Buffett and Beyond

By

Dr. J.B. Farwell

This book is a work of non-fiction. Names and places have been changed to protect the privacy of all individuals. The events and situations are true.

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This book is dedicated first and foremost to Tom Barnes, Chief Engineer of the S.S. Yellowstone in 1978. Without him, I would not be here to write this book.

To those of you who insisted that I write this book and especially to Debby who was there through the many long years of research, the writing of that dang Doctoral Dissertation and then the writing and re-writing and re-re-writing of this manuscript.

To my wonderful family who always stood behind me. Always. I love you dad.

And of course to Warren Buffett, the greatest investor of all time. After all is said and done, we all want to be as successful as Warren.

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DISCLAIMER

There is no guarantee that while the method of stock investment described in this book has been effective in the past it will be so in the future. This publication contains the opinions and ideas of its author. It is not a recommendation to purchase or sell any of the securities discussed in this book. Both the author and publisher are not engaged in rendering legal, accounting, investment, financial or other investment services. Thus, neither the publisher nor the author will assume liability for any losses that may be sustained by use of the methods described in this book. Any such liability is hereby expressly disclaimed.

INTRODUCTION

The Timeliness of this Book

By the late 1990s, stock ownership had become commonplace. In 1985, only 17% of all U.S. households owned stock. In 1995, 43% of households owned stock and by 2002, 63% of all the households in America participated in stock ownership.

The number of financial advisers grew from 33,000 to 110,000. Insurance companies recommended investments. Banks sold mutual funds and stock brokers sold annuities, mortgages and yes, even stocks.

The stock market roared and soared. Everyone seemed to be an expert on the market. Almost everyone had tips on stocks that would gain 100% over the following six months. The internet allowed access to anyone who wanted free research on company data. People quit their jobs to become day traders.

Through all of this "irrational exuberance" little was heard from Warren Buffett. Buffett said he really didn't understand what was going on in the technology field and so, no high-flying technology stocks graced his Berkshire Hathaway portfolio. During the latter part of the 1990s, most people began thinking of him as a relic of the past and very few sought his opinion on the market. In fact, many of the new brokers and new investment advisers had never heard of him. Also during the late 1990s, fundamental analysis was not considered important by many investors because everything went up in price.

Then one day the bubble blew. Enron happened and stock analysts were exposed to criticism because of their conflicts of interest. Advisers began scratching their heads. The major questions for the beginning of the 21st century was what happened to the stock market and much more importantly, what do we do now?

As the dust cleared, Warren Buffett was sought after for investment advice once again. Buying growth stocks at a good value

was coming back into style. The problem was that very few people really understood how Warren Buffett selected his stocks. And even fewer investors had any clue whatsoever of the method he used in the determination of his all-important purchase price.

Now that the investing world has regained some semblance of sanity, you'll find out why the timeliness of this book will be so very important to your financial future. This book will show you the little-known stock selection methods of Warren Buffett. In addition, this book will also show you the very new and up-to-date research of the author which in turn, will take you one very, very important step *BEYOND*.

By D. Everett
President of Clean Surplus Investing, Inc.

FOREWORD

A Sea Story

Luck: When Opportunity Meets Preparation

A sea story is a tale or a yarn. Something like one of those "fish that got away" stories. However, our tale actually does begin with a story about the sea.

This foreword is a short story in itself. It is the story of how I came into contact with a little-known type of analysis, which was developed for the sole purpose of determining the predictability (or not) of the future performance of a company.

Predictability of future performance is the Holy Grail of investing. After all, if we can predict reasonably well, we would be able to determine which stocks should grace our portfolio in order to outperform the market averages on a consistent basis.

This method of predictability, of which I speak, eventually became known as Clean Surplus Accounting or Clean Surplus analysis. If the word accounting is intimidating to you, just substitute it with the word analysis because it really is a method of analyzing predictability.

Up until this book, Clean Surplus Accounting had pretty much been lost since its possible beginnings in 1895, except for a few rare instances between then and now. The field of accounting just did not evolve in the direction of being able to provide much-needed predictability. It very well could have, but it didn't. Clean Surplus was designed to try to provide that predictability. Very few people are presently aware of how to apply a reliable method of predictability to the fundamental elements of a stock. Very few people except for a small group of academics, a handful of practitioners and our friend, Warren E. Buffett. More on this later, but for now let's discuss the

events which guided me to my discovery of this wonderful method in the first place.

It was luck, of course. But the definition of luck is when opportunity meets preparation. Had I not been involved in researching Clean Surplus Accounting and also at the exact same time reading everything about Warren Buffett that I could find, I never would have figured it out. On with our sea story and the events which guided my discovery.

I began my post-graduate education very late in life. I began a Master's program in Business and Finance at the ripe old age of 48 or so. In my prior life, I had been a Marine Engineer and over the course of 13 years I worked on ships sailing to far away places with strange-sounding names. During that time, I rose to the position of Chief Engineer. I was working on a ship carrying grain from the United States to the then Soviet Union and our ship had just entered the Mediterranean Sea through the Straits of Gibraltar. My position on that ship was a First Engineer, which is the position directly under the Chief Engineer.

I brought most of the engine crew up on deck to see the great Rock of Gibraltar, but it was not to be, as we were sailing directly into a huge fog bank. With much disappointment, we went back down into the engine room to continue with the day's work. Unknown to us at that moment, our ship was soon to be involved in a horrible collision with a Liberian freight ship headed in our direction.

Ahh, the egos of the men in positions of power are all too great. Which ship would give way to the other? Which ship would lose 20 minutes to avoid a collision at sea? Of course, neither one. That's why we were involved in a collision.

The approaching ship smashed into us in our rear port (left) side. Our ship was constructed with the engine room aft (in the rear). Since we were loaded with cargo and sat deep in the water, and the other freighter was light in the water, the other ship shattered the hull of our ship like paper and smashed into the engine room just above our heads where I was working with most of the engine gang.

The engine room lights went out as an immense wall of water, as well as the bow of the other ship, entered our workspace. I found myself trapped in the engine room of a sinking ship quickly filling with water. The lights were extinguished immediately due to the

entering seawater short-circuiting the electric panels. This left the entire engine room totally in the dark as we were being thrown about like paper dolls on a gigantic ocean wave.

If it hadn't been for the quick thinking of the Chief Engineer, Tom Barnes, this book never would have been written. He was able to start the emergency generator, which is located in a separate space away from the engine room, in order to provide us with very limited lighting for an extra minute or so. This lighting, seemingly sent from heaven, would lead the way for some of the men fighting for their lives in the turbulent water, helping them to find their way out of what would become a watery grave for several of our friends.

Some men made it to safety and some didn't. Five men died prematurely due to the total negligence of others. Some men were saved due to the quick thinking of the Chief Engineer who was, of course, not in the engine room at the time, but was on deck and in a position to help save some of us who were otherwise sure to die. Now you know why this book is dedicated to Chief Engineer Tom Barnes.

As the engine room completely filled with water, even the emergency lights were soon extinguished. After what seemed an eternity of struggling and swimming, I could no longer hold my breath and began to suck in sea water. It was then my head popped through the surface to breathe in the sweet salt air. It was also then that I decided to change careers and leave the salty sea, where pirates don't plunder and cannons don't thunder anymore (thanks Jimmy Buffett) and head back to my cabin by the lake in the mountains of the Hudson River Valley. But what to do with the rest of my life? I had the feeling this was the beginning of a real mid-life crisis.

While sitting on my deck at home, looking at the peaceful lake and the Wall Street Journal (now there's an oxymoron), I figured I should be able to take all those little numbers and make "cents" out of them all. After all, I was an engineer.

Engineering is probably where my quantitative ability was honed to a fine edge. Ok, I'm being a bit silly here, but engineers are supposed to walk, talk and dream in numbers. And to a certain extent this is true. I would rather look at the bottom line results of a company's performance than think about the qualitative reasons the company obtained those results.

By qualitative, I mean the good things a company does for its workers, which really can't be measured or valued in dollars and cents. If you can't put a dollar value on certain aspects of a company's operations, then those aspects don't show up as value on an income statement or a balance sheet. It could be the quality of life in the work place. I believe the better a company treats its workers, the better the bottom line results will be.

Qualitative aspects could be the brainpower and/or work ethic of the employees and employers. You certainly can't put that on the balance sheet. How about those few people who light up the room when they walk in and make everyone around them happy to be there? Go ahead, accountants and finance people; put a dollar value on that!

However, if you think about it, all those good things about a company will eventually flow to the bottom line. I guess when mom said it all comes out in the wash when I was a kid, she meant for me to take note of the bottom line numbers once I eventually learned to read. I always knew mom was a finance person at heart.

During the next ten years, I made my living investing in both real estate and stocks. I found the key to performing well in the stock market was being able to consistently outperform the market averages. However, I found consistently beating the market to be very difficult indeed.

I learned about stocks by sitting in a broker's office for an entire year while trading my own account and learning all I could. I learned technical analysis and I also learned covered option writing. I use covered option writing to this day, but there is one drawback. Covered option writing brings in short-term gains to the portfolio, and short-term gains make Uncle Sam more of your partner than you had ever intended.

