

### Top three reasons to switch to TradeKing:

- » **Reason 1: Price**  
Stock trades are just \$4.95. Option trades are \$4.95, plus 65 cents per contract. There's only one base charge for multi-leg option-only trades.<sup>†</sup>
- » **Reason 2: Tools**  
Our licensed brokers provide great service, short hold times, fast email responses and instant online chat. See for yourself why SmartMoney Magazine ranked us #1 for customer service in 2008, 2010, 2011 and 2012.<sup>2</sup>
- » **Reason 3: Service**  
Get instant access to award-winning research and trading tools, including Research Reports, Interactive Charts, Technical Analysis Tools and much more. In fact, **Barron's ranked TradeKing #1 for site usability** in their 2011 annual review of online stock and option brokers.
- » **And more...**  
Interact with fellow traders and pros and see how they're performing. Check out Intelligence Reports, videos, webinars and much more.

[Open a TradeKing Account Today](#)



Select the type of account you want to open. If you are starting out and just want to buy a share, I suggest an Individual Account.

### WHAT TYPE OF ACCOUNT WOULD YOU LIKE TO OPEN?

Scroll over the ? icons to find out more about the type(s) of account that might be right for you. If you still have any questions, [Live Chat](#). We'll be glad to help.

- INDIVIDUAL ACCOUNT**
- JOINT ACCOUNT**
- CUSTODIAL ACCOUNT**
- TRADITIONAL IRA**
- ROTH IRA**
- ROLLOVER IRA**

Don't see the type of account you are looking for?  
[Please check here for additional applications.](#)

[CONTINUE](#)

Hit the green “continue” button then fill out your information on the next page.

### PERSONAL INFORMATION

**TIP:** We can't accept P.O. Boxes, mail drops, or UPS stores as Residential Addresses. You may, however, enter P.O. Boxes in the Mailing Address section.

**TIP:** There are [special requirements](#) for some foreign citizens.

Street Address	<input type="text"/>	?
	Address Line 2	
City	<input type="text"/>	
State/US Territory	select one	?
Zip	<input type="text"/>	
Country	United States	
Phone (during market hours)	<input type="text"/>	
Phone (alternate)	<input type="text"/>	
Check here if your mailing address is different	<input type="checkbox"/>	
Social Security #	<input type="text"/>	
Date of Birth (mm/dd/yyyy)	<input type="text"/>	
Country of Citizenship	United States	
Marital Status	select one	
Dependents	<input type="text"/>	
Employment Status	select one	

Next, fill out your Employment Information. Don't worry, they will not be contacting your

employer; they just need some sort of recourse to ensure you aren't wasting their time.

Employment Status

Employed

### EMPLOYMENT INFORMATION

**WHY DO WE ASK FOR YOUR EMPLOYMENT INFORMATION?** FINRA regulations require us to collect the employment information for this account prior to approving and opening the account.

Employer	<input type="text"/>	?
Street Address	<input type="text"/>	?
City	<input type="text"/>	
State/US Territory	select one	?
Zip	<input type="text"/>	
Country	United States	
Employer Phone	<input type="text"/>	
Occupation	<input type="text"/>	
Nature of Business	select one	
Employed Since	<input type="text"/> MM <input type="text"/> YYYY	?

STEP

1 2 3 4 5

< CONTINUE >

The next page is just a survey, so TradeKing can assist you with the best suggestions.



The page after is important, in the sense that you don't want to apply for margin. Investing with borrowed money is one of the worst things you can do in investing, this is how lives are destroyed and investment portfolios ruined. When the market crashes you need the patience to ride it through, but with margin accounts the broker may force repayment on big losses and force you to sell at the worst time, near the bottom when everyone else is freaking out. Just don't invest with margin.



### INVESTMENT OBJECTIVE FOR THIS ACCOUNT

CURRENT INCOME  ?

BALANCED  ?

GROWTH & INCOME  ?

GROWTH  ?

MAXIMUM GROWTH  ?

SPECULATION  ?

TIME HORIZON  ?

LIQUIDITY NEEDS  ?

RISK TOLERANCE  ?

### MARGIN AND OPTION APPLICATION

Apply for margin within this account?  
 Yes  No ?

The final step has you reviewing terms and conditions then signing your name. When dating the form, do it exactly in this way 04/18/2013.



### TERMS AND CONDITIONS

You've finished entering your personal information. The hard part is over. Now we just need you to review and approve some terms and conditions.

The next step involves transferring funds into your account so you can buy stocks. Once your checking account is approved, which I recommend doing instead of through wire or check, then you can transfer money in and out of the investment account with ease. Click on the yellow arrow on the bottom right of the screen to continue.

Funding is easy. Choose from 4 options:

Transfer funds electronically  
Transfer funds via wire  
Transfer funds by check  
Transfer assets from another broker

**FUND ELECTRONICALLY**

1. Benefits  
• Funds clear in 3 business days  
• Move money in and out of your account easily and quickly  
• Set up automatic recurring deposits, or schedule future deposits

2. Speed : [Progress bar with lightning bolt icon]

3. Ease : [Progress bar with pen icon]

Get Started

Next, enter your banking information.

Step 1: Enter your bank information below

Bank Name:

\* ABA Routing #:

\* Confirm ABA Routing #:

\* Bank Account #:

\* Confirm Bank Account #:

Account Type:

\*\* Name on Account:

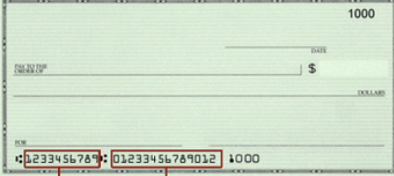
\*\*\* Individual / Joint:

Account Nickname:

**ABA ROUTING# BANK ACCOUNT#**  
\* Please enter all information carefully and accurately.  
**Do not use spaces or other characters** when entering the ABA Routing and Bank Account numbers.

