Wisdom-Line Investing

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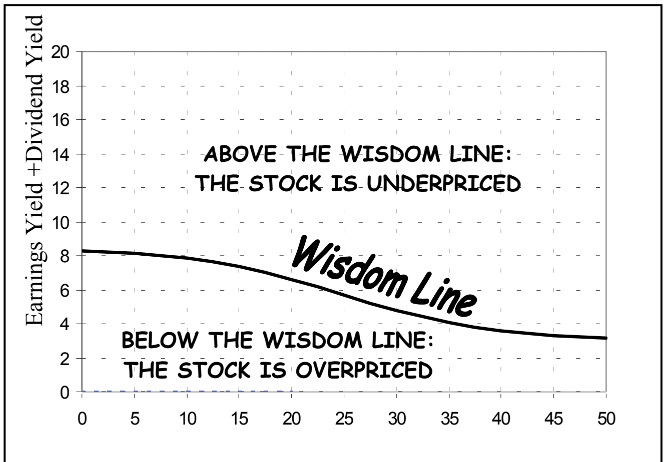
The three biggest costs of investing are:

1. Bad advice and/or bad investment
2. Income Taxes
3. MER's and Commissions

Over the years, I have developed a simple technique to discover underpriced stocks. I call it "Wisdom Line Investing". It may help you filter out potential bad investments.

How is the Wisdom Line chart constructed?
The shape of the "Wisdom Line" is a tangent-hyperbolic arc as shown below.



If I were to invest in a non-growth stock, such as a preferred share, then I would demand a return equivalent to the yield of the long-term bond *plus* a risk premium. The current long-term bond yield is about 6.3%. I require a risk premium of 2%. Therefore, I peg the Wisdom Line at 8.3, calculated as 6.3% plus 2, on the left vertical scale, at 0% annual growth rate.

On the right hand side of the chart, at 50% growth rate, the Wisdom Line is pegged at the current inflation rate on the vertical scale. In this case, I used 3.1%.

How do you plot a data point of a stock?
You need the following data for each company that you are studying:

- Price Earnings (PE) ratio
- Earnings growth rate over the last 3 or 5 years
- Dividend Yield
- Share Price

Both PE and the dividend yield can be found in the financial papers. The growth rate can be found in company annual reports, or you can try free web sites such as, www.globeinvestor.com

The *vertical* position of the data point is calculated as following:

- First calculate the earnings yield as 100 / PE
- Next, add the earnings yield and the dividend yield. This is the vertical position.

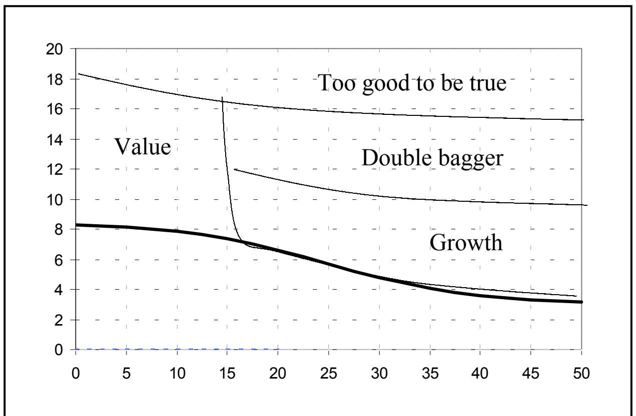
The *horizontal* position is the earnings growth rate. If the company has a steady growth, I use the recent 3 or 5 years' annual growth rate.

I plot this point on the Wisdom Line chart. If it is above the Wisdom Line, then I consider it for my portfolio. If it is below the Wisdom Line, then the stock is overpriced and I eliminate it of from my list.

How to calculate the target share price:
The stock is considered fully priced, -that it is perhaps time to sell-, when its data point reaches the Wisdom Line.

- Plot the target point on the Wisdom Line at the expected growth rate.
- Read off the value of the target earnings yield plus the dividend yield along the vertical scale.
- Deduct the dividend yield from this to obtain the target earnings yield
- Now calculate the target PE by dividing 100 by target earnings yield.
- Target Price = target PE / current PE x current price.

There is no time component in this chart. I used the same chart for several years.



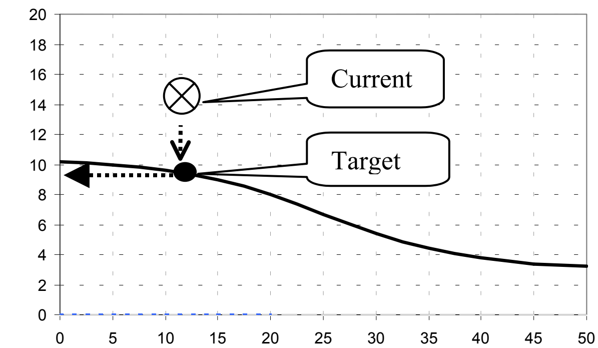
Zones on the Wisdom Line Chart

Zones:
There are four zones in the upper area of the chart: "Value", "Growth", "Double-bagger", and finally "Too Good to be True", as shown above.