My stock strategy was simple back then. Buy stocks in the Dow Jones Industrial average (all 30 of them) and sell covered calls on those securities. Yes, I had more than enough taxable, short-term gains. However, back then before most of my college students were 4 years old, you could invest in real estate and have the paper losses such as depreciation offset other gains such as income from stocks or even salary income from your job. It was a great world back then. Combining a stock portfolio with real estate was the perfect strategy. I

did it, I loved it and life was good. However, some good things eventually come to an end.

The Tax Reform Act of 1986 changed my world. The Act changed the way certain items were allowed to be written off against other income. For you young folk, before the Act, in addition to the real estate write-offs, you could also write off the interest from your car loan, credit card loans and school loans to help offset the taxable income from your job. Uncle Sam said it was good to be in debt because you could use the write-offs against salary to reduce your total tax liability. And if your real job was investing in stocks, which gave you short-term gains, then the write-offs from real estate as well as other write-offs mentioned above could offset the income from stocks.

But as I said, the Tax Act of 1986 changed all of that. Investing full time just wasn't as much fun as before. I figured it was time to change careers once again and thus began yet another mid-life crisis.

After much thought, I felt it was time to begin preparation for the fulfillment of my self-imposed obligation of many years previous. My commitment was to pass on the knowledge I learned in this world before I left this world.

A hippie friend of mine once warned me against dying an ego death. An ego death is the act of learning all your life and not passing that knowledge on to others. My obligation was definitely not to die an ego death. So, I felt I could fulfill my obligation by going back to school to teach for a while and at the same time I would be able to show the academic world just how they should be teaching about the real world.

I thought I would begin my teaching career by drawing up an outline for the finest investment course that could possibly be devised. I then submitted it to the university geographically closest to me. Not to embarrass me, they did mention it would be a wonderful course coming from a "practitioner," but I really needed to get a few more academic degrees in order to qualify as a university instructor. After all, I "only" possessed a Bachelor of Science in Engineering and really, what did an engineer know about investing? They told me that if I were going to teach a course on investing, I really should possess

a Ph.D. in Finance or something of the sort. Well, I had nothing to do for the next ten years, so I went back to school with all the kids.

Several years later, while I was at the end of the one-and-one-half-year Master's degree program (which took me four years), I went to yet another ho-hum lecture on stock selection. Within the first two minutes I really thought I'd found the Holy Grail. I felt I had discovered (come across, not discovered) a method that was so unique and so simple that I wondered why I never heard about it before. Even more bewildering was why I had never thought of this uncomplicated, straightforward method myself.

The problem was there was no name for this system, but who cared? I didn't need a name for a stock selection system that was better than anything I had seen up to that time (and since).

I sat in front of my computer for the next four-and-a-half months formulating spreadsheets on the Dow 30 stocks. I tested this simple but common sense strategy in every way possible. I took into consideration those academic measures of risk, with strange sounding names such as beta and standard deviation. I also tested the strategy on certain Dow stocks at market bottoms, at market tops and yes, even market middles.

Allow me to explain something here, folks. The academic world is filled with egos. It is filled with a lot of very bright people, many of whom do not use common sense. After all, it takes a long time to earn a Ph.D. It takes so much time to get a Ph.D. that there is little time left to gain real world experience. But those who do have a Ph.D. and want to combine real world experience with their teachings are left at the mercy of the academic system. They must obey the number one rule of the academic world.

"Thou shalt not teach anything in the university system that the students might find useful in real life."

A professor once told me that things you can actually use in the real world should only be taught in technical schools and not at the university level. Hmmmmm.

I read somewhere that Sam Walton, founder of Wal-Mart, would not be allowed to teach at the university level because he didn't have the proper credentials (degree). Hey, Warren Buffett wouldn't be

allowed a full-time job as a university instructor either because he doesn't have a Ph.D. Now tell me, are the rules of the academic world arcane and bewildering, or what?

I mentioned the two definitions of risk taught by the academics. Beta, which is a measure of how a stock moves relative to the market, and standard deviation, which is a measure of how a stock moves relative to its own, past average return. These are very simple definitions. If you want the full definitions, just take a 16-week finance course. Ho hum!

Now let me explain my very own, real life definition of risk. The market goes up, my stocks go up. The market goes down, my stocks go down. The market goes back up and somehow my stocks forget to go back up. That, my dear friends, is risk.

It is really this type of risk that the method used in this book will help you avoid. It is this risk that Warren Buffett tries to avoid. It is this risk that can almost always be eliminated by using Clean Surplus Accounting and investing for the long term. And talking about Clean Surplus Accounting, let's finish up with our sea story so we can begin both this book and your education of selecting a superior performing portfolio.

After finishing the Master's program, I finally entered a university in order to obtain my Doctoral degree. During the Doctoral program, one must find a suitable theme for his or her dissertation. The dissertation is like the final burst of glory at the end of a fireworks display. All course work should be finished and finally, this very huge research paper must be completed, accepted and defended in front of a committee of Ph.D.-type people who are there just to make sure you jump through all the hoops and whistle all the whistles. If it doesn't take a person two or three years to complete the dissertation, well, it probably isn't up to the expectations of the academic community. One of my professors told me his dissertation took him seven years to complete after all his coursework was finished.

Before we do go on, let me loosely define a few terms just for your own worldly knowledge. There is a difference between a Ph.D. degree and a Doctoral degree. Of course, the academic world likes to confuse us common folk as they bestow the title of Doctor upon both of these academic degrees. The Ph.D. develops the theoretical work.

The Doctor takes that theory and attempts to put it into practical use. Here, you can remember it this way. Next time you go enter the hospital for a procedure, you want a Doctor operating on you and not a Ph.D.

Are there Ph.D.-type people in the real world who transgress the boundary and go into business and the real world? Are there Doctoral-type people who are just theoretical and not very practical? Of course.

In order to complete either a Ph.D. or Doctoral program, the dissertation (which I just spoke about) must be undertaken and completed. The dissertation is based upon past research. In other words, there must be a foundation of research in your particular area of choice. It is upon this previous research that the author of the dissertation adds more testing and research. The purpose of the dissertation is to add to that already existing body of knowledge. Once completed, the author is considered an expert in the subject of his or her dissertation. If the subject has not been researched by many people, then the author could very well be one of the very few people in the entire world who is an expert on the dissertation subject.

Why am I torturing you with all of this? Well, I wanted to develop my dissertation on the method (the no-name method) I was exposed to several years previously. The problem was I couldn't find a name for this method. And if you don't know what something is called, then you certainly cannot explore the past research.

Thank the heavens for computers. Present-day research people no longer have to spend their entire lives in a musty university library cellar. One now sits in front of a computer for hours on end. Dressed in pajamas or sweats and armed with a cup of coffee, you now have access to most of the magazines of the world and all the academic writings from the academic journals of the world. You just keep typing in key words or phrases and the amazing search engines will find the academic and non-academic articles that contain those key words or phrases. Yes, life was good once again.

Well, I think you know where I'm going with this. I finally found a subject name for the method I wanted to research. It was called Clean Surplus Accounting. The first academic research article I found was written by James Ohlson (1989) out of Columbia University in New York.

Well, dear reader, do you know who else attended Columbia University? Our very own hero, Mr. Warren E. Buffett, the greatest investor ever. And do you know who he studied under at Columbia University? Mr. Benjamin Graham, the Father of Security Analysis.

Do these guys have a sort of club down (up, over) there? We may not answer that question in this book, but you sure will learn how I found that Warren Buffett uses Clean Surplus Accounting. And you will also find out how I, in my dissertation research work, take Clean Surplus Accounting and Buffett's work *One Step Beyond.*

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CHAPTER 1

The Purpose of This Book

The purpose of this book is very simple. This book is written for the sole purpose of exposing you to an efficiency ratio which you will use forevermore to compare the operating efficiency of one company to the operating efficiency of any other company. This efficiency ratio is evidently lost on the present investment community as shown by the inability of most professional money managers to outperform the market averages on a consistent basis. This book is written so that you, dear reader, can very easily develop your own portfolio, which should indeed, outperform most of the aforementioned professional money managers year in and year out. It is written with the K.I.S.S. principle in mind: Keep It Simply Simple!

I'll first tell you what this book is not. This book is certainly not an accounting book. However, it does discuss a concept termed Clean Surplus Accounting, (also known as Clean Surplus analysis) which is very possibly the simplest accounting method based upon the easiest-to-understand principle in the world. It will be very easy for you to understand because you actually use it every day and so does someone who is admired by the entire investing world.

We will find out how Warren E. Buffett, the world's greatest investor, utilizes this method. We will learn that a very simple ratio developed from this method (which you also use all the time) will tell us almost all we need to know about a company's operating efficiency. We will then use this ratio to compare one company's operating efficiency with another company's operating efficiency. Following operating efficiency, the discussion will focus in great depth on why the most widely used ratio of comparison, Return On Equity (ROE), is so misused and misunderstood. Next, we will discuss why investors who use the traditional accounting Return On Equity are doomed to underperform the averages.

The traditional Accounting ROE ***cannot*** be used as a comparison ratio between companies. However, the Return On Equity as configured by Clean Surplus is another story. In fact, it is our story.

Our next step will be to venture ***one step beyond*** and discuss my in-depth research on portfolio construction and how we can attempt to predict the future returns of our newly developed portfolio.