\*\* Enter your name as it appears on your bank statement.  
Example: John A Smith

\*\*\* Select the type of bank account you have



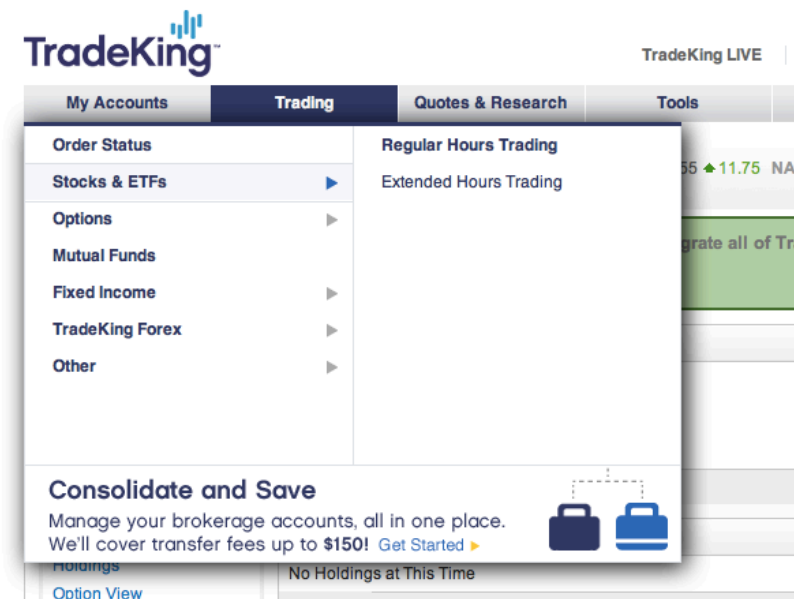
**Important!** We also need the following:

For the last step, take a picture of your driver's license and a voided check for your bank. Write down your 8-digit account number and include it in the picture as well.

Email the picture to the link provided and that's it. In a few days you can be making your first stock purchase!

## Now That You Have An Account, Buy a Stock in 4 Easy Steps

1. From the home page, highlight the "Trading" tab and then select Stocks/ETFs -> Regular Hours Trading.



2. Next, fill out the information with the number of shares you want, the stock ticker, and also select Market for a regular buy.

Action	Shares	Symbol	Price	Duration
<input checked="" type="radio"/> Buy <input type="radio"/> Sell <input type="radio"/> Sell Short <input type="radio"/> Buy to Cover	1	CVX <a href="#">Find Stock Symbol</a> <a href="#">Preferred Stock Format</a>	<input checked="" type="radio"/> Market <input type="radio"/> Limit <input type="radio"/> Stop <input type="radio"/> Stop Limit <input type="radio"/> Market on Close	<input checked="" type="radio"/> Day Order <input type="radio"/> Qualifiers
Advanced Orders: <input type="text"/> <a href="#">Disclaimer</a>				
<input type="button" value="Preview Order"/> <small>Disable Preview Step</small>				

3. Review the information and make sure you didn't make any mistakes

4. That's it! Congratulations, you've just bought your first stock.

I hope this quick picture guide was helpful and informative. I only recommend services that will help investors on their way to wealth in the best way.

## Empower Yourself by Buying Just One Share

Once you have ownership of a stock, you gain a sense of empowerment and can truly understand that the market isn't as foreign and forbidding as some might've thought. I do get paid for those who open an account

through my affiliate link but provide the link for a greater cause than just the money.

I provide this eBook for free because I want many people who want to learn about investing in the stock market to have that ability. Not only would I recommend the information in this guide to an eager learner, but I'd also recommend this to a friend. As a friendly suggestion, you can start your stock career here: [Open a TradeKing account](#).

Take a minute to create an account, then be sure to come back and continue the *Investing for Beginners 101* guide for analyzing stocks.



## Step 4/7: How to Calculate P/E Ratio: The Most Widely Used Valuation

For this part of *Investing for Beginners 101*, I'm going to help beginning investors do their own research in stocks and show how to calculate P/E ratio from a company's 10-k annual report. This guide will have pictures and links to make it very easy to follow and learn the procedure.

In order to research companies and evaluate whether they are good stock buys, you really **don't** need any special skills or education. In fact, if more people knew how to research stocks and took the time to do a little research on some companies, I think a lot of so-called experts and mutual fund managers would be **out of work!** Unfortunately, this hasn't been the case and for whatever reason, individual stock picking has been frowned upon as reckless and risky. In reality, picking individual stocks leaves all the responsibility of your money on yourself, taboo for sure.

## Reality: Only You Are Responsible

In a culture where it's never your own fault and always someone else's, no wonder the average investor flees to mutual funds every year. If more people took responsibility for their own money and were willing to see their portfolios drop in value without selling at the worst possible time, there'd be happier and increasingly profitable investors. My hope is to see more investors educating themselves and making smart, disciplined stock picks with the **long term** in mind.

Arguably the first thing you should learn about individual stock picking is how to calculate P/E ratio from a company's annual report. P/E ratio simply measures how much you are paying for a company's earnings, the higher the ratio the more expensive the company.

A higher P/E ratio generally means a company is more popular and more people are buying this stock. P/E ratios vary based on industry

and based on market conditions, and you can tell when the market is **overvalued** because the average P/E ratio is **high**.

An average P/E ratio is about **17**, and I only look for companies who have a P/E **below 15**. Most fundamentalists agree that any P/E over 25 is too high, regardless of the industry or market condition. Stocks with high P/E ratios tend to have great stories and the most optimistic of futures but, as the stock becomes more and more overvalued, the bubble eventually pops and everyone who bought in when the company had a high P/E ratio loses money. The thing with buying these stocks with high P/E ratios is that there is no way to tell when the price of the stock will catch up with its valuations, meaning when the stock prices crash to normal levels. While you can make some nice short term gains from buying stocks like this, using this strategy regularly is essentially gambling and it is not an investment strategy I promote.

I buy companies with low P/E ratios for two reasons.

**1. Low P/E = company is potentially undervalued, trading at a low price**

**2. Low P/E = company most likely has high earnings**

If you look at various studies, there has been a proven correlation between low P/E ratio and above average returns. *What Works on Wall Street* by James O' Shaughnessy showed multiple back tests proving this, and also there have been articles on the Motley Fool website confirming the correlation.

## How To Calculate P/E Ratio

To calculate P/E you take a company's market cap and divide by their earnings. P/E means price to earnings ratio, and is simply:

**P/E = Price/Earnings**

To look up a company's earnings from their annual report, go to this website: [SEC Filings](#). Type in the company's ticker in the search bar, as an example I'm going to show how to

calculate the P/E ratio for Ford (F). Once the company is found, type 10-k in the filing type box.

