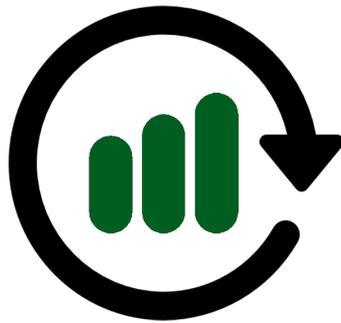


HIGH YIELD INVESTING

THIRD EDITION



JONATHAN POLAND

Third Edition

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Dear Investor,

It's been over two years now and the ideas published in the last two editions have documented 93% in pre-tax gains with last year's stocks weighing in with a total market capitalization over \$330 BILLION. The gain in the last year from a percentage basis was 2.95%, but on a dollar basis, that's close to \$10 billion.

Remember that a stock represents part ownership of a business, and once a business reaches a certain size, it's harder to grow faster than the overall market.

For now, let's recap the stocks highlighted in the second edition. We started the year with 5 stocks and ended with 6 thanks to a spinoff that generated 18%.

CNOOC Ltd (CEO)

Publish Price: \$154.03
Current Price: \$139.99
Performance: 9% Loss

Cash America (CSH)

Publish Price: \$36.73
Current Price: \$75.27
Performance: 18% Gain (with ENVA Spinoff)

China Mobile Ltd. (CHL)

Publish Price: \$47.85
Current Price: \$65.89
Performance: 38% Gain

Terra Nitrogen (TNH)

Publish Price: \$157.14

Current Price: \$147.09

Performance: 6% Loss

Joy Global (JOY)

Publish Price: \$52.79

Current Price: \$39.94

Performance: 24% Loss

Enova Intl (ENVA)

Publish Price: N/A

Current Price: \$23.63

Performance: N/A

All data above is current as of March 5, 2015.

Buy Price based on publication date closing price.

The caveat is that shortly during the first half of the year, these stocks had a gain of 20%, pushing our portfolio well over \$10,000, ending the year slightly higher than the total US economic output. This is not the type of performance we expect going forward.

Welcome to 2015! We start the year two months in with \$9,650.42 in the portfolio, bringing forward the gains in the first two editions. Turn to Chapter 8 if you've already read the last edition.



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“If I was running \$1 million today, or \$10 million for that matter, I’d be fully invested... I think I could make you 50% a year on \$1 million. No, I know I could. I guarantee that.”

Warren Buffett

BusinessWeek

June 25, 1999

Net Worth: \$72.3 Billion

as of March 5, 2015

Chapter One

Why Invest In Stocks?

If you own the first edition, thank you. If you don't, this book will have all the same information, but go even further to explaining what I call the High Yield Investing System. In fact, this edition outlines what I think is the best way for an investor to build his or her portfolio from a cash position.

There are many ways to look at investing and the stock market, so before we get into the book, these are the overall principles I would like to impart on you.

1. Anyone can learn to outperform the market.
2. The process is simple but not easy or scientific.
3. No one can beat the market every year, forever.
4. You are better off doing-it-yourself 95% of the time.
5. There is risk in doing absolutely nothing.
6. High Yield System IS NOT the only one that works.

If you're new to investing, you may be wondering, why do I need to "beat" the market? And, in a sense, the stock market is so powerful that even a mediocre investment will do better in stocks than in most other asset classes.

However, the REASON you should be acutely concerned with outpacing the overall gains provided by the market (i.e. Dow, S&P, etc.) is that there are index funds that offer very low cost entry points which simply track the

stocks within the indexes and pass on the gains to investors. If you never desired to analyze stocks for yourself, you could stop reading this book right now and simply seek out one of the funds or index funds from the previous pages to park your money into.

Doing this would help you outpace the growth of all other major asset classes over the long term, helping you accelerate the growth of your personal wealth beyond that of mere mortals.

To put it bluntly, if you are NOT investing in stocks, you ARE losing money. By doing nothing, inflation (the rate at which money is being printed) is eating your cash value at around 3% a year. And that's being generous.

Performance of Major Asset Classes

(Over the last 30 Years)

<u>Asset Class</u>	<u>Yearly*</u>	<u>On \$100k</u>
S&P 500 Index	8.03%	\$1,014,685
Median Home Price	3.12%	\$251,354
Gold Per Ounce	4.50%	\$374,531
Oil Per Barrel	3.88%	\$313,298
30 Year Treasury	3.01%	\$243,434

* These are annualized returns generated by simply buying and holding

Here's a story about the power of the stock market:
BUY: PIER 1 IMPORTS (PIR) March 2009...

In 2009, during the first three weeks of March, one of America's favorite home furnishing stores Pier 1 Imports looked like it was going out of business. Earnings had been negative for three straight years, giving traders on Wall Street a lot of worry about its future.

Looking at the trading activity in the stock, it seemed to be going under sooner rather than later. The stock had fallen from \$6 per share just a year earlier to between a quarter and a dime during the first 20 days of the month. To put that into perspective, Oprah earned about \$1 million a day in 2008 and could have bought the whole company for about 40 days worth of earnings, after taxes.

So what happened? The company operated unaffected by the drop in its stock price, got back to generating profits for shareholders, and increased net income over each of the next three years. The stock price followed as well, but in a much more explosive fashion.

A year later it was at \$7 a share, up 2,800% in one year!

As of January 2013, the stock price sits over \$20 per share. Had you loaded up on the stock while it traded

under 50 cents, that investment would be up 3,900% today. In three years, this one stock would have turned a \$10,000 investment into over \$400,000 before taxes. By contrast, the S&P 500 and Dow Jones Industrials have generated just over 1,000% gains during the last three decades; and no other major asset class can even come close to the S&P's performance. We'll talk about that later.

What a remarkable run this one investment had! And, It wasn't the only company to show investors that type of performance. In fact, throughout my career as a stockbroker, investment coach, and business owner, I've seen over a dozen instances similar to this one.

This is why finding the RIGHT STOCKS, and buying them at the RIGHT PRICE, is so valuable and why knowing the value of the company whose stock you're buying is the most important aspect of investing.

What happens when you don't know the value of something? You tend to lose, or worse, waste money, don't you agree?

My goal with this book is to create a practical guide that anyone can use to find and buy stocks that can produce above market rates of return.

The uninitiated view the stock market as a gamble, but it has been proven over the ages that wise investing is the only way to keep your money in the first place.

Through many years of trial and error, I have found this to be true in my own life and in the lives of everyone with whom I've had the privilege to work.

If you're a first time investor, congratulations! It is easier than ever to build wealth in the stock market because of the tools and cost advantages gained through technology. You only need the following:

1. An investment brokerage account.
2. The right strategies and skills
3. And, the confidence to follow them...

IN FACT, building wealth boils down to three steps.

1. Save Money
2. Invest Wisely
3. Avoid Major Mistakes

While no one can help you save, through the proper use of the skills laid out in this book you will be able to invest wisely and avoid major mistakes.

If you've ever participated in sports, you know that if you don't practice the fundamentals, you will never be very good. This book is a fundamental guide to better investing and as far as I know, is the only book that has put together the step-by-step process of finding, buying, and managing a stock portfolio.

The following illustrates the S&P 500 Index performance from 1984 to 2014. In case you were wondering, a \$1,000 investment would now be worth \$18,000.

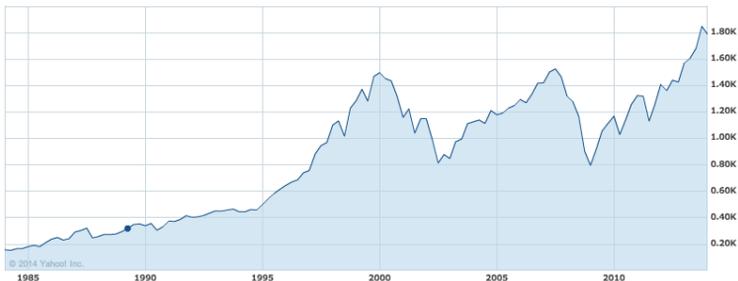
But what if you want to really accelerate your performance? What if you're not willing to settle for 18x ROI over 30 years. NO! You demand a higher rate of interest than this. You want an Apple or Microsoft type of growth rate!

Can you guess which line accompanies which company's stock? If you said that the green is Microsoft, you'd be right! Over the last 30 years MSFT has grown much faster than Apple. Of course, most of the growth happened in the 90's.

Stock ownership equals Business Ownership.

In other words, anytime you buy a stock, you own a portion of that business. If you start a business by yourself, you have 100% ownership of the business. If you have ever seen the Forbes 400 list of wealthiest people, most did not get to be billionaires through earnings they themselves generated.

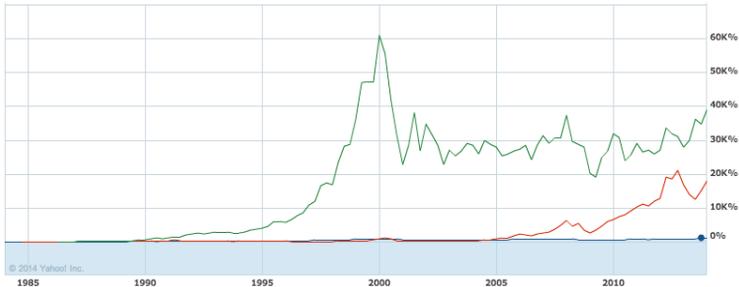
They were minted billionaires because they started a company that employed hundreds and thousands of employees, grew its value, and owned a very large chunk



of that business.

Warren Buffett, owns more than 20% of Berkshire Hathaway stock. The company has a market value of \$275 billion, making him worth over \$55 billion. His annual salary is just \$100,000.

Larry Ellison, CEO of Oracle owns 24% of the \$166 billion company, making him worth over \$39 billion. Mark



Zuckerburg, Founder of Facebook owns about 20% of the \$133 billion company, making him worth over \$24 billion.

I could continue, but the point is that if you haven't thought of stocks as ownership of a real business, then just look at the wealthiest people on earth for the example of what can truly happen if you own the right stock.

This brings me to the **LAW OF COMPOUND INTEREST.**

My father as a great man. A teacher at heart and by far and away the best basketball coach I ever had.

Anyway....

He used to give me mathematics problems during family road trips when I was a kid. During which, he would inundate me with questions like "If I gave you a million

dollars and in return you had to give me a penny today and double it every day for 30 days, would you do it?"

Not having a calculator handy (there were no cell phones back then) and not understanding the law of compounding, I would say, "Yes!" very quickly. My father would laugh and ask "Are you sure?" By this point, I was surely learning two important lessons but would keep saying "**YES!!**" rather emphatically.

He would end up stopping me with some expression like... "***You better have my money in 30 days***" My dad was a pimp in a former life, I was sure of it.

Then he would go on to describe how a single penny doubled each day would be worth over \$10 million in a month. This was my first lesson on compounding and is one that you should always be mindful of when investing. Do the math for yourself, IT WORKS OUT!

If you can compound your money over the long term, you can start with a very small amount and generate massive wealth over time.

Throughout this book, I'll walk you through the exact process I've developed through more than 20,000 hours of real-world testing by investors whom I've worked with to carefully select stocks.

In that time, the process yielded 180 stock ideas, documenting 4,240% in total (pre-tax) returns from 2002 through 2013. And it is the basis of my consulting and money management businesses.

The best part is that I'm not special.

I don't have an expensive Ivy League education. I didn't train under some top money manager. All I did was read the right books and develop a plan of action, relentlessly testing it to make sure it works.

I've compressed over a decade of experience into the pages of this book, something that anyone can read.

Thankfully, I had the ability to sell others on the idea that I could help them and they allowed me to test my theories out. Now, you can condense the time it took me to master these techniques into an hour or two of reading and an hour or two of applying until you get it down.

One more example regarding compound interest. Ever wonder why there are no self-made billionaire sports gamblers?

I mean here's a system that you can double your money in a day if you bet correctly. In fact, an entire cottage industry has cropped up around the handicapping business to sell better's picks for a portion of the winnings.

Yet, no billionaire better's! I guess for one, Vegas would have a hard time accepting a \$500 million bet on the Super Bowl, much less a much smaller women's basketball game if that's where the best "bet" was needed. But, my other suspicion is that it's just hard to win that many times in a row when you bet.

Here's the deal. If you had \$1 and 30 days of 100% gains, you'd be a billionaire. It's that simple. Make that 31 days because you'd have to pay the government 50% of your winnings.

So, let's extrapolate that to investments. Let's say you have \$1 million and want to be a billionaire in your lifetime. If you're 40 and anticipate living to 80, then you would need to earn 19% a year (on average) to turn that \$1,000,000 into \$1 billion in the next 40 years. And that's why you should invest in the stock market.

Chapter Two

What is High Yield Investing?

High Yield Investing is a trade management system designed to achieve the highest rate of interest with the lowest risk of permanent loss over the longest period of time possible.

Yield relates to the Profit derived from each investment allowing, or rather, demanding short capital payback periods as a necessity to the success of this system.

The nuts and bolts of the system is predicated upon the ability to evaluate risk and value of a specific investment.

Also, I believe that an investor can insulate their portfolio from annual swings in the market by employing options selling or use them to generate a never ending cash flow placed into long term holdings.

However, the system does not call for any special use of derivatives, futures, options, or leverage unless the investor wishes to use them, which will be covered later.

Climbing the Shoulders of Giants

In the early 1900s Benjamin Graham wrote a book called “The Intelligent Investor” that introduced the topic of investing based on business logic and provided a new way to look at the stock market.

He called the concept “Mr. Market” and asked that an investor imagine Mr. Market is your partner in business and every day he wants to sell you his side of the business.

Some days he’s happy and others he’s sad.

When he’s in a good mood, he wants a high price for his portion of the business.

When he’s in a bad mood, he asks for a low price for his side of the business.

Which will you take?

Read Graham’s book if you want more, but thinking like an intelligent investor starts with a focus on value. Identify companies that have a high intrinsic value and a low market value, and have the courage to buy them!

So, what is intrinsic value?

Billionaire investor Warren Buffett describes intrinsic value as the total amount of cash that can be taken out of a business over its life.

He too stood on the shoulders of the giants before him and everyone knows how that worked out.

If you are a stockholder, you own a certain percentage of that business, whether it's listed on the national exchanges (i.e. NYSE, NASDAQ, etc.) or in your local town. Even franchises operate this way. If you own it over a 10-year period, **the intrinsic value** would be the cash that the company generated in that time.

Plus, when you invest in publicly traded stocks, you will usually be able to sell your ownership in the business fairly quickly, so you could always add the price you pay to the intrinsic value to get a pretty good estimate of fair value. Some analyst call this Discounted Cash Flow analysis.

There are three principles to High Yield Investing.

First, stocks provide partial ownership of a real business.



Second, prices of public stocks fluctuate widely, each year. **Third**, a company's value is rarely equal to its market price.

Once you have a firm grasp on these three principles you will be much better off when looking for new investments of any kind, not just stocks.

The most important of these principles may be the second, which is to say that each year the range between an individual stocks' high and low price varies greatly.

In my opinion, this is where many investors stumble because they are trying to ride the upward trend in a stock. For me, it's much easier to buy low and sell high than to buy high and sell higher.

Exercise #1

Visit www.google.com/finance/stockscreeener and observe the 52-week price change (%) for the largest companies. Most fluctuate between -25% to +25%, yet the underlying business didn't grow or contract by that much. For this exercise simply add the following criteria to the screener and review the prices for yourself.

Thinking like a High Yield Investor

High Yield Investing takes the idea of intrinsic value to the

next level, basing the price you pay on how quickly you would recoup your entire investment based on the company's earnings.

With over 90% of American businesses failing within 10 years, if you were a private investor, you would seek the highest capital payback rate possible.

Why not use the same concept in the public markets?

With the High Yield System, the same rule applies because of principle number one: *when you own a stock, you own a piece of the business.*

To further illustrate this psychology, imagine you live in a small town with a great bakery. We'll give this business an arbitrary value of \$1,000,000. How would you determine **IF** this price was fair?

First, as we've discussed, a business is only worth the amount of cash the owner can extract over its life.