In other words, we will discover not only how to structure a superior performing portfolio but we will also learn how to determine the predictability (or not) of the future total returns of that portfolio.

We will finally develop a very simple buy and hold portfolio. A buy and hold portfolio helps keep the taxman from becoming a partner in our everyday decisions. Thus, we will develop a portfolio that does not require everyday decisions.

I will always remember what a well-seasoned money manager told me just as I was beginning my education in the stock market. He wisely said that most times it was much better taking your client out to lunch rather than sitting in front of a computer screen trying to make those few extra dollars.

What he was trying to tell me was forget about short-term gains and concentrate on developing a great long-term investment portfolio for the client. Then you can spend all the extra time telling the client about the merits of the superior portfolio you built for him/her instead of trying to trade that portfolio.

Twenty-five years later, this lesson helped me remember that I cannot single-handedly balance the U.S. budget deficit by paying extra taxes on those short-term gains that, to tell the truth, elude me to this day.

Warren Buffett has also formulated some pretty sound investment principles over the years. Let's learn from "the great one" and try not to reinvent the investing wheel. The man doesn't hide his thoughts or actions from us. It would be a foolhardy person that ignores Buffett's method of ***Proven Success***.

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SUMMARY OF CHAPTER 1

1) **This book will show you a very simple system designed to exhibit the predictability (or not) of a company's operating performance.**

2) **You will learn how Warren Buffett, known as the world's greatest investor, uses this very simple system.**

3) **We will then discuss the research, which shows how to use the predictability of the simple accounting system called Clean Surplus in order to obtain superior portfolio performance.**

4) **We will later discuss some of the aspects of a company that Buffett looks for which have earned his results, to be termed *Proven Success*.**

CHAPTER 2

About Warren Buffett

I'm not here to tell you all about the investing life of Warren Buffett. What I will discuss with you is how he uses just a few numbers from the Income Statement, at least to an extent that we can understand and utilize in a very simplified manner. Thus, this book will not go into detail about Mr. Buffett. There are so many wonderful books already written about him and every one of them I read is certainly worth reading more than once. He has been called the World's Greatest Investor and the Greatest Investor of this century. Whatever we call him, I know this for certain: we all want to be like Warren.

A friend of mine who is an admirer of Buffett (like really, who isn't?) once told me that just before he (my friend) died, he hoped Buffett's life (and not his own) would flash in front of him.

We were sitting at a beachside bar in Florida, drinking one or four beers when he mentioned flashing lives, so I wasn't sure if he was talking about Warren Buffett or Jimmy Buffett, but hey, we were happy talking about stocks (like Warren) and watching the ocean (like Jimmy). After all, isn't that the way it's supposed to be?

Now that we've discussed Warren Buffett's life in such great detail, let's talk about numbers. After all, I certainly believe that the numbers tell us almost everything we need to know about a company. Let me clarify this statement. If ***used properly***, the numbers will tell us almost everything we need to know about a company.

If *used properly*, the numbers tell us almost everything we need to know about a company.

If we use the correct numbers in the correct way, the bottom line results will tell us which companies we want in our portfolio and

which companies should be in someone else's portfolio. The problem is most analysts out there in Investment Land are using the wrong numbers. But after you finish with this book, we really won't care about the analysts out there in Investment Land.

Where is the Investment Land of which I speak? Top of the tower of Big Ben at midnight. Second star to the right and fly away 'til morning. Yes folks, many analysts and portfolio managers really believe that Never Never Land is the same place as Investment Land.

Most investment analysts use the wrong numbers for stock selection. I know, I've taught many of the present and future analysts in my college classes.

How do I know most investors are using the wrong numbers for stock selection? I'm a college teacher (my 3rd career). I teach my students finance the way (well, almost) the academic community demands finance be taught. My students then go out into the real world and use these very methods taught to them by the academic community. Most of the academic community truly believes that if you know accounting and finance, then you know how to select stocks for a portfolio.

Folks, this just ain't necessarily so and I'll teach you why very soon. Let's just say this for now. As long as students are taught finance by the present establishment and then go out and use this knowledge in the investing community, Warren Buffett will always have job security as the world's greatest investor. Even in Never Never Land.

Learning about finance and learning about investments are two totally different subjects. The problem is that most investment analysts don't know this.

How do I know that the stock valuation models taught in colleges and universities don't work very well? If they did, all the college professors would be as rich as Warren Buffett. And guess what? They're not. They (the academics) think Buffett is just plain lucky. Oh believe me, the academic community has all the answers to

the "luck" syndrome, but the bottom line is even though Buffett (and some others) have great track records, it doesn't matter to the academic community. Students just aren't taught the methods that produce the extraordinary results because in the academic community extraordinary is considered luck and luck cannot be predicted or tested through statistical analysis. But always remember what I say about luck. It is when opportunity meets preparation.

I've alluded to the fact that Warren Buffett uses a method called Clean Surplus analysis. How do I know this? Please remember that I wrote and published a several-hundred-page research paper (my dissertation) on the predictability of Clean Surplus. Please trust me that I know what Clean Surplus looks like when I see it.

One of the courses I teach at a nearby university is entitled Advanced Managerial Finance. The first case we analyze each semester is entitled "Warren E. Buffett, 1995." Yes, and on page 15, Exhibit #5, is a chart on Scott & Fetzer, which was a company purchased by our idol, Warren Buffett. The chart came from the Berkshire Hathaway, Inc. Annual Report, 1994, p.7. Well, the chart was a chart of the Clean Surplus method of analysis. But it was very strange because the author of the text did not mention anything about Clean Surplus. In fact, the chart was just sitting there alone with nothing much said about it. Just another exhibit in a case study designed to confuse the student.

Ahh, but my students were not confused because they knew what Clean Surplus looked like and they recognized the great importance of Exhibit #5 on page 15. My students understood what Warren Buffet saw in Scott & Fetzer and it is what you will see in many stocks once you finish this book.

Clean Surplus analysis is not taught in our fine business schools. This is why Warren Buffett has job security.

The second and even more important instance of Warren Buffett using Clean Surplus analysis can be found in the book "Buffettology" by Mary Buffett and David Clark. Mary is Warren's former daughter-in-law and I would imagine she knows something about her father-in-law. Right there on page 124 in her workbook is a

chart (spreadsheet) of Coca Cola. I know you know what the chart was. Yes, it was a chart showing Owners' Equity configured through the use of Clean Surplus analysis.

However, neither Mary nor David mention the term Clean Surplus. Not a mention of Clean Surplus is made in either "Buffettology" or the text I used in my advanced finance course. However, "Buffettology" begins to talk about predictability and Warren's use of this predictability. In no other book I've read on Warren Buffett will you see the mention of predictability. Dear reader, you will certainly see a lot of it in this book. So read on.

By the way, Mary and David's book is very good. Many of the books written about Warren Buffett do not cover the numbers extensively because Buffett's life is so very interesting the authors just do not have time for numbers. However, "Buffettology" covers the numbers and does so in great detail

In summary, you will not learn a great deal about Warren Buffett's life in the following pages. However, you will learn how Warren Buffett uses Clean Surplus and more importantly, why he chooses to do so. After that, we will discuss my research and see if Clean Surplus analysis can truly be used for predictability. I don't want to make you crazy and let you guess so I'll tell you right now.

My work shows that yes indeed, Clean Surplus analysis shows predictability just as was suggested by the fragmented literature that spans almost a century.

You see, we all know Warren Buffett is doing something right and after you read this book, you will know just exactly ***what*** he is doing right. And what he is doing right is called by us mere mortals ***Proven Success***.

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SUMMARY OF CHAPTER 2

1) **If *used properly*, the numbers tell us almost everything we need to know about a company.**

2) **Most investment analysts use the wrong numbers for stock selection. I know; I've taught many of the future analysts.**

3) **Learning about finance and learning about investments are two different subjects. The problem is that most investment analysts don't know this.**

4) **Clean Surplus analysis (Accounting) is not taught in our fine business schools. This is why Warren Buffett has job security**.

CHAPTER 3

Determining the Earning Capacity of a Company

(Now really, can it be this easy?)

The most important concept in investing is to determine which companies are most efficient at using their asset base to earn profits for us, the shareholders. Earning profits should not be a short-term fad. Profits should be examined as to the level of the return on assets and the consistency of those returns. In other words, an efficient company can earn more with a certain asset base than the competition, and the efficient company can do so consistently year after year after year.

Profits should be examined as to the level of return on assets and the consistency of those returns.

Remember that little lemonade stand you set up in front of your house? Then one day your competition set one up right across the street. Somehow, you had to come up with a method in order to be more efficient than the competition. After all, if you were more efficient, you could price your product lower than the competition and still generate the same or greater profit.

Possibly you had a better and more efficient lemon squeezer (like mom), which would net you more juice per lemon. Maybe you had a competitive advantage in that you were set up under the only shady maple tree on the street. People wanted to stop at your stand because it was 100 degrees in the sun and you had the monopoly on shade. Maybe you allowed your workers (little brother and sister) to

share in the profits of your lemonade stand. Always remember, ownership is a powerful incentive.