**FORD MOTOR CO CIK#: 0000037996 (see all company filings)**

SIC: 3711 - MOTOR VEHICLES & PASSENGER CAR BODIES

State location: MI | State of Inc.: DE | Fiscal Year End: 1231

(Assistant Director Office: 5)

Get **insider transactions** for this issuer.

Get **insider transactions** for this reporting owner.

Filter Results: Filing Type:  Prior to: (YYYYMMDD)

Items 1 - 40  [RSS Feed](#)

Find the latest filing date and click on documents for the 10-k. From there, click on the .htm link for the 10-k, in this case the first line, as can be seen on the right.

**Note:** Sometimes the company doesn't put their income statements on the "10-k" and instead will file it under exhibit 13. This is a rare case though and you will be able to quickly tell if a company did this after clicking on the 10-k .htm file.

[SEC Home](#) » [Search the Next-Generation EDGAR System](#) » [Company Search](#) » [Current Page](#)

Form 10-K - Annual report [Section 13 and 15(d), not S-K Item 405]				
Filing Date	2013-02-19	Period of Report	2012-12-31	SEC
Accepted	2013-02-19 07:12:51	Filing Date Changed	2013-02-19	
Documents	57			
<a href="#">Interactive Data</a>				
Document Format Files				
Seq	Description	Document	Type	Size
1	10-K	f12312012-10k.htm	10-K	7693614
2	EXHIBIT	f12312012exhibit10-a.htm	EX-10.A	59375
3	EXHIBIT	f12312012exhibit10-c.htm	EX-10.C	103327
4	EXHIBIT	f12312012exhibit10-e.htm	EX-10.E	146156

Once you are in the 10-k do a "Ctrl-F" to search, and search for "consolidated balance". Click through until you are looking at the company's consolidated balance sheet; it looks something like this:

FORD MOTOR COMPANY AND SUBSIDIARIES CONSOLIDATED BALANCE SHEET (in millions)				
	December 31, 2012		December 31, 2011	
<b>ASSETS</b>				
Cash and cash equivalents	\$	15,659	\$	17,148
Marketable securities (Note 6)		20,284		18,618
Finance receivables, net (Note 7)		71,610		69,976
Other receivables, net		10,828		8,565
Net investment in operating leases (Note 8)		16,481		12,838
Inventories (Note 10)		7,362		5,901
Equity in net assets of affiliated companies (Note 11)		3,246		2,936
Net property (Note 13)		24,942		22,371
Deferred income taxes (Note 24)		15,185		15,125
Net intangible assets (Note 14)		87		100
Other assets		5,500		4,770
<b>Total assets</b>	<b>\$</b>	<b>190,554</b>	<b>\$</b>	<b>178,349</b>

Now, we want to find the Consolidated Statement of Earnings. (Sometimes called Consolidated Statement of Income, sometimes called something completely different). Most of the time the Statement of Earnings is right above the Balance Sheet, occasionally it's

below. Scroll up until you see the income sheet, and look for Net Income attributable to Ford Motor Company. In this case for 2012, you can see it's **\$5,665 million**. Now that we have the earning number, we want to calculate market cap.

FORD MOTOR COMPANY AND SUBSIDIARIES CONSOLIDATED INCOME STATEMENT (in millions, except per share amounts)		Fo
		2012
<b>Revenues</b>		
Automotive	\$	126,567
Financial Services		7,685
<b>Total revenues</b>		<b>134,252</b>
<b>Costs and expenses</b>		
Automotive cost of sales		112,578
Selling, administrative, and other expenses		12,182
Financial Services interest expense		3,115
Financial Services provision for credit and insurance losses		86
<b>Total costs and expenses</b>		<b>127,961</b>
<b>Automotive interest expense</b>		<b>713</b>
<b>Automotive interest income and other income/(loss), net (Note 21)</b>		<b>1,185</b>
Financial Services other income/(loss), net (Note 21)		369
Equity in net income/(loss) of affiliated companies		588
<b>Income before income taxes</b>		<b>7,720</b>
Provision for/(Benefit from) income taxes (Note 24)		2,056
<b>Net income</b>		<b>5,664</b>
Less: Income/(Loss) attributable to noncontrolling interests		(1)
<b>Net income attributable to Ford Motor Company</b>	<b>\$</b>	<b>5,665</b>

You can Google a company's market cap, which is updated regularly on most financial websites. If you want to be detail oriented like me, or be able to look up a company's market cap for previous years, search the 10-k document for "shares outstanding". Once you have the number of shares outstanding for

2012, simply multiply this by the share price to get the company's market capitalization.

**Note:** You always want the Diluted number for shares outstanding, as it is more accurate (takes into account employee stock options).

**NOTE 26. CAPITAL STOCK AND AMOUNTS PER SHARE (Continued)**

**Amounts Per Share Attributable to Ford Motor Company Common and Class B Stock**

Basic and diluted income per share were calculated using the following (in millions):

	2012
<b>Basic and Diluted Income Attributable to Ford Motor Company</b>	
Basic income from continuing operations	\$ 5,665
Effect of dilutive 2016 Convertible Notes (a)	46
Effect of dilutive 2036 Convertible Notes (a)	2
Effect of dilutive Trust Preferred Securities (a) (b)	—
<b>Diluted income from continuing operations</b>	<b>\$ 5,713</b>
<b>Basic and Diluted Shares (c)</b>	
Basic shares (average shares outstanding)	3,815
Net dilutive options and warrants	101
Dilutive 2016 Convertible Notes	96
Dilutive 2036 Convertible Notes	3
Dilutive Trust Preferred Securities (b)	—
<b>Diluted shares</b>	<b>4,015</b>

So, once you have these values, simply take market cap/ earnings to calculate P/E ratio. For Ford, using today's stock price of \$13.36, we get a market capitalization of **\$53.6 Billion**. Divide this by the earnings, \$5.6 Billion, and the P/E is **9.46**. Auto makers tend to have a low P/E due to the industry, so compare to its competitors to see if the ratio is favorable.