Second, since more than 90% of all businesses vanish within 10 years, it's better to extract as much as you can as soon as you can. Thus, the bakery would need to be generating a high level of profits to justify the \$1,000,000 price tag.

The Bakery Scenario

Let's pretend that another small town has two bakeries, one earning \$150,000 a year and one earning \$75,000 a year. They both charge the same amount for coffee, bread, and pastries.

All things being equal, which company do you invest in?

Sounds easy right? You would just ask yourself "How soon would I get my money back if I bought the whole business for one million dollars?"

With the second bakery, you would need *over 13 years* to finally recoup your original investment and that's without any price drops or increased competition.

However, if you bought bakery number one, you would recoup your original investment within 7 years, and would be earning 100% positive cash for years to come.

By the time bakery #2 makes \$1,000,000 you would have made \$2,000,000... plus any interest gained along the way.

This is the basic formula for High Yield Investing.

Investors face the same choices every day in the stock market and unfortunately tend to overpay. This is why fewer than 20% are able to consistently outperform the market. The problem is that with publicly traded stocks, things are rarely created equal.

For instance, why did one baker in our example have twice the profit? It could have been for a number of reasons; better budgeting techniques, better relationships with suppliers, lower cost ingredients.

The point is that that baker had a system that allowed the business to sell the same product for less, creating more profit for the owner. For the investor, that's what matters in any company you invest in.

Exercise #2

Go back to www.google.com/finance and find the payback time frame for the following stocks. A simple cheat is to look at the company's current price to earnings (P/E) ratio.

This ratio states how much you pay based on the annual earnings of the business. Thus, if the company didn't grow or shrink, the P/E ratio tells you how long it would take to recoup your money... payback period.

Find the payback periods of the following stocks:

AAPL

AMZN

MSFT

MCD

CRM

FB

WHR

PCLN

TWTR

In closing this chapter, remember that the High Yield Investing philosophy revolves around a specific psychology where the investor should always be concerned with the earnings a company generates, just as he or she would in a privately owned business.

Sometimes P/E ratios are not the best way to evaluate a business. If all you had to do was find low P/E stocks and buy them, everyone would be outperforming the S&P 500.

More importantly, when making an investment, you should seek the shortest recovery time possible based on

the profits from the business. However, some businesses are faster growers than others.

As we go forward, you will learn the strategies to determine if a stock is worth owning and, if so, at what price based solely on the math of the High Yield System.

For purposes of this book, I will stick to evaluating companies that have a certain amount of history. But first, let's get into the method behind the system and learn how it all fits together.

Please keep in mind, that I am not a teacher or writer by trade so some of the information may be hard to follow. My goal is to make it as simple as possible and write in plain English for my own sake.

Chapter Three

Payback Theory

The entire investment valuation system (IVS) hinges on a principle I call Payback Theory. Eluded to previously, capital payback is one of the most important aspects of any financial methodology, at least for long term investors.

From my research I have noticed that the stocks tend to trade on earnings, whether realized or anticipated, with certain subtleties based on business history and potential.

In the next few pages, I want to illustrate this theory with a few examples so that you can see it respect to real market performance from a group of real stocks. These are the stocks I've chosen to look through over the following pages.

Apple Inc.
Ticker: AAPL

PepsiCo
Ticker: PEP

Microsoft Corporation
Ticker: MSFT

Priceline.com
Ticker: PCLN

Coca-Cola
Ticker: KO

Apple Inc.

Ticker: AAPL

For the purpose of these examples, we are going to stick strictly to the following per share data.

Per Share Data	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue	10.69	16.26	22.01	26.99	41.56	47.3	70.54	115.57	165.55	183.45
EBITDA	0.76	2.53	3.92	6.72	11.19	14.56	21.5	39.01	63.6	62.97
EBIT	0.4	1.92	2.8	4.96	9.23	12.94	19.88	36.08	58.43	52.59
EPS	0.36	1.56	2.27	3.93	5.36	9.08	15.15	27.68	44.15	39.75
Free Cashflow	0.98	2.66	1.78	5.04	9.31	9.86	17.82	32.11	43.85	47.86
Dividends	--	--	--	--	--	--	--	--	2.65	11.4
Book Value	6.54	8.95	11.38	16.71	25.17	35.16	52.18	82.45	125.86	137.4
Month End Price	19.38	53.61	76.98	153.47	113.66	185.35	283.75	381.32	667.11	476.75

Notice that in 2004, Apple's (AAPL) earnings per share (EPS) was a measly \$0.36, giving it a price to earnings ratio (P/E) of 53. If an investor took these numbers at face value in 2004 they may not have invested in the company.

Yet, two years later the yield would have grown to over 12% and by 2011, the company would be earning more than the 2004 market value each year. Another important metric to watch is how the company's book value grows. In Apple's case, that value increased from \$6.54 to over \$137 by 2013, 7x its market value in 2004.

Microsoft Corp

Ticker: MSFT

Per Share Data	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue	3.38	3.65	4.2	5.17	6.38	6.5	7	8.14	8.67	9.19
EBITDA	1.23	1.6	1.82	2.18	2.85	2.58	3.21	3.73	3.11	3.77
EBIT	0.83	1.34	1.56	1.87	2.35	2.26	2.7	3.16	2.56	3.16
EPS	0.75	1.12	1.2	1.42	1.87	1.62	2.1	2.69	2	2.58
Free Cashflow	1.24	1.45	1.22	1.57	1.95	1.77	2.48	2.87	3.45	2.9
Dividends	0.16	0.32	0.34	0.39	0.43	0.5	0.52	0.61	0.76	0.89
Book Value	6.93	4.45	3.93	3.32	3.9	4.44	5.33	6.82	7.92	9.48
Stock Price	28.8	24.84	23.3	29.47	27.51	23.77	23.01	26	30.59	34.55

In 2004, Microsoft earned \$0.75, giving it a P/E of 38.4. At the time, this would have been a better buy than AAPL based just on the payback period, but while Microsoft (AAPL) flat lined Apple (AAPL) soared.

Granted, MSFT only increased in value about 20% in that time, but the company did pay out \$4.92 in dividends boosting the total pre-tax return to over 37%.

What did the S&P 500 do over the same time? 59.7% Remember, anything you invest in should be able to beat the market over the long term, and as a general rule, the S&P 500 is the best benchmark.

The Coca-Cola Company

Ticker: KO

Per Share Data	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	4.27	4.48	4.83	5.13	6.19	6.84	6.65	7.53	10.02	10.47
EBITDA	1.36	1.54	1.69	1.69	2.09	2.03	2.32	3.58	3.08	3.2
EBIT	1.06	1.17	1.27	1.34	1.56	1.81	1.77	1.8	2.19	2.35
EPS	0.89	1	1.02	1.08	1.29	1.25	1.47	2.53	1.85	1.97
Free Cashflow	0.94	1.07	1.15	0.97	1.18	1.2	1.33	1.57	1.41	1.72
Dividends	0.44	0.5	0.56	0.62	0.68	0.76	0.82	0.88	0.94	1.02
Book Value	2.87	3.29	3.44	3.61	4.7	4.42	5.38	6.76	6.99	7.34
Stock Price	25.38	20.82	20.16	24.13	30.69	22.64	28.5	32.89	34.99	36.25

Coca-Cola is a 100+ year old business. And, over the last decade investors have seen the stock rise 44% plus received another \$7.22 (28%) in dividend payments, helping the stock outpace the S&P 500 over the decade.

Despite it being a slower growth stock than AAPL, Coca-Cola brings consistency and strong brands to the table, which can be counted on year after year.

That said, if you notice the rise in both book value and earnings per share you'll realize that the company was bound to grow over the years.

Financial growth always leads good technical growth.

PepsiCo Inc.

Ticker: PEP

Per Share Data	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	15.51	16.92	19.51	20.84	23.84	27	27.41	35.84	41.64	41.58
EBITDA	3.7	4.08	4.86	5.22	5.68	5.59	6.45	7.14	7.82	7.61
EBIT	2.75	3.04	3.55	3.82	4.33	4.34	5.1	5.16	6.03	5.79
EPS	2.05	2.44	2.39	3.34	3.41	3.21	3.77	3.91	4.03	3.92
Free Cashflow	1.72	2.12	2.47	2.38	2.72	2.84	2.96	3.22	3.51	3.66
Dividends	0.63	0.85	1.01	1.16	1.43	1.65	1.78	1.89	2.03	2.13
Book Value	6.93	8.06	8.63	9.41	10.68	7.77	10.78	13.43	13.21	14.49
Stock Price	46.62	52.2	59.08	62.55	75.9	54.77	60.8	65.33	66.35	68.43

Another great, slow growth, business. PepsiCo's brands and management talent account for much of the growth you see in the chart above.

EPS 2003: 2.05

EPS 2012: 3.92

Dividends: 14.56

Book Value 2003: 6.93

Book Value 2012: 14.49

P/E 2003: 22.74

P/E 2012: 17.45

Stock ROI: 78% *(with dividends)*

Priceline.com

Ticker: PCLN

Per Share Data	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	22.14	0.02	20.73	25.11	30.97	38.73	47.22	60.5	85.05	102.5
EBITDA	0.64	--	1.62	2.7	4.92	7.51	10.25	16.29	28.54	36.88
EBIT	0.21	--	0.77	1.39	3.03	5.95	9.51	15.43	27.32	35.65
EPS	0.27	0.76	4.21	1.68	3.42	3.98	9.88	10.35	20.63	27.66
Free Cashflow	0.34	--	1.11	2.22	3.08	6.11	9.99	14.8	25.29	33.72
Dividends	--	--	--	--	--	--	--	--	--	--
Book Value	3.89	5.13	9.36	9.58	15.1	17.05	29	36.89	51.69	78.14
Stock Price	17.9	23.59	22.32	43.61	114.86	73.65	218.41	399.55	467.71	620.39

This is one of my favorite examples of High Yield. Partly because I use it to book travel and hotels on occasion, but mostly because of William Shatner who made \$500 million from the company's stock being its spokesman.

Once again, noticed the increase in EPS and Book Value, which correlated to an aggressive rise in Stock Price. In fact, between 2003 and 2012 the earnings per share grew at 58% a year, while the book value grew at 35% per year.

Everyone thinks of Apple being the best buy over the last decade, but Priceline.com crushed it as well.

The reason to illustrate these stocks is to provide a glimpse into what you want to focus evaluation efforts on with every company. Finding firms that can build their book value and earnings over time is really the only way to outperform the stock market.

Later, you'll see what distinctions really matter in determining what growth rates are acceptable and how to manage a portfolio of stocks for maximum returns.

Payback Theory is just that... theory. Obviously, from the previous examples, you can see how shorter payback periods equate to faster growth of stock prices, and how growth in earnings can really accelerate that rate of gain. Notice that both PCLN and AAPL generate more in net earnings than either company was worth 10 years ago.



Chapter Four

Stock Screening

When I first started in the financial industry in 2001, there were no guides on how to screen for stocks. In fact, the only website that provided a screen, that was any good, was MSN Money.

Today, there are numerous free and premium stock screening websites, yet still no guide as how to use them properly. Maybe that's because screening for stocks should be self explanatory? If so, disregard this chapter.

But, if you want to know exactly the method I've used for 12 years to find some of the best stocks in the market outside of reading every news paper and magazine weekly, then this chapter is for you.

You will be using the following resources to screen for stocks. The free and premium websites listed below offer very good stock screening tools. For the purpose of this book, Google Finance was used for all screens.

Free Stock Screeners

www.google.com/finance/stockscreeener

www.finviz.com/screener.ashx

<http://www.cnbc.com/id/15839076>

Premium Stock Screeners

www.morningstar.com

www.valueline.com

www.gurufocus.com

The stock market is just like any other market. It's filled with buyers and sellers looking to make a profit. The only way any stock can appreciate higher is when someone wants to pay a higher price than the price at which you own it.

Seems pretty obvious, right? But, there are many different circumstances that help fuel buyers and sellers. In the end, the biggest contributing factor to why anyone would (or should) buy or sell is based on the company's earnings.

Again, this is not as cut and dry because investors pay for what the company "could" earn or the "potential" the company has in the future.

It's with this in mind, that I propose investors should only buy stocks that have the history to provide the clearest outlook for future potential.

Whether anticipated or realized, profitability is the leading factor for the supply and demand in stock trading. The more a company can grow and retain its

earnings, the higher their stock price will eventually move.

The distinction you notice here is that profit growth does not correlate to stock gains all by itself. Don't forget principles two and three: the prices of publicly traded stocks fluctuate widely each year and a stock's value is never determined by its price.

As discussed in the last chapter, growth in earnings directly correlates to growth in stock prices. And, the faster they grow, the better... all seems fairly obvious, but hindsight, as they say, is 20 / 20.

For the purpose of screening, I have always thought it best to stick with companies that are currently profitable and growing.

This has helped me find great stocks in the past, but beware that many companies will be excluded from the screen by default. Mainly because during any 10 year cycle, it's very rare to have a steady upward trend in earnings.

The following is the five-step process to screening for high yield stocks. Later in this chapter, you will see a complete breakdown of an actual screen from January 2013.

Step 1: Choose screen criteria

Step 2: Run stock search

Step 3: Add more screen criteria

Step 4: Run new stock search

Step 5: Choose stocks to analyze

Do not overlook these steps. While there are hundreds of potential screens an investor could use, the high yield system focuses on the three to four that produce the best results.

Over the following pages you will see examples from the various websites listed above. Google Finance was used for majority of the examples, but feel free to use other stock screeners to find the right fit for you. There's not a rule that says you have to use only one resource.

In fact, in the back of the book, I've listed all the resources I use on a regular basis to screen and evaluate stocks. Most are free!

Going forward, I will be outlining sample screens that you can run as you read along. The best way to do this is by running the same screens using current market data. This way, you can find your own stocks no matter what day or year the screen is performed.

Screening Criteria

When screening for stocks, the goal is to get enough stocks to evaluate that fit within your area of expertise without being overwhelmed.

Unless you're like me, and you want to evaluate hundreds of stocks a week just because that's your personality; if that's the case, then go ahead.

To get a target list, this book will use the following stock ratios and figures for screening purposes. Feel free to experiment with others as you get more comfortable.

P/E Ratio (Current)	Gross Margins
P/B Ratio (Current)	Total Cash
ROE (Current)	Long-Term Debt
ROE (5 Year Ave.)	Current Assets
EPS Growth (5yr)	Total Liabilities
EPS Growth (10yr)	Last Price
Book Growth (5yr)	52 Week Low
Book Growth (10yr)	52 Week High

Sample Screen #1

The Basic High Yield Screen

With this screen you are looking for companies that have had earnings growth in the last five and ten years and are currently trading with low price to earnings ratios (or, in other words, high earnings yields).

High yields correlate to the ability to achieve capital payback, which is the foundation of the High Yield system.

Criteria

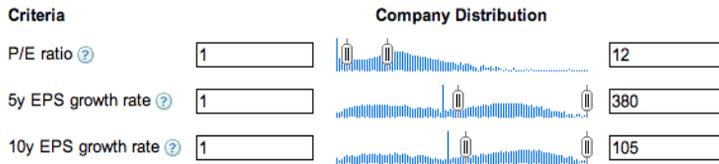
P/E Ratio Range	1 and 12
EPS Growth 5 yr	Over 1%
EPS Growth 10 yr	Over 1%

The reason we use the P/E range 1 to 12 is because a company that is growing fast can provide even quicker payback of our capital.

Priceline.com traded at 66 times earnings in 2004, but by 2012 the company was earning almost twice what its 2004 market value.

Remember that the past does not predict the future. It only provides a gauge to consistency of the business and management.

The screen from the previous page...



CAVEAT: Screening for stocks this way does not always yield every company that is fundamentally sound. The 5 and 10 year growth criteria may exclude stocks where the underlying company's earnings were skewed during the year in question. For example, if MSFT earned \$2.00 5 years ago, but \$1.99 in the current year, the stock would not make it on the screen.