Get the picture? Sure you do. But how in the world do you look at a company like General Electric, which is the largest diversified company in the world with 293,000 employees and compare it to General Motors, which is the largest auto manufacturer in the world with 363,000 employees? You have no idea which company has the most efficient lemon squeezer or which company is operating under a shade tree during the summer. Or is there a sure-fire way to tell? Ohhhh yes there is and that is what this book is all about. Please read on.

THE BEACH FACTOR

Before we go on, I want you to be aware that I firmly believe in the Beach Factor. The Beach Factor means that you can perform your work so efficiently that you have time to go to the beach. The Beach Factor is, of course, synonymous with free time. I recently bought a beautiful hammock, which is set up under that shade tree where the old lemonade stand stood so very many years ago. The hammock keeps calling my name so softly. "Come here and rest. Come here and take your mind off the world."

The Beach Factor, of course, is synonymous with free time. If you are efficient in your work, you will eventually have lots of free time.

See? That's the Beach Factor. So keep in mind as we proceed through this book that we are fine-tuning your stock selection skills so that you too, will have time to go to the beach. By the time you finish the chapter on the Top Dogs of the Dow, you too will have the Beach Factor concept embedded in your life forever.

What's that saying? Invest like Warren Buffett and live like Jimmy Buffett? Yea, that's the place we want to get to.

As you can see throughout this book, I usually succeed in bringing concepts and examples down to my level of thinking, which is somewhere between daydreaming at the beach and the real world. I lean more toward the former than the latter because it's much more fun. The reason I say this is I don't want you daydreaming as I go through some very simple concepts because the very simple concepts are part of the larger picture.

CLEAN SURPLUS

Clean Surplus is a very simple type of accounting. But please don't allow yourself to be turned off by the word accounting. I know it brings back bad memories for some of you. Remember Accounting 101? I know, I know: not if you don't have to. And those of you who never had an accounting course, please don't worry. What we are about to discuss is hardly what you would associate with serious accounting. Trust me on this one; this is going to be easier than reading a good sea story.

I'm going to introduce you to Clean Surplus toward the end of this chapter. But it will be so very subtle that you won't even know you've been exposed to it. You will learn this concept and not even realize it until I jump up and tell you. Just remember that I really do believe in the K.I.S.S. principle.

DETERMING AN EFFICIENT COMPANY

What is an efficiently operated company? It is a company which earns a very high return on the money invested into it (Owners' Equity), and does so consistently year after year.

An efficiently operated company is one that earns a HIGH and CONSISTENT return on its asset base.

Before I go on, I want you all to understand that we use Book Value, Asset Base and Owners' Equity to mean the same thing, at least for now. They really are not the same, but for now, just let it be.

TAKE YOUR BANK ACCOUNT

Think of your bank account. Bank A consistently pays you 10% interest on your money year after year. Bank B pays you 10% one year, 8% the next year, 5% the following year, 10% the year after that and on and on.

Year	Bank A	Bank B
2002	10%	10%
2001	10%	5%
2000	10%	8%
1999	10%	10%

Bank A is considered efficient because it earns a high and consistent rate of return on our invested money. Bank B is not only relatively inconsistent in its returns, but is less efficient in the use of its assets because overall, Bank B returns less on our invested money than does Bank A.

You see, investors like a high rate of return, and even more than a high rate of return, we also want a consistent rate of return. After all, this is why people invest in bonds.

In order to go on with this book you must answer the following question correctly. The question is into which bank would you entrust your hard-earned money? Hey, correct! You've earned the right to continue. See? I told you this would be easy.

Just jumping ahead a bit, the analysis of the bank example above is exactly how we're going to analyze stocks. Don't believe me? Read on.

BONDS

Sorry for the digression away from stocks, but think about bonds for a moment. People buy bonds for steady income. People buy bonds for a (relatively) high rate of return compared to other relatively low-risk investments. However, some people want a higher return over the long term, which is why somebody invented the stock market. But if you want to win in the stock market (or successfully analyze a company), you want stocks that generate both high and consistent returns on the equity that investors have put into the company.

You want your stocks to act like a bond except you want ***increasing*** earnings year after year. If the increase in earnings is not consistent, then you are increasing your risk of ownership. The big question is: Why would you want to do that?

EARNING CAPACITY

The earning capacity of a company (how much in earnings it makes) is a direct function of (1) the size of its asset base, and (2) how efficiently that company utilizes that asset base. Let's begin with the size of the asset base.

The earning capacity of a company (how much in earnings it makes) is a direct function of:
1) The size of its asset base, and
2) How efficiently that company utilizes that asset base.

Let's take two bank accounts, each with the same amount of risk, but paying us a different rate of interest. Bank account A has just $8,000 while Bank B has $10,000 of assets. We would naturally assume that the account held with Bank B would earn more interest for us as it is working with a larger asset base. However, Bank A is

paying out a higher rate of interest to us because it is investing our deposits more efficiently. Thus, it is able to pay us a greater return.

Bank A: $8,000 x **10%** = $800 in interest (earnings)
Bank B: $10,000 x **5%** = $500 in interest (earnings)

Bank B has a larger asset base than Bank A. But not only must we know the SIZE of the asset base, we must also know the RATE OF RETURN generated on that asset base in order to determine which bank is the most EFFICIENT bank.

Bank B has a higher asset base and should earn a greater return for us, but isn't because it is not making efficient use of its larger asset base.

In the above case, we see that bank A earns a greater return of $800 on a smaller asset base while Bank B is earning $500 for us on a larger asset base. A closer look reveals that Bank A is earning 10% on our invested equity while Bank B is earning just a 5% Return On Equity for us. Even though Bank B has a larger asset base, it is earning fewer dollars for us. Why? Because Bank B is earning a lower ***percentage*** return on its asset base than Bank A when it invests our deposited money. It is this ***percentage return*** that will mean so much in our analysis as we go on.

If both banks had the same amount in the accounts, Bank B would earn a much ***lower*** dollar amount than Bank A as shown below.

Bank A: $10,000 x 10% = $1,000 in Interest
Bank B: $10,000 x 5% = $500 in Interest

We must know the RATE OF RETURN (percentage return) generated on an asset base in order to know which is the more EFFICIENT bank.

The problem we are faced with in security analysis, which will be solved in this book, is how to determine the asset base of large companies and how to determine the percentage return on that asset base. And it's not the way finance people have been taught in the past. It is the method you will learn in this book that separates the great money managers from all the rest.

HOW TO DETERMINE THE OPERATING EFFICIENCY OF A COMPANY

Let's look at two separate bank accounts again, each with the same initial amount of $100 in each of them. Let's also assume all interest payments (earnings) are re-invested back into the account. Begin in the year 1998 at the bottom of each column and work your way up to the year 2002.

BANK A

YEAR	EQUITY	INTEREST	ROE
2002	$146.00	$14.60	10.00%
2001	$133.00	$13.00	10.00%
2000	$121.00	$12.00	10.00%
1999	**$110.00**	**$11.00**	10.00%
1998	**$100.00**	**$10.00**	10.00%

BANK B

YEAR	EQUITY	INTEREST	ROE
2002	**$142.45**	**$11.39**	**8.00%**
2001	$131.00	$11.45	8.74%
2000	$120.00	$11.00	9.20%
1999	$110.00	$10.45	9.50%
1998	$100.00	$10.00	10.00%

Bank A begins 1998 with **$100**. Interest of **$10** was earned in **1998** and re-invested (retained) back into the account. Thus, the following year (1999) begins with the original $100 plus the interest earned of $10 for a total of **$110**. 1999 begins with an account size of $110.

As you can see, our asset base is growing as time goes on. As our asset base grows, we would expect to earn even more interest in the year 1999. In the year 1999, Bank A earns **$11** in interest for us. Then as the asset base grows each year (because we are ***retaining*** everything we earn), we generate a higher and higher amount of interest. Again, this is due to the increasing size of the asset base.

Ahhh, but there's another very important part of this story. In fact, it is the most important part. The very serious question is what ***percentage return*** are we earning on our equity and even more important, is it a consistent return year after year?

To find the answer to this very important question, we simply divide what we made in interest (earnings) for any particular year, by the amount of money (equity) with which we began the year.

Looking at Bank A below for the first year (1998), we see that we earned $10 on the $100 in the account at the beginning of the year. In order to determine the Return On Equity (ROE) simply take the $10 earned and divide it by the amount of money ($100) with which we began the year.

YEAR	EQUITY	INTEREST	ROE
1998	**$100.00**	**$10.00**	**10.00%**

So simply, $10 / $100 = 10%. This is known as our ***Return On Equity*** or ***ROE***.

Bank B began 1998 with the same amount of $100. We earned $10 that year which gave us a 10% Return On Equity, which is the same as Bank A.

In 1999, we began the year (in both accounts) with $110. Bank A returned $11, but Bank B returned just $10.45. Bank A's Return On Equity was 10% once again, but Bank B returned ($10.45 / $110) for just a 9.5% Return On Equity.