Keep in mind that most P/E ratios you see on financial websites are calculating future earnings, based on projected numbers. Thus, these numbers can **fluctuate** greatly and quickly, which is one reason I like to use past earnings to calculate P/E ratio. I also like to average the past 3 years of earnings to make my calculations more accurate and with a longer term outlook. Depending on the rigor of the analysis, I'd also recommend calculating P/E ratio over an average of 7 years of earnings, as Ben Graham did in his book *The Intelligent Investor*.

## Real Example: P/E Ratio

Answer to previous section: 6. For this next exercise, take into consideration the numbers for both of these companies in 2011 and calculate their P/E ratios. Also, for a bonus exercise use the Rule of 72 again to calculate how long it would take for your investment to double if considering these returns.

First thought, without knowing any numbers, would you rather own Netflix or Coinstar?

Let's look at the numbers and make an educated decision based on the P/E ratio.

In 2011, Netflix (NFLX) had 54,369 shares outstanding and net earnings of \$226,126. (numbers here in thousands). The average share price for Netflix in 2011 was \$183.58.

In 2011, Coinstar (CSTR) had 31,869 shares outstanding and net earnings of \$103,883. (numbers also in thousands). The average share price for CSTR in 2011 was \$49.07.

At first glance Netflix may look more attractive because of the greater net earnings. This is why we have ratios, to give perspective to all the numbers thrown at us.

$$\text{NFLX P/E} = (54,369 \times 183.58) / (226,126)$$

$$\text{NFLX P/E} = 44.14$$

$$\text{CSTR P/E} = (31,869 \times 49.07) / (103,883)$$

$$\text{CSTR P/E} = 15.05$$

As P/E ratio shows, Coinstar is the better alternative here. CSTR is up 15%, NFLX is down -7.7% as of today (4/17/13).



## Step 5/7: The Single Two Factors Most Correlated To Success

In the past 50 years, there have been two single ratios that have correlated most with stock market gains. Low P/B ratios and low P/S ratios have done **far better** than any single one parameter. As James O'Shaughnessy proved in his book *What Works on Wall Street*, when these single ratios are implemented with various other strategies, the downside risk is greatly reduced, while positive gains are more commonly seen. Combine these ratios with the other categories of *Investing for Beginners 101* to really see some results.

### **Low P/B and P/S Correlated to Success Because They Indicate a Potentially Undervalued Stock**

A big reason why these ratios are so successful is because they both indicate if a

stock becomes overvalued from the price part. As the P/B and P/S ratios become **higher** and higher, there are more people buying the stock and driving the price up, making it **less** valuable to a smart investor. Also, they are more reliable than P/E ratio because revenue and book value fluctuate much less than earnings do. Earnings and earnings per share can be easily manipulated by companies depending on accounting practices. In fact, there have been many instances where companies were caught manipulating their earnings after the fact - and it is more common than people realize. However, sales (revenue) and book value can't be manipulated and this is another reason why these two ratios are so extremely useful and correlated to success.

Also, think about revenue. Revenue is not easily increased or decreased from year to year like earnings is. To increase earnings a company can quickly cut costs by firing workers. Revenue can only be increased through more sales. Or, a company with a successful product may have bad earnings one

year because it is using its profits to pay down debt. The P/S would tell the picture that the company is in better shape than the P/E might be telling at that time. A sufficient P/S is anything under 1, with a good one correlated to under 0.8. To calculate P/S, simply divide market cap by revenue.

### **P/S = market capitalization / revenue**

The P/B ratio, compared to the P/E ratio that is only correlated to earnings, is a better way to determine the cheapness of a stock and is utilized in many conservative value investing strategies. The father of value investing, Ben Graham, popularized the use of P/B ratio and successfully amassed a fortune while teaching countless investors how to do the same.

## **The Buy Low Strategy**

The basic premise behind buying stocks with low P/B ratios involves buying a company that is selling close to or below their book value, with the idea that you are buying a stock with **very little downside** because it has already been shunned by the market, hence its low

P/B ratio. By coupling a low P/B ratio with the limitation of only companies with a strong balance sheet and a stable dividend, you ensure the purchase of great companies trading out of favor in the short term but with great upside potential in the long term. With this strategy, you also prevent overpaying for a company, which further decreases the possible downside. A true buy low, sell high strategy involves ignoring the critics and sifting around for good companies with low P/B ratios.

This strategy has been **proven** to be correlated to success, as you can see from the following. James O'Shaughnessy extensively researched many fundamental ratios and found that investing in the companies with the 50 lowest P/B ratios over a period of over 40 years would've given you the second highest portfolio compared to any other one single variable. When combined with other limitations to reduce risk, a **low P/B ratio** becomes an integral part of any good value investor's portfolio.

To calculate P/B ratio, simply divide price by book value. A company's book value is easily calculated from the consolidated balance sheet, and equals total assets minus total liabilities. Book Value can be seen to be correlated with stability because it measures how much a company's assets cover their liabilities. To find the consolidated balance sheet, search for it in the company's 10-k as demonstrated in the [How to Calculate P/E Ratio](#) link below. An example of Apple's ([\\$AAPL](#)) balance sheet is shown below (in millions):

[Table of Contents](#)

CONSOLIDATED BALANCE SHEETS		September 29, 2012
(In millions, except number of shares which are reflected in thousands)		
ASSETS:		
Current assets:		
Cash and cash equivalents	\$	10,746
Short-term marketable securities		18,383
Accounts receivable, less allowances of \$98 and \$53, respectively		10,930
Inventories		791
Deferred tax assets		2,583
Vendor non-trade receivables		7,762
Other current assets		6,458
Total current assets		57,653
Long-term marketable securities		92,122
Property, plant and equipment, net		15,452
Goodwill		1,135
Acquired intangible assets, net		4,224
Other assets		5,478
Total assets	\$	176,064

Total Assets = **\$176,064**

LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	\$	21,175
Accrued expenses		11,414
Deferred revenue		5,953
Total current liabilities		38,542
Deferred revenue - non-current		2,648
Other non-current liabilities		16,664
Total liabilities		57,854

Total Liabilities = **\$57,854** So, book value = \$176,064 – \$57,854 = **\$118,210**

The price part of the formula comes from the market capitalization, calculated the same way as shown in [How to Calculate P/E Ratio](#). So, again price to book value is calculated like this:

**P/B = Market cap/ book value = Market cap/ (total assets – total liabilities)**

For the example, Apple's market cap is (945,355 shares) \* (market price of \$452.08) = \$427.3 billion. So, their **P/B** ratio in this case is 427.3/ 118.2 = **3.6** and the stock is therefore still quite a high valuation.