Earnings Yield Screen (ROE Add-In)

Return on Equity (ROE) is very important metric to any stock valuation. ROE represents the amount of profit earned on shareholder equity. Why is this so important?

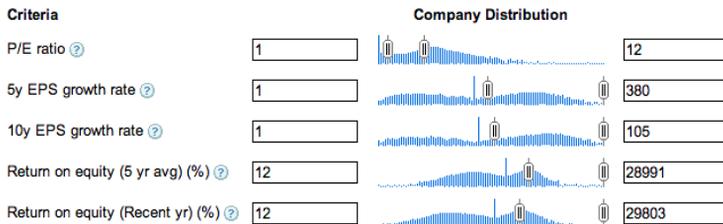
Again, all things being equal, the company that can earn more from its shareholder equity is more likely to produce better returns for its owners than another company that earns less on its shareholder equity.

I know... All of this seems sooooo simple doesn't it!?!?

Just because these are the rules, doesn't mean that it's easy to find these types of investments or be able to trade them.

Criteria

P/E Ratio Range	1 and 12
EPS Growth 5 yr	Over 1%
EPS Growth 10 yr	Over 1%
ROE 5 Year Average	Over 12%
ROE Current Year	Over 12%



NOTE: We use 12% as the baseline for corporate ROE because this provides better quality corporations to analyze. However, just like with EPS growth, the results could be skewed and disqualify many good businesses. BRK for example has an 8% ROE.

While screening specifically for stocks that possess above average returns on equity may provide a more narrow

group of stocks to evaluate, it is important to always review the ROE value when looking at companies in which you wish to invest. This usually drops the total number of stocks in the screen down considerably. If at this point, you get zero stocks, the market may be overly priced and poised for a drop.

Earnings Yield Screen (Gross Margin Add-In)

Coca-cola has been one of the best investments of the last 100 years, with a 60% gross margin, while United Airlines has produced uninspiring shareholder results and has a 15% gross margin.

As a rule, gross margins of 25% or lower is usually an indicator that the industry is fiercely competitive where no one company can take the lead over the others, as seen in the example above. This measure is not fail-safe, but is a good indicator to look for consistency.

Criteria

P/E Ratio Range	1 and 12
EPS Growth 5 yr	Over 1%
EPS Growth 10 yr	Over 1%
ROE 5 Year Average	Over 12%
ROE Current Year	Over 12%
Gross Profit Margin	Over 25%

Criteria		Company Distribution	
P/E ratio ?	<input type="text" value="1"/>		<input type="text" value="12"/>
5y EPS growth rate ?	<input type="text" value="1"/>		<input type="text" value="380"/>
10y EPS growth rate ?	<input type="text" value="1"/>		<input type="text" value="105"/>
Return on equity (5 yr avg) (%) ?	<input type="text" value="12"/>		<input type="text" value="28991"/>
Return on equity (Recent yr) (%) ?	<input type="text" value="12"/>		<input type="text" value="29803"/>
Gross margin (%) ?	<input type="text" value="25"/>		<input type="text" value="560"/>

Earnings Yield Screen (52 Week High Low Add-In)

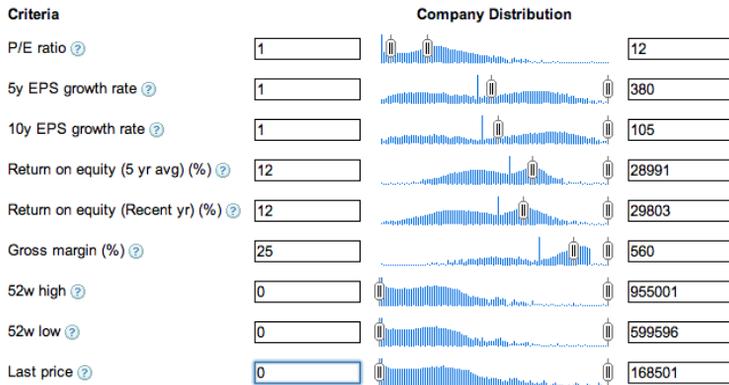
The final step in the earnings yield screening process is to find out where each stock falls in their annual trading cycle. In the grand scheme of things and based on the high yield system, buying stocks closer to their 52 week low will yield better results than buying at or near their 52 week highs.

Criteria

P/E Ratio Range	1 and 12
EPS Growth 5 yr	Over 1%
EPS Growth 10 yr	Over 1%
ROE 5 Year Average	Over 12%
ROE Current Year	Over 12%
Gross Profit Margin	Over 25%
52 Week High	Default
52 Week Low	Default
Last Price	Default

This should not change the total number of potential targets that the screen yields. It is only used as a measuring tool.

Basic High Yield Screen



As of January 26, 2014, this screen yielded 32 potential targets.

Exercise #3

Now, take this process and do your own stock screen. Then write down the number of total stocks the screen yielded, and make a list of stocks that are close to their 52 week lows.

Another rule of thumb in the High Yield System is to rarely, if ever, invest in stocks close to their 52 week high. This can be disregarded if the range between 52 week low and high is less than 20%.

Sample Screen #2

The Book Value Screen

Using the first screen, add book value growth 5 year and 10 year over 1% annualized. This produces a list of stocks that not only increased earnings per share, but also generated steady growth in book value.

Criteria

P/E Ratio Range	1 and 12
EPS Growth 5 yr	Over 1%
EPS Growth 10 yr	Over 1%
ROE Current Year	Over 12%
Gross Profit Margin	Over 25%
Book Growth 5 yr	Over 1%
Book Growth 10 yr	Over 1%
52 Week High	Default
52 Week Low	Default
Last Price	Default

The book value of a company is generally considered its net worth; the book value per share would be the net worth of a company divided by the number of shares outstanding. For the last 40 odd years, Warren Buffett has used his company's book value as a metric to measure its growth by. Seems to work for him... so why not follow that strategy!?

Book value is also an important metric for measuring consistency because it provides perhaps the best correlation to a businesses true value.

Growth in book value is an easy way to judge how a company has used its retained earnings, which is a very important concept in determining future value.

#	Selected Fields	Minimum Value	Maximum Value	Remove All
1	<input type="text" value="Current PE Ratio"/>	<input type="text" value="1"/>	<input type="text" value="12"/>	<= Remove
2	<input type="text" value="EPS Growth 5-Year"/>	<input type="text" value="1"/>	<input type="text"/>	<= Remove
3	<input type="text" value="EPS Growth 10-Year"/>	<input type="text" value="1"/>	<input type="text"/>	<= Remove
4	<input type="text" value="Return on Shareholders' Equity"/>	<input type="text" value="12"/>	<input type="text"/>	<= Remove
5	<input type="text" value="Book Value Growth 5-Year"/>	<input type="text" value="1"/>	<input type="text"/>	<= Remove
6	<input type="text" value="Book Value Growth 10-Year"/>	<input type="text" value="1"/>	<input type="text"/>	<= Remove
7	<input type="text" value="Gross Margin"/>	<input type="text" value="25"/>	<input type="text"/>	<= Remove
8	<input type="text" value="Price 52-Week High"/>	<input type="text"/>	<input type="text"/>	<= Remove
9	<input type="text" value="Price 52-Week Low"/>	<input type="text"/>	<input type="text"/>	<= Remove
10	<input type="text" value="Stock Price"/>	<input type="text"/>	<input type="text"/>	<= Remove

I apologize if some of these images are blurry, but I hope the illustration is enough to show the screening process.

Sample Screen #3

The Net Current Asset Screen

The Net Current Asset screen uses the company's balance sheet to determine its net liquidation value compared to its current market capitalization. If the company's Net Current Asset Value (NCAV) is higher than the entire market value of the stock, you have what Benjamin Graham called a "margin of safety".

In fact, when Warren Buffett was managing his investment partnership, he exclusively used this formula, which is why he got into trouble buying Berkshire Hathaway and subsequently had to transform it into a different organization. Nonetheless, it's still a great tool for finding bargain stocks.

The net current assets of a company can be found by adding all the current assets and subtracting the total liabilities. If that number is higher than the market capitalization, you may have a margin of safety.

NCAV = Current Assets < Total Liabilities

MOS = NCAV < Market Capitalization

MOS = margin of safety

Benjamin Graham's NCAV Calculation...

Cash and equivalents + (0.75 * accounts receivable) + (0.5 * inventory) - total liabilities

There are four great websites to screen for these types of stocks. CNBC is the only free resource.

- www.cnbc.com
- www.valueline.com
- www.morningstar.com
- www.gurufocus.com

If you are interested in doing these screens yourself, here are a few examples to follow. Just remember that the market capitalization should be less than current assets minus total liabilities.

Screen A

Current Assets (\$ mil) > 100

Total Liabilities (\$ mil) < 80

Market Capitalization \$ mil) < 20

Select Custom Criteria			
<div style="border: 1px solid #ccc; padding: 2px; margin-bottom: 5px;">Company Overview</div> <p>Select All Criteria</p>	<input type="checkbox"/> Company Name <input type="checkbox"/> Shares Outstanding <input type="checkbox"/> S&P Member <input type="checkbox"/> State / Province <input type="checkbox"/> ADR <input type="checkbox"/> Sector		
	<input checked="" type="checkbox"/> Market Cap <input type="checkbox"/> Exchange <input type="checkbox"/> DJ Member <input type="checkbox"/> # Employees <input type="checkbox"/> Beta <input type="checkbox"/> Industry		
<p>✘ Current Assets</p>	<p>Greater Than : \$ 100 Million</p> <p>Show Button View</p>		<p>3,025 Company Matches</p>
<p>✘ Total Liabilities</p>	<p>Less than : \$ 80 Million</p> <p>Show Button View</p>		<p>5,342 Company Matches</p>
<p>✘ Market Cap</p>	<p>Less than : 20 Million</p>		<p>4,449 Company Matches</p>
<p>3 Criteria used for this screen</p>			<p>TOTAL COMPANY MATCHES: 1</p>

Select Custom Criteria			
<div style="border: 1px solid #ccc; padding: 2px; margin-bottom: 5px;">Company Overview ▾</div> Select All Criteria	<input type="checkbox"/> Company Name <input type="checkbox"/> Shares Outstanding <input type="checkbox"/> S&P Member <input type="checkbox"/> State / Province <input type="checkbox"/> ADR <input type="checkbox"/> Sector	<input checked="" type="checkbox"/> Market Cap <input type="checkbox"/> Exchange <input type="checkbox"/> DJ Member <input type="checkbox"/> # Employees <input type="checkbox"/> Beta <input type="checkbox"/> Industry	
<input checked="" type="checkbox"/> Current Assets	Greater Than ▾ : \$ 50 Million Show Button View		3,556 <small>Company Matches</small>
<input checked="" type="checkbox"/> Total Liabilities	Less than ▾ : \$ 30 Million Show Button View		4,621 <small>Company Matches</small>
<input checked="" type="checkbox"/> Market Cap	Less than ▾ : 20 Million		4,449 <small>Company Matches</small>
3 Criteria used for this screen			TOTAL COMPANY MATCHES: 2

Screen B

Cash (\$ mil) = minimum value 100

Long-Term Debt (\$ mil) = maximum value 50

Market Cap (\$ mil) = maximum value 50

Company	Ticker	Cash	LT Debt	Market Cap
Acorn International Inc	ATV	101.25	0	46.2
Petrobank Energy & Res. Ltd	PBG.TO	102.91	0.57	33.18
Carver Bancorp Inc	CARV	104.65	0	26.6
Advanced Battery Technologies	ABAT	111.13	0	29.81
RINO International Corp	RINO	134.49	0	0.57
ChinaCast Education Corp	CAST	148.43	14.09	1.47
Exceed Co Ltd	EDS	151.78	0	49.45
Sycamore Networks	SCMR	371.62	0	15.6

Further analysis is necessary regardless of which screener you use. What's necessary is the process of subtracting out all of the liabilities from a conservative estimate of current assets to deduce a value. And, if that value is less than the market value, you have a margin of safety.

You should always use the latest quarterly data and while profits are not as important in this particular calculation, it is always better to invest in companies that generate a profit.

Example:

Exceed Co. Ltd

Ticker: EDS

Market Value: \$56.62 Million

Cash And Equivalents	96.3	Accounts Payable	12.4
Marketable Securities	--	Tax Payable	--
Accounts Receivable	175.1	Other Accrued Expenses	11.3
Inventories, Raw Materials &	--	Current Portion of	3.3
Inventories, Work In	--	Other Current Liabilities	0
Inventories, Inventories Adjustments	--	Total Current Liabilities	28.1
Inventories, Finished	--	Long-Term Debt	--
Inventories, Other	0.4	Capital Lease Obligation	--
Total Inventories	2.2	Pension & Retirement	--
Other Current Assets	2.9	Deferred Tax And Revenue	--
		Other Long-Term Liabilities	7.9
		<hr/>	
Total Current Assets	276.5	Total Liabilities	36

NCA Value: \$195.55 Million
Margin of Safety: 71%

All numbers are in millions

Exceed Company Ltd. engages in the design, development, and wholesale of footwear, apparel, and accessories under the brand name of ~~Xidalong~~ in the People's Republic of China. As of January 2014 the company is being taken off the public markets in a 'going private' transaction for \$1.78 per share.

NOTE: These types of businesses are generally smaller in nature and carry more market risk than stocks in the S&P or Dow.

Example:

Acorn International

Ticker: ATV

Market Value: \$42.6 Million

Cash And Equivalents	85.5	Accounts Payable	10.7
Marketable Securities	--	Total Tax Payable	0.1
Accounts Receivable	11.3	Other Accrued Expenses	13.2
Inventories, Raw Materials & Components	--	Other Current Liabilities	0.8
Inventories, Work In	--	Total Current Liabilities	28.6
Inventories, Inventories Adjustments	--	Long-Term Debt	8.5
Inventories, Finished	--	Capital Lease Obligation	--
Inventories, Other	18.2	Pension & Retirement	--
Other Current Assets	13.2	Deferred Tax & Revenue	0.9
		Other Long-Term	1.3
		Total Liabilities	38.3
Total Current Assets	128.2		

NCA Value: \$77.98 Million

Margin of Safety: 45%

Acorn International, Inc., an integrated multi-platform marketing company, operates TV direct sales businesses and a nationwide distribution network in the Peoples Republic of China. The stock trades about 12,000 shares a day. Not a liquid issue.

Chapter Five

Stock Analysis

The entire investment process comes down to finding the value of an asset and compared to its market price.

Stock evaluation starts with the understanding that as a part owner of a business you should know exactly what you're buying. Keep in mind that you own something tangible, not just a number that blinks on a computer screen.

Evaluating stocks is a step by step process. Like a puzzle, you don't need to do it the exact same way every time as long as you have all the pieces. However; like a recipe, there is a certain sequence to doing it that can help you save time and make better decisions, especially in the beginning.

Analysis Process

Every publicly traded stock in the United States publishes its financial records for anyone to see via the Securities and Exchange Commission (SEC) and its Edgar database.

This provides trust that the company's current information is accurate. Of course, this is not always the case, as there are numerous examples of fraud.

However, these examples are few and far between in the grand scheme of the stock market and while it may be

easy to focus on the negative, using the high yield system will help you avoid it all together.

Peak performance coach Tony Robbins theorized if you remove a word from your vocabulary and you will no longer experience the emotion attached to it.

So, it may be appropriate to remove certain words from your habitual language pertaining to investing. One may be speculation.

On the following pages you will learn how to take the stocks you just screened and evaluate them quickly and efficiently. More importantly, as you continue to use them, your skills will become masterful. (Is that a word? Who cares!)

The best part is that you only need to look at one website for all your stock evaluation information – www.gurufocus.com. There are other sites (see appendix), but this is really the only one you need.

Within the High Yield Investing system, there are three pillars that form the basis of all stock evaluation and the sequence to follow to determine ownership potential.

In layman's terms, if you follow the recipe laid out, you will find the right stocks.

The essence of this sequence is meant to build trust with the company, understand where it's going, and determine whether you want to jump on its bandwagon.