BANK A

YEAR	EQUITY	INTEREST	ROE
2002	**$146.00**	**$14.60**	**10.00%**
2001	$133.00	$13.00	10.00%
2000	$121.00	$12.00	10.00%
1999	**$110.00**	**$11.00**	10.00%
1998	**$100.00**	**$10.00**	10.00%

BANK B

YEAR	EQUITY	INTEREST	ROE
2002	**$142.45**	**$11.39**	**8.00%**
2001	$131.00	$11.45	8.74%
2000	$120.00	$11.00	9.20%
1999	$110.00	$10.45	9.50%
1998	$100.00	$10.00	10.00%

Let's jump ahead and look at the year **2002** for both bank accounts. **Bank A** began the year with **$146** in equity. It earned interest (earnings) of $14.60 for us that year. We made $14.60 on an asset base of $146 for a Return On Equity (ROE) of **10%** ($14.60/$146)**.** This is what we like. We want a high and consistent rate of return from our investments.

Bank B began the year (2002) with **$142.45** in equity. It earned interest (earnings) of **$11.39**. $11.39 divided by $142.45 is an **8%** Return On Equity.

Let's take the previous sentence and put the results into real terms used in the investing world. In 2002, Bank A had a 10% Return On Equity (ROE), while Bank B had an 8% Return On Equity (ROE).

The earning capacity of a company (how much in earnings it makes) is a direct function of:
1) The size of its asset base, and
2) How efficiently that company utilizes that asset base.

SOOOOO…. IMPORTANT

Dear reader, the above example is so very important because it is the very basic fiber of investing. If you can answer the following questions, you are well on your way to being able to develop your own, above-average performing portfolio. This means that you will outperform 96% of the professional money managers over an average 10-year period.

Question #1

Why does Bank Account A have more money in it (equity) in the year 2002 when both accounts began with $100 in 1998?

Answer to Question #1

Because Bank A earned a higher and more consistent rate of return. Bank A had a higher Return On Equity (ROE) than did Bank B.

Question #2

Why did Bank A earn a higher Return On Equity (ROE) than Bank B?

Answer to Question #2

Who cares? Ok, ok, you may think I'm being silly here, but really, who cares? Think about banks in real life. One is paying you 4% on your savings and another is paying 5%. Really now, when was the last time you sat down and asked how the banks were investing their (your) money? As my students would say, like, er, ahh, like neveerrrr!

YOU SEE… ROE TELLS US EVERYTHING BECAUSE VALUE IS DETERMINED BY THE CREATION OF WEALTH

Hey, wait a minute! Is the example with Bank A and Bank B simple? Of course it is. And do you know what I just did? I just taught you **Clean Surplus Accounting**. Hellooooo! Did you hear me? ***You just learned Clean Surplus Accounting!!!!!***

And the name is exactly what it means. It's nice and ***CLEAN***. And the ***Surplus,*** in its simplest terms, is the profit. And from Clean Surplus, which is how we figured the equity in the bank year after year, we were able to calculate the Return On Equity generated by both banks. And because we were able to calculate the ROE ***in the same manner*** for each bank, we were able to determine the most efficient bank.

You see, the Return On Equity (ROE) which we just configured using, yes, say it again, **Clean Surplus Accounting**, tells us almost everything we need to know about a bank or a company. If the ROE is high and consistent over the years relative to other companies, we have a company we just may consider purchasing for our portfolio.

LET'S ASK WARREN

Let's for a moment go from banks to companies and ask what Warren Buffett would begin to look for in a company.

First of all, he would say he wants a company with a high ROE and a consistent ROE. How do we know he says this? In Bruner's Case Studies in Finance, he (Bruner) tells us that "Buffett sought to judge the simplicity of the business, the consistency of its operating history, the attractiveness of its long-term prospects, the quality of management, and the firm's capacity to create value."

Wow, all that? Gee Professor, how can I determine all of this? I'm certainly no Warren Buffett!

Well, let's analyze what he said and take this step by step (and, yes, **simply),** and relate these qualities to the ROE from Clean Surplus Accounting. You know, Clean Surplus is the ROE we just figured using our bank examples.

If the ROE is high and consistent we can pretty much assume the company has a good quality of management. A high and consistent ROE means management is doing things the right way.

If the ROE is high and consistent, we know the firm has the capacity to create value because it is already doing so.

If the ROE is high and consistent and the past is any indication of the future, we can assume the firm will have attractive long-term prospects.

Hey, what about the simplicity of the business? Buffett says he understands ice cream better than he understands computer software. And Buffett is smart. I'm sure he understands computer software.

Yes, but here's the real story. Buffett understands where the ice cream business will be in ten years, but he has a hard time trying to figure out what the computer business will be like in ten years or how the present companies in the computer business will be positioned in the whole scheme of things in ten years.

So if you take a business that you understand and that company has a high and consistent Return On Equity, you are

probably looking at a pretty good contender for a Top Dog for your stock portfolio. Learn about Top Dogs in a later chapter.

SUMMARY – THE KEY TO THE INVESTING BUSINESS

The key to investing is really very simple. We want to invest in companies which have a relatively **high** Return On Equity (ROE), and we want companies that have a very **consistent** Return On Equity.

Didn't you figure out very quickly into which bank you wanted to invest your hard-earned money? Selecting stocks for your portfolio is almost this easy. I'll prove to you later on in Chapter 13 (yes, another sea story) that even a blind person can select good stocks using exactly what you've learned so far. Yes, I said a blind person.

WHY HASN'T THE ENTIRE WORLD FIGURED THIS OUT YET?

Wait a minute Professor; this last chapter was pretty simple. I hear about ROE all the time. Everybody uses ROE. What's up here?

Well, my dear readers, the entire world has gone in a different direction relative to the calculation of ROE. The entire world uses the traditional Accounting ROE and NOT Clean Surplus ROE, and this difference in calculating the ROE makes ALL the difference in the world.

It is the difference between structuring an average portfolio and constructing a superior performing portfolio. It is the difference between buying the S&P 500 Index (in one form or another) or developing a very simple, above average performing portfolio and going to the beach. Please remember the Beach Factor.

YOU WILL LEARN

Between what you will learn from Mr. Buffett and the results you will observe from my research, your investment philosophy will be changed forever. And it will be changed for the better. As I say to both you and my students, this stuff is a piece of cake!

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SUMMARY OF ALL THREE CHAPTERS SO FAR

1) Buffett uses numbers in a different manner than most people.

2) Buffett is cool. Buffett is more successful than most others and we want to find out why.

3) If *used properly*, the numbers tell us almost everything we need to know about a company.

4) The earning capacity of a company (how much in earnings it makes) is a direct function of: 1) the size of its asset base, and 2) how efficiently that company utilizes that asset base.

5) Most investment analysts use the wrong numbers in their stock selection process. I know, I've taught many of our future analysts in college.

6) Learning about finance and learning about investments are two different subjects. The problem is that most investment analysts don't know this.

7) **Clean Surplus analysis (Clean Surplus Accounting) is not taught in our fine business schools. This is why Warren Buffett has job security**.

8) Buffett wants to invest in companies that he understands. And he needs to understand the business environment and where a company will be in that business environment 10 years from now. The future of ice cream is easier to determine than the future of computer software companies.

9) Companies we choose for our portfolios must be efficient. They must have a high and consistent Return On Equity as configured by Clean Surplus Accounting.

10) Clean Surplus analysis is a piece of cake. Clean Surplus analysis is so easy, you just learned it in this chapter and didn't even know you learned it.

CHAPTER 4

My Theory of Why Most Money Managers of the World Cannot Outperform the Market Averages

I would like to take a time out from numbers for a little bit while we let the last chapter sink in. Let's take this occasion to discuss the academic world which spawns the future accountants and finance professionals (analysts and money managers) of the world.

If you look at the statistics of money manager returns you will see headlines in any given year such as, "75% of the money managers (public stock mutual funds) UNDERPERFORMED the market averages over the past year."

One study showed that out of the 25% of the money managers who were able to outperform the market in any given year, 67% of those money managers did not outperform the averages the following year. Of course, by market averages we are speaking of the Dow Jones 30 Industrials and/or the S&P 500 Index.

Over the longer term, fewer and fewer money managers are able to outperform the averages over the entire time period. I recently read that over any 10-year period, just 4% of the money managers are able to outperform the S&P 500 Index on a risk-adjusted basis. Please remember when we speak of outperforming or not outperforming the averages we are speaking about portfolios, which exhibit the same risk as the Dow or the S&P 500. In other words, we are speaking of portfolio returns which exhibit the same risk as the market or portfolio returns which are ***adjusted*** to the same risk as the overall market.

The above performance statistics lend credibility to the followers of the efficient market hypothesis. Real world performance gives the academics a lot of ammunition, as the efficient market hypothesis is a mainstay of the academic community. The academics look at the returns of the publicly traded common stock mutual funds and right there in black and white are the multitudes of mutual fund money managers who cannot outperform the Dow or the S&P 500 averages.

I subscribe, from time to time, to the Morningstar database. Morningstar is the publication that follows and rates mutual funds, just as Value Line is best known for its analysis of individual stocks.

I asked the Morningstar database which mutual funds were outperforming the S&P 500 Index over any 1, 3, or 10-year period. One thing I noticed was that the funds that were underperforming the S&P 500 were doing so on average by about 1.5% per year. Well, it just so happens that this amount turns out to be the cost associated with running most publicly traded mutual funds. My observation told me that most money managers are able to perform just as well as the index averages, but the return to the shareholder was less due to operating expenses.