## Take a Break, and then Push On!

With 5 of the 7 categories completed by this point, the information may seem overwhelming and a little intimidating. If you have made it this far, I must **commend** you and I know you have what it takes to become a good investor. Really all you need is a desire to educate yourself, and by making it this far

you have more than proved this fact. It is the reason why I urge you not to stop here. With only 2 steps left to go, it may be easy to think you've learned enough and in it **lies a true danger**. The danger that you've stumbled upon this guide, only to not utilize it to fully benefit yourself.

I urge you to take a break at this point if you feel fatigued, and just bookmark the page and continue when you are ready. If you are taking notes and attempting these exercises as we go along, **only then** will you learn and retain the information. You must have full attention and feel rested to complete through the rest of this guide and have it benefit you as much as it potentially can. So please, take a break and then push on through the rest of the guide. I know it will be worthwhile for you in your quest to long term wealth.

## Real Example: P/B Ratio

Again we are going to look at Apple, and also Barnes and Noble, which both have retail stores that can be found in any mall. How do

you know which to pick? It's a little more complicated than which store is busiest during holiday season, and let me show you why.

In 2012, Barnes and Noble (BKS) had 57,337 shares outstanding and shareholder's equity of \$747,657 (numbers here in thousands). The average share price for Barnes and Noble in 2012 was \$15.20.

In 2012, Apple (AAPL) had 945 shares outstanding and shareholder's equity of \$118,210 (numbers here in millions). The average share price for AAPL in 2012 was \$529.65.

$$\text{BKS P/B} = (57,337 \times \$15.20) / (\$747,657)$$
$$\text{BKS P/B} = 1.16$$

$$\text{AAPL P/B} = (945 \times \$529.65) / (\$118,210)$$
$$\text{AAPL P/B} = 4.23$$

A P/B analysis in 2012 would have proven that Apple was expensive while Barnes and Noble was cheap, and buying BKS then would have given you a gain of 11.7% today (4/19/13). You would've avoided a -26.2% loss in AAPL.

While it's true that buying Apple stock in 2012 would've been a really bad move, please realize that stock analysis is dependent on time and price. Just because a stock was a bad play in the past **doesn't** make it a bad play in the future. In fact, some of the best stock picks come from stocks that have been hammered and abandoned by the public.

By using the valuations in this eBook, you will be able to understand when a stock becomes favorable again. If we continue to see Apple's stock price deteriorate and as a result the P/B ratio fall to acceptable levels, then Apple could be reexamined as a good play. As long as the other valuations indicate a sound company, (which they do) then once the P/B becomes acceptable than Apple could be poised for a comeback.

It's so important to remember that we want to see acceptable levels in **all** 7 categories before buying a stock. As you can see from the example, even just one bad valuation can result in losses for the investor. With over 10,000 stocks to choose from, we must be

very selective in our stock picking process in order to limit the downside risk.

## Real Example: P/S Ratio

In the apparel textile industry I again present two stocks, Coach (COH) and the much less sexy Sketchers (SKX).

In 2012, Coach (COH) had 294,129 shares outstanding and revenue of \$4,763,180 (numbers here in thousands). The average share price for Coach in 2012 was \$62.70.

In 2012, Sketchers (SKX) had 49,942 shares outstanding and revenue of \$1,560,321 (numbers also in thousands). The average share price for SKX in 2012 was \$16.79.

$COH\ P/S = (294,129 \times \$62.70) / (\$4,763,180)$

$COH\ P/S = 3.87$

$SKX\ P/S = (49,942 \times \$16.79) / (\$1,560,321)$

$SKX\ P/S = 0.53$

SKX has gained 28.8%, COH has lost -18.3%. The numbers don't lie; need I say more?

## Step 6/7: Cashing In With a Dividend is a Necessity

Welcome to Step 6 of this comprehensive guide. First and foremost, I explain why a dividend is so important to investors, then I explain how much of a dividend a company should pay, and then move on to other parameters. This section covers a lot of important ground and each of these parameters diversifies your stock picking requirements to reduce risk.

Simply put, this step makes sure that the entire picture of the stock looks good. As with all parameters examined in the stock picking process, each category should be regarded with equal weight.

### A Dividend Creates Compounding Interest

The first parameter we want to examine is the dividend yield of a company. This aspect is important because a good investment is

constantly returning cash to the shareholders. Receiving a dividend and **reinvesting** that dividend is so crucial for you in utilizing the power of compounding interest. Dividends are guaranteed return on investment, and as I've said before I **never** suggest buying a stock that pays no dividend. A healthy dividend yield and dividend payout reflects a company that is using excess cash efficiently. It's really as simple as that, but it is also very important. That being said, let me show you how to calculate these parameters.

Dividend yield is quite easy to calculate, and will often be explicitly stated next to a stocks price as a %. For those who are more ambitious and want to be able to accurately calculate this % at all times, just divide dividends the company paid for the year by the current share price.

**Dividend yield % = dividend/share price**

The only hard part about this is finding the information. You can quickly Google this to find it out, however if you are researching years prior it's really good to know how to

extract this from the 10-k annual report. Here's what I do: Once you have the annual report document open; hit Ctrl+F to search for "dividends". You can also search "quarter" or "quarterly" to see the dividends paid along with share price numbers for each quarter of the year you are looking at. Sometimes the dividend paid is included in the statement of income, which helps out if you are filling out spreadsheets.

<b>Reinvested Earnings (Accumulated Deficit)</b>
Balance at beginning of year
Net income attributable to Verizon
<b>Dividends</b> declared (\$2.03, \$1.975, \$1.925) per share
Balance at end of year

Next we want to know dividend payout %. If a company had too high of a %, this could indicate a company being irresponsible. It also commonly warns of a company in trouble who is trying to hide its balance sheet failures by still paying high dividends.

On the surface the company may still seem to be in good shape, but a prudent investor who

has done his/her due diligence will be able to identify this by use of the payout ratio. To calculate this, take the dividend paid for the year divided by the company's EPS (earnings per share found in the statement of income).