Value Stock Example:

Let's first look at a value stock: In October 1995, TD Bank was trading at around $21, its PE was 10 and its dividend yield was 4.2%. It was growing at 12% per year. See the inset below for locating the data point and the target point[1].

Value example: TD Bank as of October 1995



Current point (as of October 1995):
Horizontal Scale: growth rate: 12% per year
Vertical Scale: earnings yield + dividend yield:
=100 / 10 + 4.2 = 14.2

Target Point:
Horizontal scale: expected growth rate: 12% per year
Vertical scale: read off the vertical scale as 9.6
Target earnings yield = 9.6 - dividend yield
= 9.6 - 4.2 = 5.4
Target PE = 100 / 5.4 = 18.5
Target Price : Target PE / current PE x current price
= 18.5 / 10 x $21 = $38.90

(All figures are pre-split.)

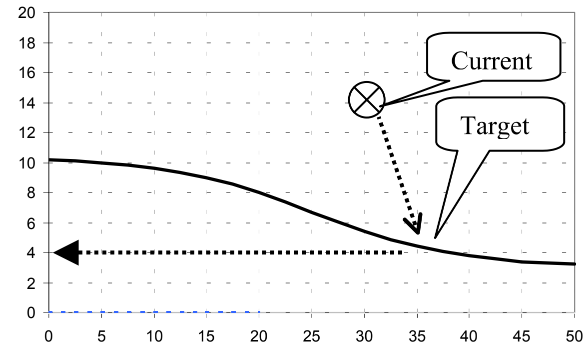
Eventually, the earnings grew to $2.95 per share. The PE ratio also reached about 18. At that point the TD shares were fully priced, ripe for ringing the cash register[2].

Growth Stock Example:

In October 1995, I looked at a stock recommended in a newsletter: Precision Drilling. It had a growth rate of 30%, P/E was 7, it paid no dividend, and its share price was about $14 (again, all figures are pre-split). See the inset for locating the data point and the target point.

Eventually, the earnings reached $2.88 in 1997 and the price exceeded $60, placing the stock below the Wisdom Line, in the overpriced region. At that point, it was time to sell.

Growth Example: Precision Drilling as of October 1995



Current point (as of October 1995):
Horizontal Scale: growth rate: 30% per year
Vertical Scale: earnings yield + dividend yield:
=100 / 7 + 0.0 = 14.3

Target Point:
Horizontal Scale: expected growth rate: 35% per year
Vertical Scale: read off the vertical scale as 4
Target earnings yield = 4 - dividend yield
= 4 - 0 = 4
Target PE = 100 / 4 = 25
Target Price : Target PE / current PE x current price
= 25 / 7 x $14 = $50

(All figures are pre-split)

After purchasing a stock, continue plotting its position on the chart quarterly. If the earnings keep growing, it will continue giving you a new target price, preventing you from selling your stock prematurely.

The Wisdom Line chart protects you from investing in following types of situations:

- companies losing money (negative PE),
- companies that are not growing (growth rate less than zero)
- companies growing at surrealistic rates (regardless of what the actual growth rate is, the maximum you can enter on the chart is 50%)
- overpriced companies

The chart includes the effects of inflation and the long term bond yield, as well as the dividend price-support of the share price. It can help you estimate the degree of risk if its growth rate changes.

After gaining some experience using the Wisdom Line chart, you will no longer agonize in choosing between growth or value style investing. You can take advantage of the opportunity, whether it is value or growth.

The Wisdom Line chart does not cover takeover targets, special situations, merger & acquisition opportunities. For

[1] Note that both long- term bond yields and inflation rate was higher in 1995. Therefore, the Wisdom Line is shown higher than where it is today.

[2] Subsequently, after the merger proposal, the share price kept climbing becoming more and more overpriced, but that is outside the scope of the Wisdom Line chart.

an average investor, it is better to avoid this type of speculation anyway.

After choosing companies for your "buy" list, before investing any money, check the financial health of each company using the balance sheet and the standard methods.

Avoid thinly traded stocks. You may not be able to sell them easily at a fair price when you want to. It will also help, if a few, but not a lot of, mutual funds also own the stock.

When you are considering the expected growth rate, keep an eye on the future earnings estimates. Do you expect the growth rate to stay the same? Otherwise use a more conservative growth rate.

To back-test, you may want to plot the data point as if you were studying the same company in the previous year. Sometimes you discover that the company permanently resides in the "double-bagger" zone. If this is the case, there is probably something wrong with the company, it is better to avoid it.

Before you rush out and buy the first company that looks attractive on the Wisdom Line chart, study several companies and get the feel for the chart. Make sure you have several different companies in your portfolio for a proper diversification.

Remember that investing is risky. Carefully study all aspects of investments before investing and consult a professional or your investment advisor.

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