The Pillars of Investing

I. Financial Pillars

- a. Income Statement
- b. Balance Sheet
- c. Cash Flow Statement
- d. Distinctions

II. Valuation Pillars

- a. Future EPS Value
- b. Future Book Value
- c. Distinctions

III. Market Pillars

- a. Stock Price
- b. 52 Week Range
- c. Probabilities

IV. Management Pillars

- a. Trade Management
- b. Portfolio Management
- c. Accelerated Strategies

Each of these “pillars” provide a foundation to a solid investment operation and can help you generate cash flow as well as build wealth over the long term. Remember that the longer you compound you money at a high rates, the more you will create.

The first three pillars encompass stock analysis within the High Yield System, while the last pillar focuses on how to manage an investment portfolio for the maximum gain with least amount of risk. This chapter will be longer and more detailed to provide examples and commentary on important traits for investment analysis.

High Yield Investing focuses on the following 12 distinctions:

1. Price to Earnings (P/E) Ratios under 12
2. Long Term Debt to Income Ratio under 5
3. Return on Equity Historically over 12%
4. Operating Costs to Income Under 75%
5. Capital Purchases to Income under 75%
6. Gross Profit Margins over 25%
7. Consistent Growth in Earnings
8. Consistent Growth in Book Value
9. Consistent Growth in Sales
10. \$1 for \$1 retained to market growth
11. Meet 15% baseline growth estimate
12. Never buy at 52 week high prices

Pillar One

Financial Statements

Building Trust in the Company...

Financial data in any company is perhaps the most important attribute of its success. As Jay-Z would say “Men lie, Women lie, Numbers don’t.”

If a company has good financial data, it’s usually because they have a good brand, good marketing, and a good management team to back it up.

You do not need to be able to evaluate every aspect of the company financially in order to know if it’s mis-priced or not. You just need to know the distinctions discussed in this book.

If you’re not an expert at accounting, don’t worry; you can evaluate the balance sheet, income statement, financial ratios, and current financial position without being burdened with a CPA License.

The reason to look at the financials directly after screening for stocks is to find out which companies are the most consistent, possess solid fundamentals, and have the best potential. I'll walk you through each distinction within the financial statements without getting too cumbersome on specific detail.

For instance, is it really necessary to think about how McDonald's works with suppliers and franchisees to create sales and profits?

NO...

Because when you invest in the public markets, you trust that the company will continue to run the business as before. Plus, if you like McDonalds, ticker MCD, then you probably know a lot about the company anyway. This is called your circle of competence. Finding more and more of the companies you already know and like is a good start. Buying at prices that make business sense is essential.

If something changes, you simply sell your shares. What matters is that you buy at the right price; looking for consistency in the financial statements will help you determine that while building trust.

By this point, you've screened for stocks that have rising profits. Generally, for a company to have rising profits, it must have rising sales as well. Yet, rising sales alone means nothing unless shareholders profit.

Again, the only site you need is:
[www.gurufocus.com/financials/\(symbol\)](http://www.gurufocus.com/financials/(symbol))

Pillar Two

Income Statement

A financial statement that measures financial performance over a specific accounting period. It also shows the net profit or loss incurred over a specific accounting period, typically over a fiscal quarter or year.

In the following section, I'll outline the sequence in which to evaluate any company's income statement based on the High Yield System.

While everything will be left to personal judgment, I will outline, in a later chapter, specific examples from my current research to give you a better understanding of the blueprint.

To start, navigate to the following link:

<http://www.gurufocus.com/financials/KO>

What you are looking for within the income statement is whether or not the company has strong fundamentals and can withstand market volatility. To do this, it will need a competitive advantage.

While opinions from analysts are nice, the only real way to know if a company has this advantage is by looking at

the financial statements and evaluating the market, which you do everyday with most companies.

Income Statement

Gross Profit Margin

A financial metric used to assess a firm's financial health by revealing the proportion of money left over from revenues after accounting for the cost of goods sold. Gross profit margin serves as the source for paying additional expenses and future savings.

$$\text{Gross Margin} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

Gross Profit should be more than 25% of the company's total revenue. If you did your job in the screening process, you will only analyze companies with this characteristic.

Evaluate whether the gross margin is decreasing, increasing, or remaining steady. This will help you to determine whether the business has a competitive advantage or not.

The Coca-Cola Company (KO)

<u>2004</u>	63.1	<u>2009</u>	64.4
<u>2005</u>	64.7	<u>2010</u>	64.2
<u>2006</u>	64.5	<u>2011</u>	63.9
<u>2007</u>	66.1	<u>2012</u>	60.9
<u>2008</u>	63.9	<u>2013</u>	60.3

Apple Inc. (AAPL)

<u>2004</u>	27.3	<u>2009</u>	40.1
<u>2005</u>	29.0	<u>2010</u>	39.4
<u>2006</u>	29.0	<u>2011</u>	40.5
<u>2007</u>	34.0	<u>2012</u>	43.9
<u>2008</u>	35.2	<u>2013</u>	37.6

Priceline.com (PCLN)

<u>2004</u>	16.9	<u>2009</u>	50.7
<u>2005</u>	21.7	<u>2010</u>	53.9
<u>2006</u>	27.8	<u>2011</u>	61.9
<u>2007</u>	35.7	<u>2012</u>	70.7
<u>2008</u>	45.4	<u>2013</u>	77.6

Pepsico (PEP)

<u>2004</u>	54.1	<u>2009</u>	52.9
<u>2005</u>	56.7	<u>2010</u>	53.5
<u>2006</u>	56.5	<u>2011</u>	54.1
<u>2007</u>	55.1	<u>2012</u>	52.5
<u>2008</u>	54.3	<u>2013</u>	52.2

Income Statement

Gross Profit Margin

The next number you want to pay close attention to is the company's operating costs. Excellent business managers are generally spending less than 80% of their Gross Profit on expenses tied to operations.

These expenses include research and development (R&D) and selling and general administrative costs (SG&A).

The higher this margin, the more money the company has to spend to keep itself alive at current levels.

$$\text{Gross Margin} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

The Coca-Cola Company (KO)

<u>2003</u>	60.7	<u>2008</u>	57.2
<u>2004</u>	59.5	<u>2009</u>	57.1
<u>2005</u>	59.2	<u>2010</u>	58.8
<u>2006</u>	60.4	<u>2011</u>	61.5
<u>2007</u>	59.3	<u>2012</u>	61.2

Apple Inc. (AAPL)

<u>2003</u>	63.4	<u>2008</u>	24.1
<u>2004</u>	46.1	<u>2009</u>	21.5
<u>2005</u>	43.5	<u>2010</u>	17.3
<u>2006</u>	36.3	<u>2011</u>	14.6
<u>2007</u>	28.5	<u>2012</u>	16.8

Priceline.com (PCLN)

<u>2003</u>	87.0	<u>2008</u>	63.4
<u>2004</u>	77.8	<u>2009</u>	58.0
<u>2005</u>	76.5	<u>2010</u>	55.3
<u>2006</u>	76.3	<u>2011</u>	51.7
<u>2007</u>	70.6	<u>2012</u>	52.5

Pepsico (PEP)

<u>2003</u>	64.8	<u>2008</u>	69.3
<u>2004</u>	66.5	<u>2009</u>	65.0
<u>2005</u>	67.0	<u>2010</u>	73.0
<u>2006</u>	65.9	<u>2011</u>	72.0
<u>2007</u>	66.3	<u>2012</u>	73.0

Exercise #4

Now take the stocks from the recent screen and calculate the Gross Margin and Operating Costs for each of them.

Disqualify all the stocks that have operating costs higher than 80% or gross margins lower than 25%.

Income Statement

Historical Earnings Growth

If a company's revenue and earnings are moving higher year after year, you would first find the rate of gain by dividing the current earnings per share (EPS) by the EPS 10 years prior.

Inside the screening section, this was one of the basic criteria used to determine which stocks fit into the high yield system.

In order to calculate value, you need to know exactly what rate of growth the company has historically achieved over a 10 year period and how consistent that growth has been.

The longer and more consistent a company's earnings are, the easier it is for an analyst to determine the intrinsic value.

$$10 \text{ Yr Total Growth} = (2013 \text{ EPS} \div 2004 \text{ EPS}) - 1$$

$$5 \text{ Yr Total Growth} = (2013 \text{ EPS} \div 2009 \text{ EPS}) - 1$$

Annualized Growth Rate (AGR)

$$\text{AGR} = (\text{EPS } 2013 / \text{EPS } 2004) ^ { (1 / 10) } - 1$$

Some example calculations are listed on the following pages to help you process the formula.

Coca-Cola (KO)

<u>2003</u>	0.89	<u>2008</u>	1.25
<u>2004</u>	1.00	<u>2009</u>	1.47
<u>2005</u>	1.02	<u>2010</u>	2.53
<u>2006</u>	1.08	<u>2011</u>	1.85
<u>2007</u>	1.29	<u>2012</u>	1.97

$$10 \text{ Yr} = (1.97 \div 0.89) - 1 \quad \text{GR} = 121.3\%$$

$$5 \text{ Yr} = (1.97 \div 1.25) - 1 \quad \text{GR} = 57.6\%$$

Apple Inc. (AAPL)

<u>2004</u>	0.36	<u>2009</u>	9.08
<u>2005</u>	1.56	<u>2010</u>	15.15
<u>2006</u>	2.27	<u>2011</u>	27.68
<u>2007</u>	3.93	<u>2012</u>	44.15
<u>2008</u>	5.36	<u>2013</u>	39.75

$$10 \text{ Yr} = (39.75 \div 0.36) - 1 \quad \text{GR} = 10,942\%$$

$$5 \text{ Yr} = (39.75 \div 9.08) - 1 \quad \text{GR} = 338\%$$

Income Statement

Sporadic Earnings Growth

If a company's revenue and earnings have not consistently increased, then instead of taking the 10 year historical growth rate, you should find the total earnings the company generated over the period or stay away from these businesses all together.

This could have been useful with Pier 1 Imports when the stock was trading at \$0.21, because the prior decade produced much more than that in total earnings, and as long as the company could produce profits in the future (which it obviously did), the stock would move higher. In fact, let's take a look at that:

Over the last decade, Pier 1 Imports stock went from \$16 a share to \$0.21 back to \$18 a share. Now, it's true that the past does not predict the future and that Pier 1 Imports had a great story behind it.

It demonstrates the power of fundamental analysis even further. However, all things being equal, you want to own stocks with a high rate of consistency.

See the next page for analysis...

Amazon Inc. (AMZN)

<u>2003</u>	0.08	<u>2008</u>	1.49
<u>2004</u>	1.39	<u>2009</u>	2.04
<u>2005</u>	0.84	<u>2010</u>	2.53
<u>2006</u>	0.45	<u>2011</u>	1.37
<u>2007</u>	1.12	<u>2012</u>	-0.09

5 Year Total EPS = \$3.88 10 Year Total EPS = \$11.22

Pier 1 Imports (PIR)

<u>1999</u>	0.75	<u>2006</u>	-2.60
<u>2000</u>	0.97	<u>2007</u>	-1.09
<u>2001</u>	1.04	<u>2008</u>	-1.45
<u>2002</u>	1.36	<u>2009</u>	0.86
<u>2003</u>	1.39	<u>2010</u>	0.85
<u>2004</u>	0.69	<u>2011</u>	1.48
<u>2005</u>	-0.46	<u>2012</u>	1.20

5 Year Total EPS = (\$2.18) 10 Year Total EPS = \$0.68

Looking at the total EPS the company generated prior to 2007, if you had any inkling that it was going to be around in 2012, you would be buying the stock with two hands.

In essence, stock analysis is contingent on whether the company has consistent or sporadic earnings. Over time, earning a profit and retaining those earnings are the single best factor to determining a company's value, which is why the High Yield System looks for growth in earnings to result in a growth in book value.

**Amazon Inc. (AMZN)
Book Value Per Share**

<u>2003</u>	-2.58	<u>2008</u>	6.23
<u>2004</u>	-0.56	<u>2009</u>	11.84
<u>2005</u>	0.59	<u>2010</u>	15.22
<u>2006</u>	1.05	<u>2011</u>	17.05
<u>2007</u>	2.88	<u>2012</u>	18.04

Despite posting sporadic earnings over the last decade, the company grew its book value at a very steady rate. This contributed to the stock price rising from \$52 to over \$380 a share in that time.

Financial Pillar

The Balance Sheet

With the balance sheet, an investor is simply trying to analyze the use of cash within the business and see if the company's have been good stewards of capital or not.

To start, stay on the same page or open a web browser and navigate to <http://www.gurufocus.com/financials/KO>, then scroll down the page until you see Balance Sheet.

A financial statement that summarizes a company's assets, liabilities and shareholders' equity at a specific point in time. These three balance sheet segments give investors an idea as to what the company owns and owes, as well as the amount invested by the shareholders.

The balance sheet must follow the following formula:

Assets = Liabilities + Shareholders' Equity

It's called a balance sheet because the two sides balance out. Accounts such as cash, inventory and property are on the asset side of the balance sheet, while on the liability side there are accounts such as accounts payable or long-term debt. The exact accounts on a balance sheet will differ by company and by industry, as there is no one set template that accurately accommodates for the differences between different types of businesses.

The Coca-Cola Company

Assets

<u>Fiscal Period</u>	<u>Latest Q.</u>
Cash And Cash Equivalents	11,118
Marketable Securities	9,341
Cash, Cash Equivalents, Marketable Accounts Receivable	20,459
Inventories, Raw Materials & Inventories, Work In Process	5,116
Inventories, Inventories	1,683
Inventories, Finished Goods	--
Inventories, Other	--
Total Inventories	1,297
Other Current Assets	341
Total Current Assets	3,321
	31,576
Land And Improvements	--
Buildings And Improvements	--
Machinery, Furniture, Equipment	--
Construction In Progress	--
Gross Property, Plant and Accumulated Depreciation	24,401
Property, Plant and Equipment	-9,853
Intangible Assets	14,548
Other Long Term Assets	27,503
Total Assets	15,805
	89,432

The Coca-Cola Company

Liabilities & Shareholder Equity

<u>Fiscal Period</u>	<u>Latest Q.</u>
Accounts Payable	--
Total Tax Payable	418
Other Accrued Expenses	10,590
Accounts Payable & Accrued Expenses	11,008
Current Portion of Long-Term Debt	22,034
Other Current Liabilities	468
Total Current Liabilities	33,042
Long-Term Debt	14,173
Capital Lease Obligation	--
PensionAndRetirementBenefit	--
DeferredTaxAndRevenue	5,307
Other Long-Term Liabilities	10,085
Total Liabilities	57,300
Common Stock	1,760
Preferred Stock	--
Retained Earnings	61,187
Additional Paid-In Capital	12,122
Treasury Stock	-38,238
Total Equity	32,132

Balance Sheet

Debt To Net Ratio

Now, we're going to highlight a few distinctions to look for on the balance sheet when you do your analysis.

Debt is only a problem when it carries too high of interest payments and cannot be paid off within a short period of time.

In non-bank stocks, the best debt to net (income) ratio is 0, but some businesses are just capital intensive. In those cases, you should raise your level of acceptable debt to a maximum 5 to 1.

In other words, if the net income is \$100 million, the debt should not exceed \$500 million.

This does not apply to financial stocks (i.e. banks) who earn their profits mainly from the debt they lend. In these situations you should look for an equity to liabilities ratio above 10%.

On the next page, review the balance sheet of a prominent bank from Charlotte, NC. To determine financial health of this business divide the total equity by the total liabilities. The higher above 10% this number is, the better the business is doing.

Bank of America

Balance Sheet

<u>Fiscal Period</u>	<u>Latest Qtr</u>
Cash and cash equivalents	142,862
Money Market Investments	190,328
Net Loan	922,167
Securities & Investments	524,938
Accounts Receivable	59,448
Deferred Policy Acquisition Costs	--
Property, Plant and Equipment	10,475
Intangible Assets	80,470
Other Assets	292,587
Total Assets	2,223,275
Total Deposits	1,119,271
Accounts Payable	135,662
Current Portion of Long-Term Debt	45,999
Long-Term Debt	249,674
Other liabilities	439,984
Total Liabilities	1,990,590
Common Stock	155,293
Preferred Stock	13,352
Retained Earnings	72,497
Additional Paid-In Capital	--
Treasury Stock	--
Total Equity	232,685

Aflac Inc.