**Payout ratio % = dividend / EPS**

The next parameter to consider is price to cash (or P/C) ratio. This ratio reflects the profitability of a company and their ability to generate cash. Basically by buying a company with a low P/C ratio, you are getting access to their cash flow at a low price. A stock with a P/C of 10 means you are paying \$10 for \$1 of cash generated.

Over time, a ratio of 10 or lower will usually pay the investor great dividends, both literally and metaphorically. Many well respected investing figures swear by the price to cash ratio, notably Warren Buffett and Porter Stansberry.

The ability for a company to convert profits into cash is absolutely essential, and is

uncovered by the P/C ratio. To derive this ratio, simply divide a company's market capitalization by their net cash at end of year.

### P/C = market cap/ net cash

To find the net cash at end of year, scroll down to statement of cash flows in the 10-k annual report. This section can be found directly below either the balance sheet or statement of income.

Near the bottom of the page lies the net cash numbers, organized by year.

	13 matches	Q1 consolidated stat	Done
Provision for uncollectible accounts	972	1,026	1,246
Equity in earnings of unconsolidated businesses, net of dividends received	77	36	2
Changes in current assets and liabilities, net of effects from acquisition/disposition of businesses			
Accounts receivable	(1,717)	(966)	(859)
Inventories	(136)	208	299
Other assets	306	86	(213)
Accounts payable and accrued liabilities	1,144	(1,607)	1,075
Other, net	(3,423)	(2,900)	(1,930)
Net cash provided by operating activities	31,486	29,780	33,362
<b>Cash Flows from Investing Activities</b>			
Capital expenditures (including capitalized software)	(16,175)	(16,244)	(16,458)
Acquisitions of investments and businesses, net of cash acquired	(913)	(1,797)	(652)
Acquisitions of wireless licenses, net	(3,935)	(221)	(786)
Proceeds from dispositions	27	35	2,594
Net change in short-term investments			(9)
Other, net	494	977	251
Net cash used in investing activities	(20,502)	(17,250)	(15,054)
<b>Cash Flows from Financing Activities</b>			
Proceeds from long-term borrowings	4,489	11,060	-
Repayments of long-term borrowings and capital lease obligations	(6,493)	(11,805)	(8,136)
Increase (decrease) in short-term obligations, excluding current maturities	(1,437)	1,928	(1,097)
Dividends paid	(5,230)	(5,555)	(5,412)
Proceeds from sale of common stock	315	241	-
Proceeds from access line spin-off			3,083
Special distribution to noncontrolling interest	(8,325)	-	-
Other, net	(4,662)	(1,705)	(2,088)
Net cash used in financing activities	(21,253)	(5,335)	(13,650)
Net cash used in investing activities	(21,253)	(5,335)	(13,650)
Increase (decrease) in cash and cash equivalents	(10,269)	6,694	4,659
Cash and cash equivalents, beginning of period	13,362	6,668	2,009
Cash and cash equivalents, end of period	\$ 3,093	\$ 13,362	\$ 6,668

See Notes to Consolidated Financial Statements

In picture: Net cash numbers for 2010-2012

## Earnings: Don't Get Pulled In but Be Aware

Last but not least is the parameter of earnings growth. Earnings are the name of the game for most investors, and therefore can't be ignored. While earnings can be manipulated and don't show the whole picture, they are useful for discovering momentum. High earnings usually correlate with a high stock price.

Popularized by mutual fund phenomenon Peter Lynch in his bestselling book *Beating the Street*, so called growth investors' primary focus is earnings growth. And because it is so widely **popular**, the type of stocks with good earnings growth can be **volatile**, as minor changes in growth can cause major upswings or downswings because of the multitude of investors focusing so intently on growth.

For example, a highflying stock with stellar growth may see its growth slow down, and in turn many growth investors might see this as



unfavorable and their selling could drive the stock low very quickly. Because of this volatility, earnings growth becomes only one part of my investing strategy instead of the whole focus. A good long term plan won't be adversely affected by such short term swings.

Earnings growth percentage is calculated by subtracting the previous year's earnings from current year earnings and dividing by previous year's earnings; then multiplying this quotient by 100 to get the percentage.

**Earnings growth = 100\* (Current earnings – last year's earnings) / last year's earnings**

To increase accuracy and get a better feel for how much a company is growing over a longer time period, average the earnings growth percentage over the 3 most recent years. For example, if earnings growth for a company was:

**2012** 2.4% **2011** 4.6% **2010** 3%

Then the average earnings growth for the

company is  $(2.4+4.6+3)/3 = 3.33\%$ . A good earnings growth is around 3%, and indicates a stock with possibly a very bright future.

Make sure to catch the last and final step to *Investing for Beginners 101*. The topic covered is the **BEST** way to avoid risk, how this ratio prevents catastrophic losses and then the final step to putting it all together to make precise buy and sell decisions.

## Real Example: P/C Ratio

Let's look at 2 oil giants in 2010 for a good representation of P/C ratio, Chevron (CVX) and Occidental Petroleum (OXY).

In 2010, Chevron (CVX) had 2,007 shares outstanding and net cash at end of year at \$14,060 (numbers here in millions). The average share price for Chevron in 2010 was \$79.61.

What about one of their competitors, OXY? In 2010, Occidental Petroleum had 812 shares

outstanding and net cash at end of year at \$2,578 (numbers here in millions). The average share price for OXY in 2010 was \$85.63.

$$\text{CVX P/C} = (2,007 \times \$79.61) / (\$14,060)$$
$$\text{CVX P/C} = 11.36$$

$$\text{OXY P/C} = (812 \times \$85.63) / (\$2,578)$$
$$\text{OXY P/C} = 26.97$$

A difference of 15 in the P/C ratio may not seem like much on the surface, but in fact the difference is great. Any stock with a P/C ratio over 20 is both overvalued and potentially dangerous, as it signals a company with cashflow problems. You generally want P/C ratios hovering around 10, steering clear of those hovering around 20 or more.

The results in this example show a 45.5% gain in CVX, and a -7% loss in OXY. Much strength can be found in companies with cash, and thus there are 2 categories dedicated to the subject. The next parameter in determining this strength is in the dividend.