Please be aware that any time you look at a database such as Morningstar, the results will almost always be different depending on the particular day you are searching the database. If you look at the database today, the three-year results will be different from the three-year results if you perform your tests tomorrow. In other words, this is not pure research. It is merely an observation.

Students, the future analysts and future money managers of our country are driven crazy by the academic world. They are taught that they cannot outperform the market averages.

Bruner, *Case Studies in Finance*, quotes Kilpatrick, *Of Permanent Value*, p. 353, who in turn quotes Buffett in that "It has been helpful to me [Buffett] to have tens of thousands turned out of business schools taught that it didn't do any good to think."

First of all, this is scary, but why do you think Buffett says this? I'll tell you why right now. Remember that I began a teaching

career AFTER I spent 22 years seriously investing in real estate and the stock market. Thus, I was exposed to all the theory AFTER I learned how to survive in the real world. What a shocker to be exposed to the academic teachings AFTER you've already learned the survival skills needed to be fairly successful.

Once I had my Doctoral degree in hand and was able to teach full-time at the college and university level, I sometimes taught the Principles of Finance course in which I taught students the efficient market hypothesis. This theory tells us that you cannot use either past information, present information or inside information in order to outperform the market averages. Actually the meaning of this theory is that all information is already reflected in the price of a stock and thus, you cannot use any information to gain ***abnormal returns*** on your chosen stocks.

Efficient Market Theory: All information about a company is always fully reflected in the price of their stock.

Of course, I always wondered what ***abnormal*** meant. Abnormal is anything that is not normal. But it is at the discretion of the writer to tell us what normal is so that we can understand what he or she means by abnormal in any given circumstance.

You may think I'm being a bit foolish here, but let me give you an example. Let's talk about earnings. You may read an academic headline shouting out that Company X generated abnormal returns (earnings) for a certain period. Again, only academics would say such a thing. Abnormal could mean that 6% is normal because 6% might be the present cost of cash at that particular time. In other words, you could earn a 6% return on a T-Bond.

Or normal could be the amount of earnings the "average" company in the S&P 500 earned during a particular time frame. Thus, abnormal returns would be above (or below) the average earnings returns for the S&P 500 stocks. Or abnormal could be the earnings returns above the normal (average) earnings returns of that particular stock over a particular period of time.

Confused? The lesson here is don't read academic articles unless forced under duress of death.

Back to the students of the world. In the Principles of Finance course, students are taught that under the efficient market hypothesis, they cannot outperform the markets because there are no mispriced securities. In other words, all securities are fairly priced because their price reflects all available and non-available information about those securities at any particular time.

Some people have taken literary license in deciphering the meaning of the hypothesis. You've heard stories such as a stock picker cannot select a portfolio that will outperform a person who randomly selects a portfolio of stocks from the Wall Street Journal.

Random selection has taken on a less serious meaning in the past ten years or so. Now, they (whoever is being most ridiculous at the time) will have a monkey select a portfolio of stocks. Not long after the monkey, the random stock picker became a blindfolded monkey throwing darts at pages of the Wall Street Journal.

MY CONTEST —- BEWARE HOW YOU SELECT THE RANDOM PORTFOLIO

Just to add to the fun, I once ran my very own stock-picking contest. I contacted over 60 students in the doctoral program at Nova Southeastern University and had them select a portfolio of up to 10 stocks which would be held for one year without change. Four of these people were professionals in the world of money management.

I then very scientifically selected a market portfolio against which the contestants would compete. My scientific method was to have my wife cover her eyes and point to stocks in the Wall Street Journal. Thus, her selection became the randomly selected portfolio. Much to my dismay, my wife eventually heard about the blindfolded monkey and of course, she thought she was the er, … well, you get the picture. It took many, many long-stemmed roses for me even to get into the house, let alone back on speaking terms.

The contest? Oh yes, the contest. The professional money managers were in the bottom half of all contestants. The randomly selected portfolio was also in the bottom half. But the portfolio

selected by me, which was selected by the Clean Surplus method, came in third. The portfolios which came in first and second consisted of just one security each. These guys went for broke in order to win the contest. The portfolio which earned last place also consisted of just one security.

Hey, not very scientific, you say? Of course not, but we're talking about monkeys and professional stock pickers, so don't talk to me about scientific.

BACK TO MY STUDENTS

After my students become brainwashed by academic theory telling them they cannot outperform the market averages, they then take a course called (of course) Advanced Managerial Finance. This is a case study course, in which the students study cases of well-known companies. They get to see charts and balance sheets and income statements and cash flow statements and, and, and….

In all cases, something goes wrong and the company gets itself into trouble. The students must then use the financial statements to try to find out if the problems could have been foreseen.

ONE STEP BEYOND BUFFETT

Warren Buffett, more or less, says his job as the world's greatest investor is secure because the money managers of the world are taught it does no good to use either fundamental or technical analysis to select a superior performing security. The reason for this is that, according to the efficient market hypothesis, all the information about a stock, past, present and inside information, is already reflected in the price of that stock. The money managers try to outperform the averages, but in the black recesses of their minds there is a little voice whispering to them that they cannot outperform the averages. And

you know what? Very few of them are able to outperform the averages.

But I take Buffett's analysis of the situation one step further. I use my vast knowledge of psychology (not!) to justify that the future money managers are crazy. O.K., not crazy, but confused. You see, they are first taught it doesn't do any good to think (in the first finance course) and then they are taught they can look at the accounting numbers and discover that a company is about to get into trouble.

Taking this a bit further, if they can discover by using the accounting numbers that a company is getting into trouble, shouldn't they be able to look at the numbers and tell if a company is doing everything right and ***not*** getting itself into trouble? And if this is so, then shouldn't they be able to construct a portfolio of those "good" companies and leave out the "bad" companies and have this "good" portfolio outperform the averages? Don't forget: the market averages contain both the "good" and "bad" companies.

So in the first finance class they are taught they cannot select good companies and in the second class they are taught they certainly can select good companies through elimination of the "bad" companies. Is this enough to drive you crazy? Following this non-logical logic, it is my theory that all these students are driven crazy by the academic world. How can we expect our brightest to perform well if we drive them crazy while still in college?

YOU DON'T HAVE TO WORRY

Now you know why you really don't have to worry about all those professional money managers outperforming your very own self-selected portfolio. First of all, they are suffering from the, "no you can't, yes you can" syndrome and second of all, they don't know about Clean Surplus Accounting. Why? Because Clean Surplus Accounting is not well known in the academic world and is not taught in our fine business schools. And furthermore, Clean Surplus Accounting is much too simple to be considered to have credence with the academic community.

So there you have it. Only you, me and Warren Buffett know about Clean Surplus Accounting. And folks, we are all that matter.

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SUMMARY OF CHAPTER 4

1) **Most money managers cannot outperform the market averages. Those who do have less than a 33% chance of continuing this performance through the second year.**

2) **Clean Surplus Accounting is not taught in our fine business schools. Therefore, those who understand Clean Surplus Accounting have a distinct advantage over those who have not had access to this method of accounting, which includes just about all the college graduates of this country.**

CHAPTER 5

A Very Simple Income Statement and an Even Simpler Balance Sheet

This chapter is for the novice investor, the finance professional and the seasoned accountant. We will thoroughly discuss some common and yet very important terms, but we want to make sure you understand ***how*** they will be used in the following text. The finance people and accountants may use certain terms a bit differently than they are used in Clean Surplus Accounting. Thus, in order to fully understand the concept of Clean Surplus, we must all begin on the same page.

If you don't understand any part of the next several pages, don't worry. We will go over this information again and again.

The rest of this book will differentiate the average investor and the professional money manager from you, who after understanding this book will forever outperform the averages.

Let's get on with some simple but very important concepts. Please be aware that I am making these concepts as simple as possible. Thus, I am taking great literary license in order to fully achieve the simplicity process.

THE INCOME STATEMENT

The Income Statement is also called the Statement of Operations or a Profit and Loss (P&L) statement. In other words,

money in (Revenues or Sales) minus money out (Expenses) leaves us with Net Income.

INCOME STATEMENT

Revenues
Minus all Operating Expenses,
Interest and Taxes

= Net Income
Minus all Non-Recurring Items

= Earnings

Earnings *Minus* ***Dividends*** = **Retained Earnings**

Continuing on, Net Income less certain Non-Recurring Items, ***which are unique to a single company and not part of ordinary, everyday operations,*** leaves us with Earnings.

Earnings minus Dividends paid out to investors (shareholders) equals Retained Earnings. Retained Earnings is the money put back (retained) into the company so the company can grow.

These are Clean Surplus Accounting terms and will be used in this manner for the remaining chapters of this book.

That's it for the Income Statement as far as we are concerned. This is all we will use from here on in.

THE BALANCE SHEET

The Balance Sheet tells us how much the company is worth. Or at least that's what they tell us in school. Assets minus Liabilities equals the amount that the company is supposedly worth. This value is termed Book Value or Owners' Equity.

In other words, what the company ***owns*** minus what the company ***borrowed*** and still owes to the bank and/or bond holders equals the Book Value or Owners' Equity.