Balance Sheet

<u>Fiscal Period</u>	<u>Latest Qtr</u>
Fixed Maturity Investment	103,471
Equity Investments	22
Short-term investments	470
Net Loan	--
Cash and cash equivalents	2,749
Accounts Receivable	950
Deferred Policy Acquisition Costs	9,173
Property, Plant and Equipment	510
Intangible Assets	--
Total Assets	119,918
Unpaid Loss & Loss Reserve	3,853
Unearned Premiums	11,601
Future Policy Benefits	72,744
Policyholder Funds	5,739
Current Portion of Long-Term Debt	--
Long-Term Debt	4,953
Total Liabilities	105,260
Common Stock	67
Preferred Stock	--
Retained Earnings	19,380
Additional Paid-In Capital	1,605
Treasury Stock	-5,933
Total Equity	14,658

Balance Sheet

Retained Earnings

When a business earns a profit, it can spend that profit in two ways. One, it can return the profits to stockholders by way of dividends or share buy-backs. Or, it can use the money to increase its profitability.

For example, a company earns a \$100. It can pay this entire amount to stockholders who can then use that money as they think fit. Or the company can use all that profit to invest in the business with a view to increasing profits in future years. Or the company can do a bit of both, which is what most dividend paying companies do.

The ability of management to use retained earnings wisely is a sign of a good company. If the company cannot do any better with earnings than the broad market, an investor is better off if the company pays out the full amount in dividends.

A secret from the Warren Buffett playbook is whether a company has generated at least a dollar-for-dollar increase in market value for the earnings they retain. In other words, for every \$100 in retained earnings, you want \$100 in market value, at the very least. This is another reason you want to own companies with consistent earnings.

Berkshire Hathaway (BRK.A)
Retained Earnings

<u>2003</u>	31,881	<u>2008</u>	78,172
<u>2004</u>	39,189	<u>2009</u>	86,227
<u>2005</u>	47,717	<u>2010</u>	99,194
<u>2006</u>	58,912	<u>2011</u>	109,448
<u>2007</u>	72,153	<u>2012</u>	124,272

(numbers above are in millions)

Over the last 10 years Berkshire has grown its retained earnings by \$92,391,000,000. This has led to a rise in market value of \$150,000,000,000; a rise of 1.63 for every dollar retained by the company in that time.

The Coca-Cola Company (KO)
Retained Earnings

<u>2003</u>	26,687	<u>2008</u>	38,513
<u>2004</u>	29,105	<u>2009</u>	41,537
<u>2005</u>	31,299	<u>2010</u>	49,278
<u>2006</u>	33,468	<u>2011</u>	53,621
<u>2007</u>	36,235	<u>2012</u>	58,045

As for Coca-Cola, over the last 10 years it has grown retained earnings by \$31,358,000,000. This has led to a rise in market value of \$46,678,880,000; a rise of 1.49 for every dollar retained by the company in that time.

Balance Sheet

Return on Equity

Return on equity measures the rate of return on the ownership interest of the common stock owners. It measures a firm's efficiency at generating profits from every unit of shareholders' equity.

The rate of return a company earns for its owners is vital to the valuation process. In capital intensive businesses, a high return on equity serves as the greatest barrier to entry and sets those types of companies apart from the competition.

Since retained earnings is a key ingredient in building the value of a business, then the higher a company's rate of profit on these earnings the better.

Another way to think about it is this: Imagine you and your best friend are in the same industry, earning the same annual income, but you have less overhead. From an economical standpoint, if you wanted to double the

size of your business, it would be much easier for you than your friend.

As for the minimum acceptable rate of return: 12%.

This is the rate a slightly above average corporation will earn annually, and it's always better to invest in companies that are doing better than average financially.

Sometimes, good companies operate with negative ROE because they just don't need to keep any retained earnings to produce earnings.

Bank stocks can get by with higher debt to equity ratios. As a rule, a bank should have no less than 10% equity to total liabilities. And remember, Warren Buffett's Berkshire Hathaway has an ROE consistently below 10%.

Most valuation websites calculate the ROE for you, but to do it by hand all you need to do is take the net income and divide it by shareholder's equity.

Calculation

$ROE = \text{Net Income} \div \text{Shareholder's Equity}$

How do you use this to analyze the company?

Alone, the return on equity figure may not be too helpful other than showing how strong and consistent a business has been.

Over time the figure can help you determine the potential rate of growth in the book value, which correlated with earnings growth rate and price to book averages could produce a much clearer estimate of the future stock price of a business.

The Coca-Cola Company (KO)

Return On Equity (%)

<u>2003</u>	30.90	<u>2008</u>	28.40
<u>2004</u>	30.40	<u>2009</u>	27.50
<u>2005</u>	29.80	<u>2010</u>	38.00
<u>2006</u>	30.00	<u>2011</u>	27.10
<u>2007</u>	27.50	<u>2012</u>	27.50

(numbers above are in millions)

Earnings Per Share

<u>2003</u>	0.89	<u>2008</u>	1.25
<u>2004</u>	1.00	<u>2009</u>	1.47
<u>2005</u>	1.02	<u>2010</u>	2.53
<u>2006</u>	1.08	<u>2011</u>	1.85
<u>2007</u>	1.29	<u>2012</u>	1.97

Book Value

<u>2003</u>	2.87	<u>2008</u>	4.42
<u>2004</u>	3.29	<u>2009</u>	5.38
<u>2005</u>	3.44	<u>2010</u>	6.76
<u>2006</u>	3.61	<u>2011</u>	6.99
<u>2007</u>	4.70	<u>2012</u>	7.34

If you demand this type of consistency from every stock you analyze, eventually you will have a portfolio that is hard to beat.

Financial Pillar

Cash Flow Statement

One of the quarterly financial reports any publicly traded company is required to disclose to the SEC and the public.

The document provides aggregate data regarding all cash inflows a company receives from both its ongoing operations and external investment sources, as well as all cash outflows that pay for business activities and investments during a given quarter.

For our purposes, the cash flow statement will be used to ensure the company isn't spending too much money to generate profits.

The more money spent on property, plant, and equipment, the lower a company's competitive advantage and retained earnings will be. No company can consistently grow while spending more than it earns on property, plant, and equipment (PP&E) each year.

To follow along, please start by navigating to the following site: <http://www.gurufocus.com/financials/KO> and scroll down the page to the Cash Flow Statement.

Let's look at Coca-Cola's spending on PP&E.

The Coca-Cola Company (KO) Capital Expenditure Ratio (%)

	<u>Net</u>	<u>CapEx</u>	<u>Ratio</u>
2003	4,347	-812	18.7%
2004	4,847	-755	15.6%
2005	4,872	-899	18.5%
2006	5,080	-1,407	27.7%
2007	5,981	-1,648	27.6%
2008	5,807	-1,968	33.9%
2009	6,824	-1,993	29.2%
2010	11,787	-2,215	18.8%
2011	8,584	-2,920	34.0%
2012	9,019	-2,780	30.8%

As you can see, the blueprint is pretty clear. If you want to invest in a winner, look for companies where capital expenditures are low. Now, let's look at an industry that has always been a great benefit to society, but not so for shareholders. The airline business!

Delta Air Lines (DAL)
Capital Expenditure Ratio (%)

	<u>Net</u>	<u>CapEx</u>	<u>Ratio</u>
2003	-790	-744	n/a
2004	-5,217	-760	n/a
2005	-3,836	-814	n/a
2006	-6,205	-413	n/a
2007	1,612	-1,036	64.3%
2008	-8,922	-1,522	n/a
2009	-1,237	-1,202	n/a
2010	593	-1,342	226.3%
2011	854	-1,254	146.8%
2012	1,009	-1,968	195.0%

In 10 years, we can see why the company's stock has produced a negative return. Any company that is losing money and having to pay out 100% to 226% of their income to buy new equipment is a losing business. Stay away from stocks in these types of businesses.

Pillar Two

Business Valuation

Understanding where it's going...

The first step was to build trust in the company you are analyzing. (Or, in Wall Street jargon, to know if it's "rock solid.") The second step is to find out if it's a bargain. Once you understand how to evaluate public stocks from a fundamental standpoint, you can immediately understand how to analyze any business in the private market.

Determining value comes down to a general estimate of the future aspects of the business. Once again, this is why consistency is vital.

The stronger and more reliable a company's past, the more easily predictable is its future. With that in mind, the high yield system uses a combination of traits to specifically determine value.

1. Future EPS Value
2. Future Book Value
3. Future Cash Value

Once you have a grasp on a company's financials, and trust that they are consistent and worthy of a deeper look, it's time to step up and estimate the value of the business.

Exercise #4

If you currently own any stocks (even through a mutual fund) take the current price and multiple it by 4.

This will give you the price the stock would need to achieve over a 10 year period to generate a 15% annualized return.

Warren Buffett (supposedly) won't buy a stock unless he believes it can provide at least a 15% annualized gain. At least this used to be his premise. This is a great premise that you should adopt if you want to beat the market.

Business Valuation

Future EPS Value

Calculating the Future EPS Value is a four step process.

First, find the historical growth rate; Second, calculate future EPS estimate; Third, find the historical price multiple (P/E); Fourth, calculate a future price estimate.

The Coca-Cola Company (KO)

Future EPS Value Estimate

	<u>EPS</u>	<u>P/E</u>
2003	0.89	28.52
2004	1.00	20.82
2005	1.02	19.76
2006	1.08	22.34
2007	1.29	23.79
2008	1.25	18.11
2009	1.47	19.39
2010	2.53	13.00
2011	1.85	18.91
2012	1.97	18.40

Growth Rate: 8.27%
EPS Estimate: \$4.36
Ave. P/E Ratio: 20.30
Price Estimate: \$88.51

With Coca-Cola (KO), it is acceptable to use the historical growth rate, because its future will probably look very similar to its past.

To take a more conservative stance simply subtract the growth rate of a tax-free government treasury to find a more conservative growth rate.

Another way is to calculate the probability of the EPS estimate based on the number of years the company has grown versus the prior year, lowering the probability 10% for each down trend in earnings growth.

	<u>EPS</u>	
2003	0.89	
2004	1.00	
2005	1.02	
2006	1.08	
2007	1.29	
2008	1.25	← Down years lower the probability estimate by 10% giving KO an 80% probability of achieving the future EPS estimate.
2009	1.47	
2010	2.53	
2011	1.85	←
2012	1.97	

Future EPS Value

The Calculation

Historical Growth Rate:

$$\begin{aligned} & (\text{Current EPS} \div 2003 \text{ EPS}) ^ { (Y1 \div Y10) - 1} \\ & (1.97 \div 0.89) ^ { (0.10) - 1} = 8.269\% \end{aligned}$$

Future EPS Estimate:

$$\begin{aligned} & \text{Current EPS} \times (1 + \text{Growth Rate}) ^ { 10} = \text{Future EPS} \\ & (1.97 \times 1.08269) ^ { 10} = \$4.36 \end{aligned}$$

Historical P/E Ratio:

$$\begin{aligned} & \text{Sum total of last 10 years} \div 10 = \text{Historical P/E} \\ & (0.89 + 1.00 + 1.02\dots) \div 10 = 20.30 \end{aligned}$$

Future Price Estimate:

$$\begin{aligned} & \text{Future EPS Estimate} \times \text{Historical P/E Ratio} \\ & 4.36 \times 20.30 = 88.51 \end{aligned}$$

The price will be lower, if you decide to use the probability ratio from the previous page.

	EPS	P/E
2003	0.89	28.52
2004	1.00	20.82
2005	1.02	19.76
2006	1.08	22.34
2007	1.29	23.79
2008	1.25	18.11
2009	1.47	19.39
2010	2.53	13.00
2011	1.85	18.91
2012	1.97	18.40

Business Valuation

Future Book Value

Calculating the Future Book Value is a four step process.

First, find the historical growth rate; Second, calculate future Book estimate; Third, find the historical price multiple (P/B); Fourth, calculate a future price estimate.

The Coca-Cola Company (KO)

Future Book Value Estimate

	<u>Book</u>	<u>P/B</u>
2003	2.87	8.84
2004	3.29	6.33
2005	3.44	5.86
2006	3.61	6.68
2007	4.70	6.53
2008	4.42	5.12
2009	5.38	5.30
2010	6.76	4.87
2011	6.99	5.01
2012	7.34	4.94

Growth Rate: 9.85%
Book Estimate: \$18.77
Ave. P/B Ratio: 5.94
Price Estimate: \$111.65

Future Book Value

The Calculation

Historical Growth Rate:

$$\begin{aligned} & (\text{Current Book} \div 2003 \text{ Book})^{(Y1 \div Y10)} - 1 \\ & (7.34 \div 2.87)^{(0.10)} - 1 = 9.85\% \end{aligned}$$

Future Book Estimate:

$$\begin{aligned} & \text{Current Book} \times (1 + \text{Growth Rate})^{10} = \text{Future Book} \\ & (7.34 \times 1.0985)^{10} = \$18.77 \end{aligned}$$

Historical P/B Ratio:

$$\begin{aligned} & \text{Sum total of last 10 years} \div 10 = \text{Historical P/B} \\ & (8.84 + 6.33 + 5.86...) \div 10 = 5.94 \end{aligned}$$

Future Price Estimate:

$$\begin{aligned} & \text{Future Book Estimate} \times \text{Historical P/B Ratio} \\ & 18.77 \times 5.94 = 111.65 \end{aligned}$$

There is no need to use probabilities for book value estimates in my opinion...

	Book	P/B
2003	2.87	8.84
2004	3.29	6.33
2005	3.44	5.86
2006	3.61	6.68
2007	4.70	6.53
2008	4.42	5.12
2009	5.38	5.30
2010	6.76	4.87
2011	6.99	5.01
2012	7.34	4.94

Business Valuation

Future Cash Value

The total cash value is the sum total of the future earnings plus today's fair value. This is my alternate to discount cash flow analysis and requires finding the company's fair value currently and adding that to what it could produce over the next 10 years in total earnings.

The Coca-Cola Company (KO)

Future Cash Value Estimate

	<u>GR</u>	<u>EPS</u>
Y1	8.27%	2.13
Y2	8.27%	2.31
Y3	8.27%	2.50
Y4	8.27%	2.71
Y5	8.27%	2.93
Y6	8.27%	3.17
Y7	8.27%	3.44
Y8	8.27%	3.72
Y9	8.27%	4.03
Y10	8.27%	4.36

Growth Rate:

8.27%

Current EPS:

\$1.97

Ave. P/B Ratio:

20.30

Price Estimate:

\$71.29

Future Book Value

The Calculation

Calculate Fair Value:

$$\begin{aligned} \text{Current EPS} \times \text{Average P/E} &= \text{Fair Value} \\ 1.97 \times 20.30 &= \$39.99 \end{aligned}$$

Calculate Total Future Net Earnings (10 Year)

$$Y1 = 1.97 \times 1.0827$$

$$Y2 = 2.13 \times 1.0827$$

$$Y3 = 2.31 \times 1.0827$$

$$Y4 = 2.50 \times 1.0827$$

Y5, Y6, Y7, Y8...

$$\text{Sum} = \$31.30$$

Future Price Estimate:

$$\begin{aligned} \text{Fair Value} + \text{Future Net Earnings (Est)} \\ 31.30 + 39.99 &= 71.29 \end{aligned}$$

This is not an exact science
so use your own judgment
when making evaluations...

	GR	EPS
Y1	8.27%	2.13
Y2	8.27%	2.31
Y3	8.27%	2.50
Y4	8.27%	2.71
Y5	8.27%	2.93
Y6	8.27%	3.17
Y7	8.27%	3.44
Y8	8.27%	3.72
Y9	8.27%	4.03
Y10	8.27%	4.36

How do you know if forecasts are accurate?

Truthfully, you never will 100%.

The best question to ask at this point is whether you think that in the next 10 years KO will trade between \$71 and \$111 per share. There is no way of knowing ahead of time, but that's why it's called forecasting.