## Real Example: Dividend Yield and Payout

For this next example we are going to look at 2 stocks that have increased their dividend for more than 50 years in a row. While these companies are long established and have outstanding long term track records, this factor alone doesn't constitute a good buy. Just because a company has a history of increasing stock prices and dividends **does not** mean a blind buy and hold strategy will be profitable.

In 2012, 3M (MMM) had a cash dividend of \$2.36 per share, average share price of \$88.72, and EPS of \$6.32.

In 2012, Diebold (DBD) had a cash dividend of \$1.14 per share, average share price of \$35.29, and EPS of \$1.23.

How can we use this information effectively? Let's first calculate dividend yield %, then look at payout ratio to determine sustainability.

Div. yield MMM =  $(\$2.36) / (\$88.72)$

Div. yield MMM = 2.6%

Div. yield DBD =  $(\$1.14) / (\$35.29)$

Div. yield DBD = 3.2%

From this DBD initially looks more attractive. However, we can't look only at yield to decide which stock to purchase.

Payout Ratio MMM =  $(\$2.36) / (\$6.32)$

Payout Ratio MMM = 37.3%

Payout Ratio DBD =  $(\$1.14) / (\$1.23)$

Payout Ratio DBD = 92.6%

As we can see from the calculations Diebold's dividend is unsustainable at these levels. 3M's dividend is much healthier, as it is below 40%. As a result, 3M's stock price has seen a gain of 19% since 2012. Meanwhile, DBD has lost -17% as of today (4/21/13).

### Real Example: Average Earnings Growth

With plenty of companies showing earnings growth year after year, there is no reason to gamble with negative growth. Instead, wait for a company to prove it has made a

comeback, and only the numbers can truly identify such a time.

The average stock price for RadioShack (RSH) in 2010 was \$20.85. Earnings numbers for the years 2007-2010 for RSH looked like this:

2010 RSH \$206.1

2009 RSH \$205

2008 RSH \$189.4

2007 RSH \$236.8

At the same time, competitor Walmart (WMT) had an average stock price of \$50.72.

Earnings numbers for 2007-2010:

2010 WMT \$14,355

2009 WMT \$13,400

2008 WMT \$12,731

2007 WMT \$11,284

The growth numbers for RSH were 0.5%, 8.2%, and -20%. Average growth = **-3.7%**  
The growth numbers for WMT were 7%, 5.2%, and 12.8%. Average growth = **8.3%**

Since 2010, WMT has gained 54.3% while RSH has lost -85%. Growth numbers matter.

## The Best Way to Avoid Risk, and Putting it all Together!

Congratulations on making it to the final step of *Investing for Beginners 101*! I've done my best to save the best for last, but each part of this guide is equally important and I encourage those who have skipped sections to go back and read what was missed.

In this final step, you will learn what I've found to be the best way to discover and avoid risk to save yourself from catastrophic losses. Through many back tests for my Value Trap Indicator dating back to 1994, I've found a common characteristic in companies about to experience substantial stock price drops or bankruptcy. These companies would consistently score above 1,000 on my Value Trap Indicator, triggering a strong sell in my system **before** the stock price greatly deteriorated.

The common characteristic I discovered was too much debt when compared to

shareholder's equity.

### Avoid Risk by Avoiding Debt

Debt to equity is a common measure of risk in investing. If you think about it, it makes sense too. A person more likely to become bankrupt is one with too much debt, and the same is true for companies.

If the company considered doesn't have enough assets to cover their liabilities, or shareholder equity, then they have debt to equity ratios that skyrocket to the sky. Financial companies like banks have extremely high debt to equity ratios compared to other industries because of the nature of their business, but in my opinion you can still use debt to equity ratio to determine their risk as well. For a normal company, you want to see a debt to equity ratio that is at least **below 1**. For financial companies, a number **below 10** is best to avoid risk.

A company like Lehman Brothers had a debt to equity ratio of 60 right before their

bankruptcy, and my Value Trap Indicator would've triggered a **strong sell** signal to prevent investors from losing their shirts at that time. Many investors overlook the debt to equity ratio and in turn become shocked at seeing staggering portfolio losses, which is why I've saved this ratio as the last and most important one. Now that I've uncovered its importance, it's time to show how to calculate debt to equity ratio.

There are two ways to calculate debt to equity ratio, using total liabilities or looking at only long term debt.

It's important to consider total liabilities instead of only long term debt because a company should be able to cover all their total liabilities with their total assets in case of a financial struggle. Also, a company with less total liabilities is obviously in a favorable financial condition and this must be accounted for. Debt to equity ratio is the total liabilities divided by shareholder's equity, which is total assets minus total liabilities. The lower the ratio, the more likely to avoid risk.

Take a look at Citigroup's balance sheet:

CONSOLIDATED BALANCE SHEET (Continued)		Citigroup Inc. and Subsidiaries December 31,	
<i>In millions of dollars, except shares and per share amounts</i>		2012	2011
<b>Liabilities</b>			
Non-interest-bearing deposits in U.S. offices		\$ 129,667	\$ 110,437
Interest-bearing deposits in U.S. offices (including \$889 and \$848 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		247,716	223,851
Non-interest-bearing deposits in offices outside the U.S.		65,024	67,267
Interest-bearing deposits in offices outside the U.S. (including \$558 and \$478 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		488,163	465,231
Total deposits		\$ 930,560	\$ 866,930
Federal funds purchased and securities loaned or sold under agreements to repurchase (including \$118,889 and \$97,712 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		211,238	168,373
Brokerage payables		87,913	56,698
Trading account liabilities		115,549	128,282
Short-term borrowings (including \$818 and \$1,354 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		82,027	64,441
Long-term debt (including \$29,754 and \$24,372 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		239,483	323,505
Other liabilities (including \$2,910 and \$3,742 as of December 31, 2012 and December 31, 2011, respectively, at fair value)		87,816	69,272
Liabilities of discontinued operations held for sale		—	—
<b>Total liabilities</b>		<b>\$1,673,663</b>	<b>\$1,694,305</b>
<b>Stockholders' equity</b>			
Preferred stock (\$1.00 par value; authorized shares: 30 million); issued shares: 102,038 as of December 31, 2012 and 12,038 as of December 31, 2011, at aggregate liquidation value		\$ 2,562	\$ 312
Common stock (\$0.01 par value; authorized shares: 3 billion); issued shares: 3,945,163,204 as of December 31, 2012 and 2,937,755,021 as of December 31, 2011		30	29
Additional paid-in capital		106,391	105,804
Retained earnings		97,809	80,620
Treasury stock, at cost: December 31, 2012—14,269,201 shares and December 31, 2011—13,877,688 shares		(847)	(1,271)
Accumulated other comprehensive income (loss)		(16,892)	(17,788)
<b>Total Citigroup stockholders' equity</b>		<b>\$ 189,049</b>	<b>\$ 177,808</b>

As can be seen from the picture above, Citigroup ([\\$C](#)) had a debt to equity ratio of  $\$1,673,663 / \$189,049 = 8.85$ . This number is under 10, which is in the preferred range for financial companies to avoid risk.