BALANCE SHEET

Assets
Minus All Liabilities

= Book Value or Owners' Equity

The term Book Value is used interchangeably with Owners' Equity. The problem is even though Book Value ***numerically*** equals Owners' Equity on the Balance Sheet, they are defined differently. And therein lies the really, really big problem.

1) Book Value is defined as Assets minus Liabilities just as we see above.

2) Owners' Equity is defined as how much money the owners of the company (stockholders) have put into the company through the sale of common stock as well as all the profits which were put back into the company over the years. These retained profits are called Retained Earnings.

This discrepancy in meaning between Book Value and Owners' Equity is what Clean Surplus Accounting is all about. The next several chapters are designed to clear up that difference.

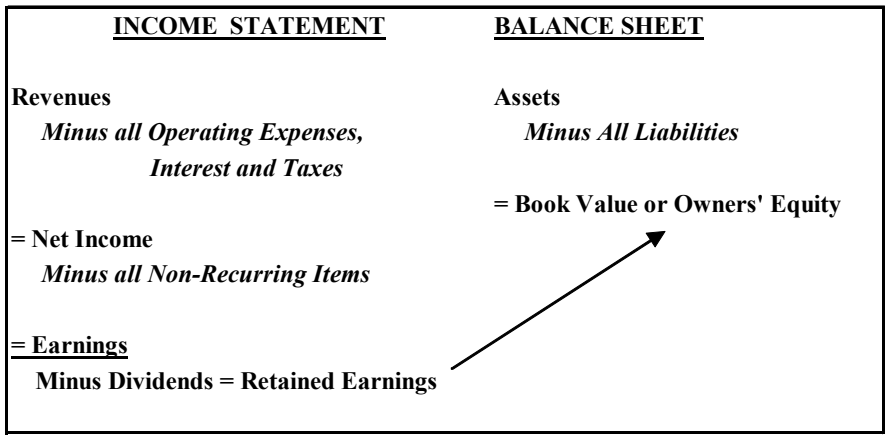
TYING TOGETHER THE INCOME STATEMENT AND THE BALANCE SHEET

If a company shows a profit on the Income Statement from operations and reinvests this profit back into the company, then the company must be worth more, just as our bank account was worth more when we retained the interest we earned each year.

The profit which is shown on the Income Statement, minus any Dividends paid to stockholders is called Retained Earnings. Retained Earnings is the part of Earnings that is re-invested back into the company and, of course, Retained Earnings increase the value of the company. This added value will be shown (must be shown) on the Balance Sheet because the company is worth more. Remember, the Balance Sheet shows the Book Value or Owners' Equity of the company.

Here's how the two statements tie together.

THE LINK BETWEEN THE INCOME STATEMENT AND THE BALANCE SHEET



Once again, the profit (earnings) from the Income Statement, minus money paid out to stockholders as Dividends, equals the Retained Earnings or money re-invested back into the company for future growth. The Retained Earnings is carried over to the Balance Sheet (arrow), which in turn, increases the Book Value or Owners' Equity of the company.

This makes sense (cents), because if the company earns a profit and that profit is kept inside the company, then the company must be worth more. Think of our bank account examples. If we left interest earned in the account, the account increased in value.

The Retained Earnings add to the value of the company and this value is shown on the Balance Sheet as an increase in Book Value or Owners' Equity. This is why Retained Earnings is called the link or tie-in between the Income Statement and the Balance Sheet.

There you have it. This is really as complicated as it gets. Let's now get on with the reasoning behind the structuring of a superior performing portfolio and your education of separating the men and women from the boys and girls.

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CHAPTER 6

The Return On Equity Ratio

What is the Difference Between the Accounting Return On Equity We Hear About Every Day and Clean Surplus Accounting Return On Equity?

Answer: EVERYTHING!

Note: This is the most important chapter in the book. This chapter contains the knowledge that separates you from the rest of the world. Even if you don't understand as much as you'd like to at first, the rest of the book works with this information so that you will understand everything by the time we get to the Top Dogs of the Dow chapter. And for your diligent efforts, you will be rewarded for the rest of your life.

WHAT YOU MUST REMEMBER FOR THIS CHAPTER

1) Book Value is used interchangeably with Equity (Owners' Equity), even though they do not have the same definition.

2) The Return On Equity (ROE) ratio is the most widely used (misused) method of comparing the operating

efficiency of one company to the operating efficiency of another company.

3) In accounting, the ***Return*** portion of Return On Equity is Earnings from the Income Statement and the ***Equity*** portion of ROE is Book Value (Owners' Equity) from the Balance Sheet.

WHAT WE WILL LEARN IN THIS CHAPTER

1) The traditional ***Accounting*** ROE is an extremely ***inefficient method*** of comparing the operating efficiency of one company to the operating efficiency of another company.

2) The ***Clean Surplus*** ROE is the ***only reliable method*** of comparing the operating efficiency of one company to the operating efficiency of another company.

The Return On Equity (ROE) ratio is the most widely used ratio for the comparison of the operating efficiency of a company in all of investing land. However, there is a huge difference between the traditional Accounting Return On Equity as configured by the accounting numbers (which everyone uses) and the Return On Equity as configured by Clean Surplus, which we use.

You already know the basics of Clean Surplus. It is your bank account. However, the traditional Accounting ROE is different. The Accounting Return On Equity has three very major flaws.

1) The Return part of the equation is not configured to conform to all companies.

2) The Equity part of the equation is not configured to conform to all companies.

3) It just plain doesn't work.

The third and of course main flaw is that it just doesn't work. How do we know this? Because most of the money managers in investment land cannot outperform the averages. And since accounting ROE is the most widely used comparison ratio, then intuitively, we know that accounting ROE is not working.

We also know it doesn't work because in all my advanced finance classes I have my students run association (correlation) tests between the traditional Accounting Book Value (Equity) and stock returns. The association is very, very low. In fact, there is almost no association.

However, when the students run association tests between Clean Surplus Book Value (Equity) and stock returns, the association is very, very high. This means that Clean Surplus Book Value (Equity) has a direct influence on the value of a company, but Accounting Book Value definitely does not.

Please remember that Warren Buffett says that (accounting) Book Value is meaningless relative to the intrinsic value of a company. *(Brunner, Case Studies in Finance)*. However, Buffett (Annual Report to Shareholders, 2002) speaks so fondly of Book Value. In fact, he talks about how well the Book Value of his investing company, Berkshire Hathaway, has grown.

How in the world can he say that Book Value is meaningless as an indicator of intrinsic value and then on the other hand talk about Book Value having great importance when he talks about his Berkshire Hathaway company? The answer could be that he may be talking about two different Book Values. Why don't we find out!

We will show the results of the association tests and predictability of Clean Surplus Book Value when we apply Clean Surplus Book Value to the Return On Equity ratio in later chapters. We also show later that Clean Surplus ROE shows a very high relationship to the future returns of a stock portfolio. In other words, we see that indeed, there is predictability in Clean Surplus Accounting and Clean Surplus ROE. And the desire for predictability is why Clean Surplus was invented.

THIS CHAPTER AND THE NEXT AND THE NEXT

The next chapter, Chapter 7, will cover the Return portion of the Return On Equity ratio, and Chapter 8 will cover the Equity portion of the Return On Equity ratio. Chapter 9 will then show you how to determine a true Clean Surplus Equity number.

We will see why the ROE from the accounting statements (traditional Accounting ROE) ***does not*** represent a ratio that can be used to compare one company's operating efficiency to another company's operating efficiency. We will also learn why Clean Surplus Accounting ROE ***does indeed*** represent the best method of comparison of the operating efficiency of a company.

First, let's review just one thing. In Chapter Three, we calculated the earning capacity of a company (bank examples) by using the Return On Equity as configured by Clean Surplus. It is simply the amount ***earned*** during a certain period divided by the amount of money with which we ***began*** that period.

We perform this calculation ourselves all the time for our own bank accounts and our own stock accounts. We are concerned not only with the dollar amount we earned during a particular period, but more importantly, the ***percentage return*** we earned during a particular period. All we need to know is how much we started with and how much we ended up with. Why do we use percentage returns? Because percentages are easily understood and thus easily compared to other returns.

Very simply, if we began with $100 and ended up with $112, we would want to brag about how much we made. We know we earned $12.

Next, we want to know what a profit of $12 represents in percentage terms. Simply put, the profit we earned ($12) divided by the amount we began with ($100) is 12%.

The formula is:

Ending Value minus Beginning Value Divided by Beginning Value
Or
(Ending Value – Beginning Value) / Beginning Value

The common term for this result in the world of investing is Return On Equity or Return On Owners' Equity.

The Return On Equity (ROE) is the amount of money earned in a certain period divided by the beginning period amount of money.

The Return On Equity (ROE) in this example is Clean Surplus. If we could perform the same calculations for companies as we do for our bank account, we would be able to compare the Return On Equity of one company to the ROE of another company because we are performing the calculations the exact same way for both companies. The companies with a higher and more consistent ROE would be the companies with which we would grace our portfolios. And this is what we will certainly discuss very thoroughly in the next several chapters.

However, before we go on, I want to make sure you understand or for now are at least aware that the ROE we calculate using Clean Surplus is not the traditional Accounting ROE we see and hear about every day.

The traditional Accounting ROE that you hear about all the time is not the same as Clean Surplus ROE that you are learning in this book.