Please keep in mind that by using a company like Coca-Cola for the sample, there isn't much needed in the form of discounting future earnings.

However, when looking at most stocks, discounting future earnings or book value growth by the inflation rate is usually a good standard to go by. These calculations are simplified approaches to the deeper methods and thoughts I employ, but they still work very well.

More importantly...

Based on our 15% annualized return baseline, is the stock worth buying at today's price? Remember the price estimate that needed to be met as a baseline for growth was \$155.

KO at the current level does not seem like it will reach our baseline for growth.

A brief word on market capitalization...

The High Yield System was developed to look at the overall value of a company, breaking it down into easily understood parts, and determining value on a per share basis.

Smaller companies that are growing at consistent rates tend to have more upside because they can grow longer. However, once you reach the size of an Apple or Coca-Cola, the upside growth is limited drastically by the market size of the company.

More experienced stock analysts will be able to integrate the principles here into a more detailed look using the company's overall market value.

Pillar Three

The Market

Determining if you should jump on...

Once you have a price forecast for the stock, get excited! You are very close to determining whether or not you have a stock to buy... or not.

The next step is to figure out the rate of return and if it's worth jumping in on based on the current price point in the market.

The goal of the High Yield Investing system is to buy stocks that have a high level of consistent growth at a price that ensure the fastest payback of capital.

Can the company produce at least 15% year?

Coca-Cola (KO)... priced at \$38.87 as of January 28, 2014, would need to reach \$155 in the next decade to produce 15% a year for the owner.

The current analysis has estimated that the range will be between \$71 and \$111, so in order to meet that the stock would need to be bought around \$28.00.

Is it a High Yield Stock?

The number one rule of High Yield Investing is to capture the quickest payback possible. In order to do that, you have to buy stocks that are traded at low price to earnings multiples. The calculation is simple.

Take the current market capitalization and divide it by the company's net income.

From the example, Coca-Cola is not one of those stocks, even based on future earnings; it doesn't trade under 12 times earnings. For some investors, that doesn't matter, but remember Warren Buffett bought the stock in the late 80's when others thought the stock had a very high price multiple.

Yet, adjusted for splits, the stock's earnings per share today is really around \$25 based on its shares outstanding in 1988. Buffett bought the stock at around \$5 per share, and has ridden that high yield investment to 1,000% gains in the last 25 years.

The reason to look for P/E ratios under 10 is that the S&P 500 index normally trades with a price multiple around 15.

Logically, finding companies that momentarily trade for less than the market, or their own historical average, is a good sign of a mis-priced investment. P/E Ratios alone do

not determine value, but they are always a good starting point.

Why Low P/E ('high yield') Matters

When investing based on my High Yield Investing System, its important to remember that the stock just represents a partial ownership in the overall business.

And, if you (the investor) were to buy a business, the first thing you'd want to know is when the initial investment capital laid out would be paid back.

The businesses that provide the quickest payback of capital tend to be the best investments. This is called Payback Theory and pervades the entire high yield system.

The 52 Week Paradigm

In the High Yield Investing world, it's not enough to just demand for quick investment payback based on a businesses earnings. NO! We need to make sure that when investing in publicly traded stocks, the market price paid is never near the 52 week high price.

Some will disagree with me here, and many analyst have extravagant financial models and examples of breakout stocks that kept moving higher. And, I AGREE! There is

more than one way to skin a cat, as they say. However, in the 12 years I've been in the market, I've found it's easier to buy low and sell high, rather than buy high and sell higher. Is this a perfect model? NO.

But, I digress...

Short Interest Ratio

When investing based on my High Yield Investing System, its important to remember that the stock just represents a partial ownership in the overall business.

And, if you (the investor) were to buy a business, the first thing you'd want to know is when the initial investment capital laid out would be paid back.

The businesses that provide the quickest payback of capital tend to be the best investments. This is called Payback Theory and pervades the entire high yield system.

Share Buy Backs

This, simply put, is the repurchase of outstanding shares (buyback) by a company in order to reduce the number of shares on the market.

Companies will buy back shares either to increase the value of shares still available (reducing supply), or to eliminate any threats by shareholders who may be looking for a controlling stake.

This is another great way to financially engineer a stock higher. If a company can continually reduce the overall shares available in the market, while keeping the income at the same level, the price will trend higher.

International Business Machines (IBM)

Share Buy Backs to Share Price Increase

	<u>Shares</u>	<u>EPS</u>	<u>Price</u>
2004	1,709	5.03	98.58
2005	1,628	4.96	82.2
2006	1,554	6.20	97.15
2007	1,451	7.32	108.1
2008	1,382	9.07	84.16
2009	1,341	10.12	130.9
2010	1,287	11.69	146.76
2011	1,214	13.25	183.88
2012	1,155	14.53	191.55
2013	1,103	15.06	187.57

IBM's net income climbed from \$7,479 million in 2004 to over \$16 billion by the end of 2013, but while that only represents a 120% rise, through share buy backs the company's earnings per share increased close to 200% sending the stock up fairly steadily. The price increase happened despite a modest rise in the company's market capitalization.

Has the company added value to shareholders?

While there is no magic bullet for success, it is worth noting that every year since 1977; Warren Buffett has mentioned the upward growth of the shareholder equity (book value) of his conglomerate – Berkshire Hathaway.

If every dollar in retained earnings can generate at least the same in market value, then the company has added value to shareholders.

In our sample stock KO, the company added \$31 billion in retained earnings to its balance sheet, thus producing over \$46 billion in market value for its shareholders.

However, in our IBM example, the company tacked on \$92 billion in retained earnings, but used its profit to buy back stock. In fact, at the end of fiscal 2013, the company had a lower shareholder equity figure than it did in 2004. This is why screening for stocks is not 100% certain to find good businesses.

By now, you hopefully have a firm grasp on the basic calculations along with a core understanding as to what distinctions really matter when looking at a company's financial statements.

The next step is portfolio management.

Chapter Six

Portfolio Management

Remember that most stocks will not move in a straight upwards line. In fact, some stocks will lose as much as 50% before appreciating.

From my experience, as long as you continue to buy financially strong companies that have growth in earnings and offer market prices that provide for high yield, you will do better than 90% of the investment public.

Portfolio management comes down to protection and growth. The first thing you can do to mitigate risk is to adopt a long term focus. This will help you look at each company in a new light, realizing that market pricing does not equal business value.

The next thing you can do to mitigate risk, is to ask yourself: “What returns will I really be happy earning?” For some investors, you could produce 50% a year and they *still* wouldn’t be happy – trust me – but other investors will be happy with 3%. What matters is your personal level of comfort.

As a general rule, I tell everyone that invests in the market that if you’re not outperforming the S&P 500 Index over a 5 year period, you should place the majority of your assets in an Index Fund.

Now, if I've done my job with this book, you've learned some skills that will help you outperform the broad market.

Portfolio Management

The Equal Weighting Strategy

Risk management is an important part of portfolio management. The great hedge fund manager, Joel Greenblatt has an easy formula to follow. Between 1988 and 2004, Mr. Greenblatt utilized a value investing approach within a specific management system to document 30.8% annually in a portfolio of stocks.

Not a bad record to try to model.

His strategy was to divide the total investment capital into at least 20 stocks giving them equal weighting regardless of their size.

Then buy and hold each stock for one year; sell the losing positions before the one year mark and sell the winners after the year mark, for tax benefits. Then repeat.

This is a great strategy that anyone can apply with success. This is an especially effective strategy within an IRA because you have the ability to buy and sell while pushing the tax liabilities out to a later date.

In fact, Mr. Greenblatt has put together a great website for investors to screen for top stocks. Many of his are also good fits for the high yield system. For more information visit the site at www.magicformulainvesting.com.

Equal Weighting Portfolio Management System

The following is the step-by-step guide to this portfolio management strategy.

1. Divide your capital into equal positions
2. Buy and hold each stock for one year
3. Sell the losers before one year
4. Sell the winners after one year
5. Repeat

For instance, if you have \$10,000 and plan to invest in 20 new companies this year, each position would involve an investment of \$500. Just add a zero for your own asset level.

The beauty of the equal weighting management system is that there is not much guess work involved. Just plug in the capital divisions per position and let the stock trade.

A significant drawback to this portfolio strategy is that it forces many investors to become fully vested too soon, thus exposing their holdings to market volatility.

One way to limit this risk is by allocating the division of capital to one position at time over a period of months.

Portfolio Management

The Mae West Strategy

There isn't a rule that says you have to sell the stocks you own at the end of one year. In fact, if you own a great company at a great price, you may never wish to sell it. That's right! And, later when we delve into accelerated strategies, you may want to build really long term holdings.

Mae West was an American actress, playwright, and screenwriter whose career lasted seven decades. We can all aspire to have the same longevity in our chosen professions. This could also be called the Warren Buffett strategy since he takes the quote to heart, normally buying big positions in stocks or acquiring entire companies.

Management System

1. Choose the stock you want to own
2. Put all your available cash into the stock
3. Watch the stock very closely
4. Add to the position over time
5. Repeat with a new stock

Bottom line... if you are following the High Yield System, you should be finding a ton of opportunities.

The idea here is that if you “put all your eggs in one basket,” you are more likely to feel certain about the value of that investment and do your research before making any investment at all.

In fact, isn't this what people do with their biggest asset? Owning a home is the major asset for most people. And, most homeowners do a high level of research for years before buying.

Think about it, kids grow up knowing exactly what a home is all about based upon their parents, friends, and community. They see new homes being built and entire neighborhoods rising and falling over the years before buying a home.

This provides a great sense of certainty, which is instrumental in making a major purchase. So, when the time comes, most people know exactly what questions need to be answered before making a buying decision.

The same level of certainty can be achieved in stocks. If you still generate income, the strategy could be modified to accommodate that by deciding to put a specific amount of cash aside to use each year to buy one stock.

If you do that over a 20 year period, you will accumulate a nice portfolio of solid companies. Remember, consistency is power in the High Yield System.

Portfolio Management

The Inflation Proof Strategy

Insulate your portfolio from market volatility!

There is always risk when investing in stocks. But, there are risks in holding cash as well. In fact, if you hold cash at current interest rates (2013), you're losing about 3% a year.

In this section, I want to introduce the term bifurcation. How it works is by splitting the portfolio into two parallel operations working with one another to create the highest rate of growth possible, because the only real way to protect your assets is to increase them.

As a base for the portfolio, choose any of the other strategies to follow while buying stocks with cash in your account. Later, I'll show you how to keep your initial capital 100% in cash or index funds and generate income to re-allocate to long term holdings. Also, this portfolio strategy introduces the use of risk arbitrage trading in order to enhance the results achieved through short term positions build on margin.

Investing and trading differ only in the time frame in which you own the stock. Anytime you own a stock for less than a year, that's a trade. There is nothing wrong

with trading as demonstrated by Joel Greenblatt, it works when following a high yield strategy. In fact, in some instances, it's better to trade than invest as we'll discuss with options and arbitrage.

Using Risk Arbitrage

The actual operation of risk arbitrage will be explained further in the next chapter. In a merger, one company agrees to buy another, generally for a significant premium.

Here's the best part: typically, the buy price is not reached until the day of closing, leaving a spread. This spread is where risk arbitrage is beneficial.

What you need to know, as it pertains to this style of portfolio management, is that buying stocks based on corporate activity (e.g. mergers, acquisitions, spinoffs) will be used to capture short-term gains.

Why?

Over a 10 year period, the stock market is likely to produce at least 2 or 3 years of losses.

In those years, no matter how diligent you are in following the High Yield Investing system, the stocks you own will generally move down with the market.

However, by trading on the back of corporate actions, an investor can lock in a specific rate of return and insulate their portfolio from draw downs based solely on the probability of the deal closing, which most do!

Here's an example to help: Let's say that you buy the highest quality stocks at the best prices possible and hold them for years. At some point in that holding cycle, they are bound to suffer a 50% or more decrease in price. That is something you should expect as a rule.

During that same year (or, any year for that matter), there are normally 50 or more corporate mergers happening. It's the nature of the business.

NOTE: Only trade mergers that offer at least a 15% annualized ROI.

Management System

1. Buy stocks in cash – using any portfolio strategy
2. Borrow against cash positions to arbitrage
3. Trade as many high yield mergers as possible
4. Add arbitrage profits to the long term positions
5. Repeat arbitrage trades

Portfolio Management

The Cash Generation Strategy

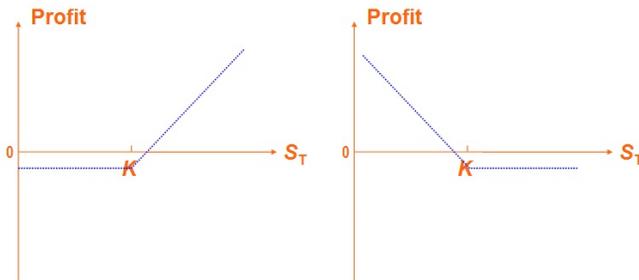
How would like to keep 100% of your cash and make money every month whether the stock market as a whole goes up or down?

Sound too good to be true?

Well, it is..

However, the next closest thing is a cash generation strategy that utilizes writing (or selling) stock options contracts to create a steady flow of cash, every month, like Warren Buffett... but without buying an insurance company.

Option contracts are denoted in 100 share round blocks of the underlying stocks and there are two types: Puts and Calls.



Stock Options

Definitions

PUT: An option contract giving the owner the right to sell a specified amount of an underlying asset at a set price within a specified time. *The seller collects money for taking the risk of potentially having to purchase the stock at the strike price.*

CALL: An agreement that gives an investor the right to buy a stock, bond, commodity, or other instrument at a specified price within a specific time period. *The seller collects a premium for taking the risk of potentially having to sell the stock at the strike price.*

In the Money - ITM: For a call option, when the option's strike price is below the market price of the underlying asset. For a put option, when the strike price is above the market price of the underlying asset.

Out of the Money - OTM: A call option with a strike price that is higher than the market price of the underlying asset, or a put option with a strike price that is lower than the market price of the underlying asset.

NAKED: A type of options contract that is not backed by an offsetting position that would help mitigate risk.

EXPIRATION: The date which the option contract expires.

Using Puts To Generate Cash Flow

A Put, by definition, allows one investor to “put” or sell the stock to another investor at a pre-determined price called the “strike” price.

International Business Machines (IBM)

Option Chain for February 2014

Stock Price: \$176.40

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
15.05	18.8	160	0.2	0.4
10.15	13.9	165	0.59	0.68
7.1	7.8	170	1.43	1.5
5.25	5.45	172.5	2.06	2.12
3.75	3.9	175	3.05	3.15
2.48	2.56	177.5	4.15	4.4
1.58	1.66	180	5.6	5.95
0.97	1.03	182.5	7.6	8.05
0.53	0.73	185	9.6	10.3
0.33	0.45	187.5	10	13.7
0.2	0.27	190	13.05	16.15

How It Works?

IBM is a company that you may want to own for the future. With the stock price at \$176.40, there are many potential trades here and the next chapter will discuss strategy in more detail, but the key with this strategy is to write (e.g. sell) contracts that are just out of the money.

If you want to own IBM, this may mean writing a Put at 175 and collecting \$3.05 (1.7%) while you wait for expiration date. The risk here lies in market fluctuations, which could result in a loss (at least on paper) if IBM were to drop below 171.95 by the expiration date.

If you do not want to own IBM, but think that the stock will not get much cheaper, you could write a put a little further out of the money, and collect a little less of a premium.

What if you are a long term buyer of IBM?

Then this strategy actually is the best way to ease into the position without overpaying for the stock because it forces you to wait and watch.

Most stocks listed on the NYSE and NASDAQ have option contracts associated with them. A great resource to find exact pricing details is www.oscreener.com.

Using Calls to Exit a Position

Let's say that you own IBM at \$80, have held it for a while, and now you want to liquidate the position for greener pastures. Why sell it at the market, when you can get paid to sell it?

If you're willing to sell it at \$175, you would collect an extra 2.2%. If you decided that \$177.50 is better price for it, then you would collect 1.4% plus need the stock to rise before expiration. Either way, you get paid to exit.