**Debt to equity = total liabilities / shareholder's equity = total liabilities / (total assets minus total liabilities)**

With this final lesson, I've equipped all my readers with the tools they need to get started investing in the stock market. You know how to avoid risk, calculate important ratios, and dollar cost average. I hope you've enjoyed

Investing for Beginners 101, as I've enjoyed sharing what I know and have learned through various sources. I strongly recommend to my readers to **take the next step** and apply what they have learned to make specific stock selections starting as soon as possible. To quantify this stock picking format into an easy to follow method, I've formulated my Value Trap Indicator to explicitly state whether a stock is a buy or not. Using the 7 steps of this *Investing for Beginners 101* guide, my Value Trap Indicator assigns any stock a number, with a strong buy being 0-100, a buy being 101-125, and a strong sell being larger than 800. My Value Trap Indicator showed an 800+ score for both Lehman Brothers and Circuit City the year right before their **bankruptcies**.

I've also performed multiple back tests in which my Value Trap Indicator greatly outperformed the S&P 500, by buying stocks near their lows and selling stocks with bad financials and also near their highs. I present the method completely in my eBook, which is available **soon**; complete with back tests and

free excel spreadsheets that perform the calculations for you based on numbers you input from the 10-k annual report. I've clearly shown where these numbers can be found in each step of my guide, and I am extremely confident that the money you spend on the eBook will pay for itself multiple times over. If for whatever reason you are unsatisfied in the first 30 days, I will refund your money completely! That's how good I feel about this discovery I've made. I know it can help any investor at any skill level. Being an electrical engineer, numbers are my passion and it took much tweaking and playing with the numbers until I formulated the perfect indicator for buying and selling stocks. I **urge** you to try it.

## Example: Debt to Equity

For this final example, we will examine two more financial companies and determine which stock is the safer choice. In 2011, MF Global Holdings (MFGLQ) had total liabilities of \$39,037,258 and shareholder's equity of \$1,373,731. The average share price for MFGLQ was \$7.56.

In 2011, Citigroup (\$C) had total liabilities of \$1,694,305 and shareholders' equity of \$179,573. The average share price for Citigroup for 2011 was \$37.20.

Just as a reminder to you, we want a debt to equity ratio below 10 for financial companies and banks and a debt to equity ratio below 1 for all other companies.

Debt to eq. C =  $(\$1,694,305) / (\$179,573)$

Debt to eq. C = 9.4

D/eq. MFGLQ =  $(\$39,037,258) / (\$1,373,731)$

D/eq. MFGLQ = 28.4

As we can see from the results, MF Global Holdings was extremely overleveraged in 2011. Consequently, the company went out of business the next year. At the same time, a company like Citigroup with a healthy debt to equity ratio remained intact and saw stock price appreciation.

As of today (4/22/13), Citigroup has gained 21% while shareholders in MFGLQ have lost everything (-100%).

## 7 Rules to Invest By

1. Don't buy any stock with negative earnings for the year
2. Don't buy a stock not paying a dividend
3. Remember you are a long term investor
4. Don't sell a stock that you haven't owned for more than a year
5. Don't sell a stock just because it has gone down in price
6. Sell a stock that no longer has good ratios
7. Remember, mistakes are part of learning

## Resources

### Additional Suggested Readings

[\*Value Trap Indicator\*](#); Andrew Sather

[\*The Intelligent Investor\*](#); Benjamin Graham

[\*The Richest Man in Babylon\*](#); George Clason

[\*What Works on Wall Street\*](#); J. O'Shaughnessy

[\*The Millionaire Next Door\*](#); Thomas J. Stanley

### Additional Suggested Websites

For financial data: [FINVIZ](#)

For annual reports: [SEC.gov](#)

[The Investor's Podcast](#) archives

[The Money Tree Investing Podcast](#)

### Photo Attributions

Wall Street: <http://flic.kr/p/9Zisvi>

Invest: <http://flic.kr/p/59DwbZ>

### Recommended Stockbroker

TradeKing: [Open a TradeKing account](#)

## I'd Like to Say Thank You

First and foremost, thank you God for giving me a second chance at life when I didn't deserve it. Thank you for your mercy.

I'd like to say thank you to my loving wife, who dealt with my many long hours of work and supported me the whole way through. I strive to give you and our daughter everything you both deserve.

Thank you is in order to my mentor Mike, who introduced me to investing and has shared so much wisdom that I try to apply every day.

Also I'd like to thank Pat Flynn from [www.smartpassiveincome.com](http://www.smartpassiveincome.com). I've learned

so much from your work and your story is so inspiring. Thank you to gadsavage from [www.fiverr.com](http://www.fiverr.com) for the fantastic design work.

Finally, I have to thank **you**, the reader of my eBook. My message is only as effective as the actions from my readers, and I am confident in all of your future successes.

To everyone who has supported me through my affiliatelink: [Open a TradeKing account](#), thank you. This eBook wouldn't be **free** for all without you. People who give back instead of only take are the ones who make the world go round.

For those who have shared my website link [www.einvestingforbeginners.com](http://www.einvestingforbeginners.com) with their friends, on Facebook or Twitter, or any other way I owe you my utmost gratitude.

I hope to have at least planted the seed to your eventual wealth. While this is just the beginning for many in their investing journey, there is so much power in educating yourself by reading this book. I wish the best to you.