IBM Option Chain for February 2014

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
15.05	18.8	160	0.2	0.4
10.15	13.9	165	0.59	0.68
7.1	7.8	170	1.43	1.5
5.25	5.45	172.5	2.06	2.12
3.75	3.9	175	3.05	3.15
2.48	2.56	177.5	4.15	4.4
1.58	1.66	180	5.6	5.95
0.97	1.03	182.5	7.6	8.05
0.53	0.73	185	9.6	10.3
0.33	0.45	187.5	10	13.7
0.2	0.27	190	13.05	16.15

Trading in real life does not happen in a vacuum. You will need to bid on options with limit prices just like you do with stocks. Just like with risk arbitrage, a good rule of thumb is to look for 15% annualized returns. This equates to about 1.25% a month with option contracts.

Management System

1. Divide your total portfolio into equal parts
2. Find stocks that you want to own
3. Sell OTM options contracts on each stock
4. Repeat until you are fully vested
5. Leverage positions to trade risk arbitrage
6. Exit positions by writing covered calls
7. Re-balance portfolio annually.

PLEASE REMEMBER: Option contracts are denoted in 100 share increments. If you write a put contract on Apple Inc. at 500, you'll have to pay \$50,000 if the stock gets put to you.

Portfolio Management

Other Points of Interest

Dollar Cost Averaging

Anytime you find that a company can produce above average investment performance based on thorough analysis, you should consider owning it, regardless of whether you already own it at a different price.

Let's go back to the Pier 1 example for a moment. If you estimated the value of the company in 2008 at \$12, you probably bought it all day long for \$4. What happens if the stock dropped to \$1 and you still valued the company at \$12?

Would you sell or buy more? Had you bought the same dollar amount of stock, you would have owned 4 times more stock at the lower price, making more money over time.

Pier 1 Imports (PIR)

Price on September 19, 2008:	\$4.43
Shares on Initial \$10k Investment:	2,250
Price on January 9, 2009:	\$0.57
Shares on New \$10k Investment:	17,500
Total Investment:	\$20,000
Total Shares:	19,750

Price on January 3, 2013:	\$20.71
Total Account Value:	\$409,000

This is an extreme example, but during any long-term market cycle, there are plenty of opportunities to dollar cost average to success. The key is not doing it blindly.

Dividend Policy

Anytime you own stocks that pay dividends, get the checks sent to you and re-invest the money on your own behalf, even if that means putting it back into the same stock.

When you get the checks sent to you, put aside money to pay the taxes. I've seen way too many people who have automatic re-investment plans get a big tax bill and have to liquidate a good position to pay for it.

Psychology Management Policy

Proper management of your portfolio boils down to how well you control your emotions. Buying and selling stocks can be very emotional for people. Even people which are adept in running a business struggle with it. So give yourself a break.

Education and experience helps limit emotion. Stock investing is done best when it's done in a businesslike manner, especially since you are buying and selling pieces of a real business, right?

To be more business-minded, start to think more like a business owner when it comes to your own portfolio. This is why the High Yield System focuses on earnings payback, not price movements.

What you must understand is that when you buy and sell stocks, you cannot time the market perfectly. This is precisely why you should always think long term.

Over the long term, a good business (stock) will continue to do well, pound out cash, and increase earnings, which will invariably translate into high prices. If you study the past performance of certain stocks you will find this rule to be constant.

Stress Relief Guidelines

1. Never ***Invest*** On Borrowed Money
2. Never Short-Sell Stocks
3. Never Buy Any Options
4. Always Think Long Term

While the strategies outlined in this book will help you find and buy better stocks in any market, you will have to manage your stress level.

You never lose money until you sell your stock, as long as the company remains in business and trading on an stock exchange.

Many things could happen while you own a stock, yet armed with this book you will be able to find companies that can provide safety and a very good return for your money.

Losing money in stocks is bound to happen. The key is to not to let it happen too often or affect your portfolio too greatly. Like in golf, the player who makes the fewest mistakes, win. To that end, a level of diversification should be employed, but is not absolutely necessary to the investment portfolio.

One caveat is not to get emotional if your stock is down 50% from your initial purchase price. In my experience, many of the best companies lost 50% of their market value before becoming big gainers.

Again, nothing hinders long-term performance more than emotion. So, while it is appropriate to feel good about making a profit and to feel bad about taking a loss, it is

not beneficial to allow either of these feelings influence your future decisions.

While you may make 1,000% on one stock, never let that exuberance cloud your judgment on future investments. Learn and learn... and take action.

Chapter Seven

Accelerated Strategies

Accelerated Strategies

The Nitty Gritty of Risk Arbitrage

Why Arbitrage? Because Warren Buffett does it!

In my opinion, there's no better influencer than a billionaire who does something successfully. An arbitrage trade arises when one company announces that it will acquire another. As stated previously, this involves a premium.

When deals are announced they carry a close date and while in the short term, the stock may see a sharp rise, arbitrage seeks to take advantage of the small premium left until closing date.

M+A Policy

1. Only trade stocks in companies that have already announced a merger deal. Never speculate as to the possibility of a merger.
2. Stick to all cash deals in stocks with trading volumes above 50,000 if possible.
3. Only buy when the rate of return is over 15% annualized. This can usually happen by waiting until 1-3 months before closure.

The risk with arbitrage is associated with the deal not closing. So, always keep up to date on events that surround the deals you trade.

The rate of return will be different for each situation. For instance, if XYZ Corp. is paying a 25% premium for ABC Inc., and if the two companies are merging in 4 months, you will receive an annualized return of roughly 90% as long as you can put the money back to work in similar deals.

The best part about this strategy is that ideas are always available due to the need for corporate activity.

Portfolio Bifurcation

What a unique term - bifurcation. It means to divide into two parts or branches. How does this pertain to an investment portfolio?

This is one way to ensure you always outpace the market by building a cash only portfolio and then executing risk arbitrage trades borrowing against your stock positions. Some brokerages require that you are fully vested (no cash) in order to do this.

Here's an example. Let's say that you have \$100,000 divided it into 10 equal positions that you have identified with the High Yield System as great bargains.

As long as you have an account set up for margin trades, you can borrow against these positions to make other trades like stocks and options, which we'll go over next.

If you buy a stock on margin (i.e. borrowed money) and the stock drops, you will have what's called a margin call. In that case, you will be forced to liquidate or cover the cost of the entire position.

The problem with most stocks is that you never know what's going to happen with them over the short term. Right?

That's not the case with arbitrage. Mergers always have a specific price set for a specific date, giving you the ability to lock in a specific rate of return. The risk is whether or not the deal will close and in most cases, they do.

So, you can build your portfolio using the cash you have, and borrow against those positions to trade highly probable events using the risk arbitrage strategy above.

Risk Arbitrage Example: If you want to trade a \$10 stock that is being acquired for \$12 in three months and you

pay a 6% interest rate annually to borrow money in your brokerage account, here's what the breakdown would be.

XYZ Inc. is being acquired by ABC.

ABC is paying \$12.00.

XYZ has a price of \$10.00.

The deal is closing in 3 months and you will pay 1.5% interest on the trade. Once the deal closes, you will earn \$2.00 on every share you owned.

XYZ Merger Trade:

Market Price: \$10

Closing Price: \$12

Closing Date: 3mo.

Margin Rate: 1.5%

Annual ROI: 74%

In real life, on 1,000 shares, you would pay \$150 to borrow the money on margin in order to trade the stock.

As long as the deal closed you would earn \$2,000 minus the money you borrowed less any trading fees. That's 18% profit off the trade or 74% annualized. It's simple math.

Mergers can always go bad (fail to close), and in some cases they do. However, while cash positions in long-term

holdings are much better when they are confined to less than 30 stocks, in arbitrage, the more the merrier... as long as you adhere to the arbitrage policy.

As simple technique to always outperform the S&P 500 is to buy a low fee index fund and use the risk arbitrage strategy with borrowed money to create much better returns.

This is why operating from the question: "Can this stock beat the market return this year?" is always useful.

Accelerated Strategies

Utilizing Options

I personally think that *buying* options is the most ridiculous thing in the world since the majority of contracts expire worthless.

From that frame of reference it would make sense that *selling* option contracts is the only way to go, since you gain a premium for doing it regardless of what happens.

Later in this section, I'll discuss the use of credit spreads, which is a more detailed strategy that includes buying and selling option contracts at different prices expiring in the same month.

Option Strategy #1 - Writing Covered Calls

When you write (i.e. sell) a Covered Call Option, you give the right to someone else to take the stock away from you. This is beneficial when you already own a stock and want to make money while waiting for the price to reach a specific level.

For example, if you own XYZ at \$10 and write a call at \$12, you collect a premium from the contract. If the stock is called away at \$12, you keep the premium and the \$2

profit. If the stock doesn't reach \$12, you still keep the premium.

Conversely, you could think your stock will decrease in value, and find someone willing to pay \$0.50 for the right to buy it at \$10. These are all left up to you.

Option Strategy #2 - Writing Naked Puts

When you write (e.g. sell) a Put Option you provide the right for someone else to give you the stock. This is beneficial if you want to own a specific company's shares at a specific price, but the stock is not yet trading at that price.

For example, if XYZ is trading at \$10 and you want to own it at \$7.50, you can write a put at \$7.50 and collect a premium from the buyer who may be trying to protect his/her position in the stock.

Personally, I feel that these types of option contracts are always the best way to buy into positions during volatile markets.

Options present a great way to generate extra income from your investment account until it reaches a high level of assets. Previously I stated that I would never

recommend option strategies for accounts over \$1 million.

After doing more due diligence, I think that these strategies could be utilized properly on hundreds of stocks allowing the investor to utilize naked put writing on assets into the billions.

Accelerated Strategies

Option Examples

This is going to be fun!

You can always use the high yield screen and narrow down the potential targets based on the 52 week range. Or, using the advanced screener at www.oscreener.com you can find options on companies that fit the 15% baseline criteria.

A simple screen that yields results...

Strategy Type:	Short Put
Target Profit:	1% to 500%
Minimum volume:	5 to 1000000
Distance to breakeven:	15% to 500%
Technical moving average:	Below 50D

This screen provided 454 potential options to choose from. Add expiration date and budget to really hone in on the options that provide the highest yield with the least risk.

My opinion with stock options is that by selling PUTS out of the money by 15% to 50% or more, the investor has a better chance of the contract expiring worthless. If done monthly, this could really boost ROI in the portfolio.

What's an extra 2% among investors?

On a \$10,000 account sitting just in cash earning 2% a month with options generates \$2,400 a year without compounding.

Add this with the power of the high yield system and you could be upwards of \$3,000 just by investing the premiums.

Then by re-balancing (after taxes) the portfolio, it is possible to double your money every 3 years.

Here's the math...

Let's say you earn \$2,400 a year by writing Put Options and take the capital and re-allocate to longer term holdings earning 15% a year as a baseline.

Even if you are a high earner with a personal tax rate of 39%, this would net you 16.8% a year after taxes. If you're in the middle class, then you'd be earning upwards of 23%.

Again, not bad for growth, I'm sure you'll agree.

Over a period of 10 years this would grow your original investment into more than \$79,000 after taxes. In 20 years, the \$10,000 would be well over \$600,000. Of course, you'd be in a much different tax bracket by that point.

The risks to this strategy...

Everything in life has risks. This strategy is no different. If you decide to write put contracts on poor companies and end up owning those company's stock it could get very ugly.

The last thing you want is to own a garbage stock (i.e. one that goes to ZERO) because you were looking for an extra 2% a month.

Another component to this strategy is that if you write a contract on a decent company and the stock is "put" to you, you can either hold because decent company's

rarely go to zero. Or, you can write a covered call once you own it to make up for any short term losses on the way down.

Then again, if you wrote a high enough premium, the stock may get “put” to you at a price that is still profitable.

For instance...

At this moment in time (January 30, 2014), JC Penny’s stock (JCP) is trading at \$5.77. A Put contract with a \$4.00 strike is trading for \$0.17. That’s a 4.25% yield for 22 days of holding, or an annualized return of 198%... If compounded.

The point is that if you sold this contract, pocketed \$17, and accepted the responsibility of buying the stock at \$4, JCP would have to drop 31% in a single month to trigger it.

JCP Option Chain for February 2014

<u>Calls</u>				<u>Puts</u>		
Price	Bid	Ask	Strike	Price	Bid	Ask
11.6	4.65	5.15	1	0.01	-	0.01
4.5	3.65	3.95	2	0.02	0.01	0.04
4.7	2.73	2.99	3	0.08	0.05	0.06
1.94	1.89	1.96	4	0.17	0.14	0.17
1.16	1.06	1.11	5	0.31	0.31	0.34
0.48	0.47	0.49	6	0.7	0.7	0.71
0.17	0.14	0.17	7	1.38	1.38	1.4
0.06	0.05	0.06	8	2.31	2.24	2.32
0.01	0.01	0.03	9	3.25	3.25	3.3

With the stock price at \$5.77, the \$6 Calls are yielding 8%. Option yields are directly correlated to the risk the investor must carry when selling them. In other words, the more volatile (short term) a stock has been, the more risk the investor carries, and the higher the yields.

(this made the investor a quick 8%)

KO Option Chain for February 2014

<u>Calls</u>				<u>Puts</u>		
Price	Bid	Ask	Strike	Price	Bid	Ask
4	4.15	4.4	34	0.03	0.03	0.04
3.05	3.2	3.35	35	0.05	0.05	0.07
2.12	2.3	2.33	36	0.15	0.11	0.12
1.47	1.44	1.46	37	0.25	0.24	0.26
0.74	0.75	0.77	38	0.54	0.55	0.57
0.31	0.31	0.33	39	1.1	1.11	1.13
0.12	0.1	0.12	40	1.89	1.86	1.94
0.05	0.05	0.06	41	2.79	2.81	2.87
0.02	0.01	0.02	42	4.05	3.7	3.85

(this made the investor a quick 8%)

The Coca-Cola Company (Ticker: KO) currently trades around \$38, giving Put Option sellers a 1.4% premium for the at the money price. In fact, you couldn't get anyone to sell you a contract on KO that was 30% out of the money. If you could, and Coca-cola the beverage wasn't toxic to humans because of some new condition (like zombie bee stings or something) then I would recommend selling that Put contract with all your money... as long as the yield is high.

A thought on message boards and what not...

There are a few big message boards on the internet focused specifically on stocks.

Each of these provide the investor with all sorts of opinions on every stock in the known universe. However, it is not advisable (nor profitable) to use the commentary as a guide.

The only guide is proper analysis done in a business like fashion judging future potential against past success (or failure) to determine, conservatively, an appropriate price to pay for a stock.

Doing this takes time at first, but everything you learn along the way is accretive. Most businesses (especially the good ones) do not change “what they do” over time. You can be certain that Coca-Cola will still produce the beverage in 5, 10, 20, etc... years from now.

Once you learn about a business, you’re not done, but you don’t lose any of that knowledge either. AT LEAST, unless your 94 and about to be fed your third meal from nurse Johnson.

Final Thoughts

No one can help you handle the psychological swings of the stock market. This is entirely up to you; however, allow me to offer some basic suggestions that may be of some use.

1. Try really really really hard to not allow breaking news to guide your analysis. This is to say that you should not let a bad or good announcement pressure you to make a rash decision. The news can be a great way to screen for stocks and patiently wait for some great ideas, yet you must still evaluate the business.

2. Never buy stocks at their 52-week highs. This goes hand in hand with the strategy of buying companies that are mis-priced by the market. Not many stocks trading at their annual high prices are ever undervalued.

3. Pay yourself first. While this is not a book on saving or income strategies, it's vital that you have one in order to acquire the capital necessary for investing.

Take these suggestions and you will be able to create much better returns while lowering your stress level.

Chapter Eight

Real-Time Evaluation

Step One

Run Basic Stock Screen

In this section of the book, I will walk through the entire High Yield Investing System in real-time *as of January 30, 2014*.

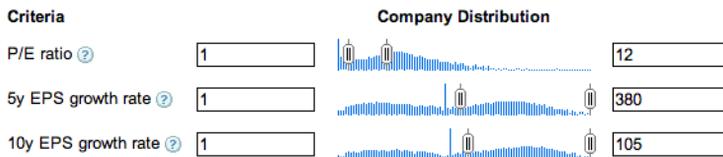
Navigate to www.google.com/finance/stockscreeener

1. Clear the current screen
2. Navigate to “Valuation” Click P/E ratio
3. Navigate to “Growth” Click 5y EPS growth rate
4. On Same Tab Click 10y EPS growth rate

Screen Criteria

Place these numbers into the boxes from the screen.

P/E ratio: 1 to 12
5y EPS growth: above 1
10y EPS growth: above 1



Step Two

Add ROE Criteria

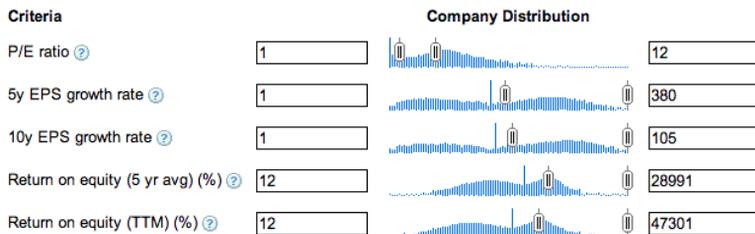
Stay on the current screen...

1. Navigate to “Operating metrics” Click Return on equity (5 yr avg) (%)
2. Stay on “Operating metrics” Tab and Click Return on equity (TTM) (%)

Screen Criteria

Place these numbers into the boxes from the screen.

Return on equity (5 yr avg) above 12
Return on equity (TTM) above 12



Step Three

Add Gross Margin Criteria

Stay on the current screen...

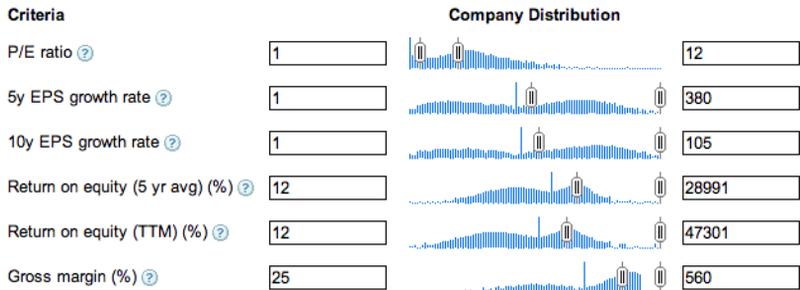
1. Navigate to “Margins” Click Gross margin (%)

Screen Criteria

Place these numbers into the boxes from the screen.

Gross margin (%)

above 25



Step Four

Add Price Data

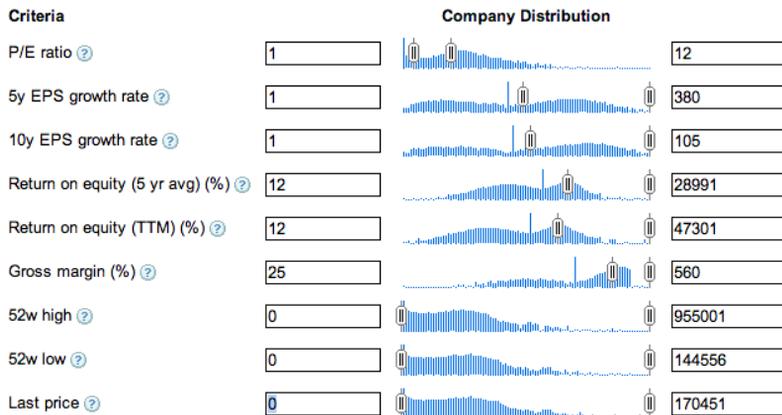
Stay on the current screen...

1. Navigate to “Price” Click 52w high
2. Stay on “Price” Tab and Click 52w low
3. Stay on “Price” Tab and Click Last price

Screen Criteria

Place these numbers into the boxes from the screen.

52w high	Default
52w low	Default
Last price	Default



Step Five

Choose Stocks Near 52 Week Lows

At this point, I start with the stocks that have the lowest P/E ratios and write down all the ones that trade close to the 52 week low price.

Remember, you can always run this screen at a different website or change up any of the criteria. In fact, by taking out the growth rate criteria, the total stocks increases. Yet, for the purposes of this book, I have gone ahead and selected the stocks that will be used in our portfolio this year.

Blank space below is for you to run your own screen...

Step Six

High Yield Analysis

Use... www.gurufocus.com/financials/ticker ... for stock data. The following evaluations are based on financial information from March 6, 2015, after market hours.

Once you have the stocks from the high yield screen and you are performing fundamental analysis, use this following checklist to select stocks to invest in:

1. Growth in Net Income
2. Growth in Book Value
3. High Returns on Capital
4. High Gross Profit Margins
5. Increase Customers / Prices
6. Low or No Long Term Debt
7. Low Capital Spending
8. Stock Price Lower Than Intrinsic Value
9. Stock Priced For High Yield
10. Price Well Below 52 Week High

It's not a perfect algorithm, but over the last 12 years it has helped me find a ton of good opportunities for investors all over the world.

Stock Ideas
2015

Terra Nitrogen Company

TNH

Market

Stock Price	\$144.27
10 Yr Baseline	\$578.00
Dividends (Last 10 Yr)	\$98.63

Financial Data

Gross Profit Margin	62%
Steady or Sporadic Growth	Steady
EPS Growth Rate (10 yr)	553%
Book Growth Rate (10 yr)	143%
Debt to Income Ratio	N/A
Return on Equity Average	120%
PP&E to Income	11%

Valuation

Current EPS	12.81
Current Book	17.62
Current P/E	8.95
Average P/E	11.48
Current P/B	8.50
Average P/B	8.95

Future Price (EPS)	\$775
Future Price (Book)	\$384

Analysis

Out with the old, in with the same. TNH didn't perform the way I wished last year, but it still fits the high yield system.

Sasol Ltd.

SSL

Market

Stock Price	\$33.36
10 Yr Baseline	\$133.44
Dividends (Last 10 Yr)	\$10.85

Financial Data

Gross Profit Margin	56%
Steady or Sporadic Growth	Sporadic
EPS Growth Rate (10 yr)	213%
Book Growth Rate (10 yr)	294%
Debt to Income Ratio	.89
Return on Equity Average	22%
PP&E to Income	61%

Valuation

Current EPS	4.08
Current Book	22.44
Current P/E	14.28
Average P/E	17.35
Current P/B	2.63
Average P/B	3.61

Future Price (EPS)	\$223
Future Price (Book)	\$320

Analysis

With the price of oil at the current low levels of the cycle, this stock looks down right cheap. It's doubtful that the stock will get to the \$200 level, but it should outpace the market this year.

Neustar Inc.

NSR

Market

Stock Price	\$22.08
10 Yr Baseline	\$88.32
Dividends (Last 10 Yr)	\$0.00

Financial Data

Gross Profit Margin	74%
Steady or Sporadic Growth	Sporadic
EPS Growth Rate (10 yr)	345%
Book Growth Rate (10 yr)	228%
Debt to Income Ratio	4.85
Return on Equity Average	24%
PP&E to Income	85%

Valuation

Current EPS	2.54
Current Book	10.06
Current P/E	8.71
Average P/E	56.38
Current P/B	2.20
Average P/B	5.60

Future Price (EPS)	\$99
Future Price (Book)	\$73

Analysis

The company offers a service that has become increasingly necessary in the marketplace - real-time information and analytics and with two decades of experience, they are one of the leaders in the field.

CNOOC Ltd.

CEO

Market

Stock Price	\$138.96
10 Yr Baseline	\$559.96
Dividends (Last 10 Yr)	\$46.72

Financial Data

Gross Profit Margin	64%
Steady or Sporadic Growth	Steady
EPS Growth Rate (10 yr)	327%
Book Growth Rate (10 yr)	695%
Debt to Income Ratio	2.4
Return on Equity Average	28%
PP&E to Income	71%

Valuation

Current EPS	20.15
Current Book	131.75
Current P/E	6.95
Average P/E	10.93
Current P/B	1.06
Average P/B	2.66

Future Price (EPS)	\$598
Future Price (Book)	\$1,114

Analysis

Another stock from last year that is still worth owning at its current valuation. Definitely think that oil and gas will be a safe hedge this year.

National Oilwell Varco

NOV

Market

Stock Price	\$52.54
10 Yr Baseline	\$210.16
Dividends (Last 10 Yr)	\$5.64

Financial Data

Gross Profit Margin	27%
Steady or Sporadic Growth	Steady
EPS Growth Rate (10 yr)	538%
Book Growth Rate (10 yr)	300%
Debt to Income Ratio	1.3
Return on Equity Average	14%
PP&E to Income	24%

Valuation

Current EPS	5.81
Current Book	48.06
Current P/E	9.23
Average P/E	14.19
Current P/B	1.12
Average P/B	1.68

Future Price (EPS)	\$342
Future Price (Book)	\$214

Analysis

Owning a few stocks within one industry that's discounted is one way we can take advantage of macro moves in the market. I think that experts always over exaggerate on both sides of the market. Another stock in the same vein is Copa Holdings (CPA)

Fossil Group

FOSL

Market

Stock Price	\$81.13
10 Yr Baseline	\$324.52
Dividends (Last 10 Yr)	\$0.00

Financial Data

Gross Profit Margin	57%
Steady or Sporadic Growth	Steady
EPS Growth Rate (10 yr)	456%
Book Growth Rate (10 yr)	144%
Debt to Income Ratio	1.68
Return on Equity Average	21%
PP&E to Income	39%

Valuation

Current EPS	6.84
Current Book	17.99
Current P/E	12.50
Average P/E	18.08
Current P/B	4.76
Average P/B	3.59

Future Price (EPS)	\$476
Future Price (Book)	\$209

Analysis

While the stock is not within the 10x yield table, it offers a great brand and should outperform this year and into the future.

Xinyuan Real Estate

XIN

Market

Stock Price	\$3.11
10 Yr Baseline	\$12.44
Dividends (Last 10 Yr)	\$0.59

Financial Data

Gross Profit Margin	26%
Steady or Sporadic Growth	Sporadic
EPS Growth Rate (10 yr)	331%
Book Growth Rate (10 yr)	4,510%
Debt to Income Ratio	N/A
Return on Equity Average	25%
PP&E to Income	2.4%

Valuation

Current EPS	0.69
Current Book	12.91
Current P/E	4.51
Average P/E	N/A
Current P/B	0.25
Average P/B	N/A

Future Price (EPS)	\$14
Future Price (Book)	\$50

Analysis

This one is not necessarily apart of the High Yield System, other than the very low P/E and the very high probability that an investor will make money over the next 5 years with the stock. Looking forward, if the company continues to earn the level of income it has in the last 4 years, the stock is dirt cheap right now. The margin of safety comes in with the Net Current Assets.

Current Assets total \$3.07 billion, while the Total Liabilities come in at \$2.27 billion, giving the company a Net Net value of \$800 million. The market cap is \$235 million. You can do the math here.

Step Seven

Build The Portfolio

Now it's time to take the stocks previously selected and build a portfolio. Remember, we have \$9,650 to use with these 7 stocks - TNH, SSL, NSR, CEO, NOV, FOSL, XIN.

Here's the breakdown.

<u>Ticker</u>	<u>Price</u>	<u>Shares</u>	<u>Investment</u>
TNH	\$144.27	10	\$1,442.70
SSL	\$33.36	40	\$1,334.40
NSR	\$22.08	60	\$1,324.80
CEO	\$138.96	10	\$1,389.60
NOV	\$52.54	25	\$1,313.50
FOSL	\$81.13	17	\$1,379.21
XIN	\$3.11	470	\$1,461.70

Now that the portfolios has been built, it's time to wait and see which one does the best over the year. For the

purpose of this book, I intentionally failed to address business branding and industry requirements because they should be specific to the individual.

For instance, there are some companies I would never buy because I don't understand the business model or its in an industry that I feel is not worth buying into.

However, if you are in that industry and can understand them, you can probably tell if your evaluation is too high, too low, or just right. The real distinction throughout this entire book is that you stick with what works and in many cases, that's what you know.

Hopefully this short book has given you some skills and strategies in helping determine value, as well as, putting a mechanism in place to generate cash and insulate performance.

I appreciate you taking the time to read the third edition of my book... did you take the time? Are you going to use it? I hope so. Though it took me some time to get it out to you, I was happy to write the book and I'll be happy whether you use it or not.

Good Luck!

Appendix A

Investor Resources

Top Websites

www.gurufocus.com

www.morningstar.com

www.google.com/finance

www.valueline.com

www.finviz.com

www.advfn.com

www.cnbc.com

money.msn.com/stocks/

Risk Arbitrage Websites

finance.yahoo.com/news/category-m-a/

www.stockspinoffs.com/

www.sinletter.com/merger-arbitrage/

www.cnbc.com/id/15839076

NCAV Websites

www.grahaminvestor.com

www.valueline.com

www.gurufocus.com/grahamncaav.php

Biz News Websites

www.wsj.com

www.bloomberg.com

www.nyt.com

www.marketwatch.com

www.seekingalpha.com

finance.yahoo.com

Economics Websites

www.mises.org

www.tradingeconomics.com

www.economist.com

www.businessweek.com

Favorite Brokerage Websites

www.interactivebrokers.com

www.tdameritrade.com

www.etrade.com

www.choicetrade.com

www.tradeking.com

Appendix B

Investor Curriculum

Here are some of the great investment books that allowed me to formulate the High Yield System. I find they are a valuable edition to anyone's library.

The Intelligent Investor
Benjamin Graham

Security Analysis
Benjamin Graham

The Interpretation of Financial Statements
Benjamin Graham

How To Pick Stocks Like Warren Buffett
Timothy Vick

Common Stocks as Long Term Investments
Edgar Smith

Common Stocks and Uncommon Profits
Phillip Fisher

The Little Book that Beats the Market
Joel Greenblatt

Big Secrets for the Small Investor
Joel Greenblatt

Beating the Street
Peter Lynch

The Templeton Plan
John Templeton

The Templeton Touch
William Proctor

The Essays of Warren Buffett
Lawrence A. Cunningham

The Warren Buffett Way
Robert G. Hagstrom

Buffett and the Interpretation of Financial Statements
Mary Buffett / David Clark

The New Buffettology
Mary Buffett / David Clark

Warren Buffett's Management Secrets
Mary Buffett / David Clark

Warren Buffett and the Art of Stock Arbitrage
Mary Buffett / David Clark

Warren Buffett Speaks:
Janet Lowe

The Winning Investment Habits of Warren Buffett and
George Soros
Mark Tier

The Snowball: Warren Buffett and the Business of Life
Alice Schroeder

How an Economy Grows and Why It Crashes
Peter Schiff

The Case for Legalizing Capitalism
Kel Kelly

Human Action
Ludwig von Mises

The Theory of Money and Credit
Ludwig von Mises

America's Great Depression
Murray Rothbard

Man, Economy, and State
Murray Rothbard

Wealth of Nations
Adam Smith

The Richest Man in Babylon
George S. Clason

Annual Letters To Berkshire Hathaway Shareholders
Warren Buffett

The End

Acknowledgements

I want to thank my father, for teaching me the value of hard work and how independent thinking sets you apart. Your love and teachings will always be with me dad. I miss you.

I want to thank my mother, who always supports me no matter what I want to do. She would have had a good laugh if I'd have said "I'm going to write a book" 10 years ago, but thank you for always being there! I love you.

I want to thank my sister who sets a new high standard for being a smarty pants. I love you so much and am so proud of you.

I want to thank the guru investors that came before me. Without them, I wouldn't be able to write this book, nor would I be able to make a living through investing. Every time you use this book, know that you are standing on the shoulders of the giant investors that came before you.

Finally, I want to thank all my loved ones, friends, associates, and clients that supported me and provided useful, sometimes crucial advice... even when I didn't like it.

Thank You For Reading