You see, the people who use Clean Surplus ROE outperform the averages. Those who use the traditional Accounting ROE (most everybody) fail, on the whole, to consistently outperform the averages.

The next several chapters will ***show*** you ***why*** the traditional Accounting ROE fails, but right now I will ***tell*** you ***why*** this ratio

fails. It fails because the traditional Accounting ROE is not a very good comparison ratio. In fact, it is just miserable as a comparison ratio. End of statement, but the beginning of a new investing career for you.

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CHAPTER 7

The Return Portion of the Return on Equity Ratio

The Return number used in the traditional Accounting ROE ratio is the Earnings number from the Income Statement.

The Income Statement (see below) shows money in, money out and the amount left over.

THE INCOME STATEMENT: RETURN

Note: I understand the term Net Income may be used differently in the accounting profession than we are using it here. But to keep everyone on the same page, let's use it as we do below. Our Net Income is Earnings before Non-Recurring items such as extraordinary items and future liabilities (AICPA Position).

I mentioned that the Income Statement shows money in and money out. Well, up to a point.

INCOME STATEMENT

Revenues

Minus all Operating Expenses,
Depreciation, Interest and Taxes

= Net Income

Here's what we have. Money in, which is ***Revenues or Sales,*** minus money out, which is all ***Expenses***. The amount left over is called ***Net Income***.

By the way, Net Income is the Return portion of Clean Surplus Return on Equity (ROE), and is figured the same among all companies. However, Net Income is not the Return portion of traditional Accounting ROE. In other words, Yay for Clean Surplus ROE, and Boo for Accounting ROE. Please read on.

If this were all there was to it, we would use the Net Income as the Return portion in the ROE ratio to compare one company to another because it is simply money in, money out, and thus, profit (Net Income). Net Income is figured the same way for every company under this scenario.

One point: Depreciation is an expense. It is not money out, but depreciation is used as an expense to determine Net Income.

However, there are other items which must be taken into consideration for individual companies. These items are collectively termed Non-Recurring items and include such items as extraordinary losses (gains) and future liabilities, and they are deducted (or added) ***after*** Net Income.

INCOME STATEMENT

Revenues
Minus all Operating Expenses including Depreciation, Interest and Taxes

= Net Income
Minus all Non-Recurring Items such as Extraordinary Losses (Gains) and Future Liabilities

= Earnings

The Earnings represent the Return portion of the traditional Accounting Return On Equity. However, because Earnings are calculated after the Non-Recurring items, which are unique to each individual company, Earnings should not ever, ever, ever be used to compare one company's profit to another.

You can see by this Income Statement that something else has come into the picture. Just after the Net Income number, which ***IS*** calculated the same way for all companies, we see Non-Recurring items, such as extraordinary losses and future liabilities, which are subtracted from Net Income to give us Earnings. These unique Non-Recurring items are ***NOT*** the same for all companies.

Extraordinary losses (or gains) are extraordinary. In other words, they do not occur during the ordinary operations of the company. Here's the really important part. **These items are *unique* to each individual company.**

Certainly, these unique events must be accounted for and they are. But in no way do these events show how efficiently you've been running your operation. And we're concerned with ***operating efficiency*** in our ROE ratio and not branches falling out of the sky because of a hurricane passing by.

Efficiency (or lack of) occurs every day. Unique items do not happen during ordinary operations and may occur just once in a

lifetime. ***The point is the Earnings are very much affected by these one-time, unique events.***

It is emphasized in Clean Surplus literature that the entries after Net Income ***do not lend themselves to predictability***, because extraordinary events are not predictable.

Clean Surplus Accounting tells us that the entries after Net Income *do not lend themselves to predictability*, because extraordinary events are not predictable.

Look at the other line under Net Income, labeled Future Liability. A Future Liability is a liability for the future and not today. In fact, there is no money outflow at the present time for this line item. A future liability may be future medical benefits for the workers who have not yet retired. This is a future liability, but it is not money flowing out of the company today. It is not an actual, present-day reduction in the asset base of the company.

In accounting, we are given the choice of subtracting some liabilities from Net Income either all at once or slowly over a period of years.

We will look at a huge Future Liability for General Motors in just a minute. In fact, General Motors experienced a whopping 80% reduction in total company value because of this one item. However, it only experienced an 80% reduction on paper and not on its real asset value. More on this very important event a bit later.

Bottom Line: All you must remember here is that the items which are listed after Net Income such as Extraordinary Losses and Future Liabilities are ***unique*** to each individual company. These items affect Earnings so that the Earnings number can have more (or less) items or events affecting Company A than those affecting Company B in any one reporting period. Thus, the Earnings number does not constitute a good comparison number.

The Earnings number is unique to each individual company because the Earnings number contains items which ***do not lend themselves to the predictability*** of future Earnings.

Since the Earnings number is adjusted differently depending on the individual company and individual situations or events, it cannot be used as a number for comparison between different companies. Thus, it follows that Earnings cannot be used as the return number in the ROE ratio when ROE is used as a comparison ratio.

A truer, more comparable number would be Earnings before extraordinary write-offs and future liabilities, which is, of course, ***Net Income***.

Clean Surplus tells us definitely and positively to use Net Income rather than Earnings for the Return number in the ROE ratio. In other words, use Net Income which is Earnings BEFORE Non-Recurring Items.

This is exactly what the founding fathers of Clean Surplus told us to do. Use Net Income and not Earnings for the Return portion of the ROE ratio. So let's do what we're told and ***use Net Income as the Return number in our ROE calculation.***

Please remember that the founding fathers of Clean Surplus were trying to develop a statement that showed predictability of the future and Earnings doesn't do that if a company has items (Non-Recurring) on the Income Statement which do not lend themselves to predictability.

If you agree with this scenario so far, congratulations because you are already one giant step ahead of most analysts.

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SUMMARY OF CHAPTER 7

1) **Earnings is the Return portion of the traditional Accounting ROE. However, the Earnings number contains non-recurring items, which do not lend themselves to predictability. Therefore, the Earnings number is NOT configured the same for all companies and thus cannot be used as a comparison number. And this is why most money managers cannot outperform the averages. They are simply using the wrong Return number in the ROE ratio.**

2) **Net Income is the Return portion of the Clean Surplus ROE ratio because Net Income is configured in the same manner for all companies and is thus, a truly comparable number.**

3) **Clean Surplus Accounting develops an ROE ratio that can be used as a comparison among all companies because the Return number (Net Income) is calculated in the same manner for all companies.**

4) **Clean Surplus ROE is absolutely and positively configured the same way for all companies. This is why the followers of Clean Surplus outperform the averages.**

CHAPTER 8

The Equity Portion of the Return On Equity Ratio

Note: The Return numbers (both Earnings and Net Income) we just finished discussing are found on the Income Statement. The Book Value or Owners' Equity is found on the Balance Sheet. The Book Value or Owners' Equity supposedly represents the Value of the company.

There are two terms we must understand before we go on. You continually hear the terms "Book Value" and "Owners' Equity." Let's discuss the definitions.

Book Value is defined as Assets minus Liabilities. Think of your house. You bought it for $100,000 with $20,000 down. You owe the bank $80,000. The Book Value of your asset (the house) is the value of the asset or $100,000 minus the liability, which is the $80,000 you owe the bank. Your Book Value is, of course, the $20,000 you put down.

Book Value: Assets Minus Liabilities

Owners' Equity is defined as the amount of equity (money) investors have put into the company. Owners' Equity equates to common stock sold by the company plus all the retained profits (Earnings after Dividends are paid out), which are put back into the company year after year so the company can grow.

Please notice that using the house example, the Owners' Equity is also equal to the Book Value of $20,000. It is the amount of your equity money that you put into the house. The problem with

accounting is that our example of the house is where the similarity ends between Book Value and Owners' Equity.

Owners' Equity: Amount of common stock sold to investors plus profits (or losses) after dividends are paid out.

The definition for Book Value is different than the definition for Owners' Equity, but yet we use both terms synonymously on the Balance Sheet and they must be numerically equal to each other on the Balance Sheet. This is a very serious problem and one that we are about to solve with Clean Surplus Accounting.

Let's go back to the Income Statement once again because the Earnings number on the Income Statement directly affects the Book Value on the Balance Sheet.

ACCOUNTING INCOME STATEMENT

Revenues (Sales)
Minus all Operating Expenses,
Interest and Taxes

= Net Income
Minus all Non-Recurring Items

= Earnings

Earnings *Minus Dividends* = Retained Earnings

There are two primary actions a company can take with Earnings. The company, through its board of directors, can decide to give the Earnings to the shareholders in the form of Dividends and/or they can reinvest the Earnings back into the company so the company can buy more assets and grow. In the instance of reinvesting all or a portion of the Earnings back into the company, the re-invested Earnings are then called ***Retained*** Earnings because the company is retaining the Earnings for company use.

Remember from last chapter that the items that appear AFTER Net Income (Non-Recurring items) on the Income Statement have no predictive qualities. If this is true, and it is, we will have little or no predictability of the future value of our stocks if we use the Earnings number to try and determine predictability.

Let's now go to the Balance Sheet.

BALANCE SHEET

Assets
Minus All Liabilities

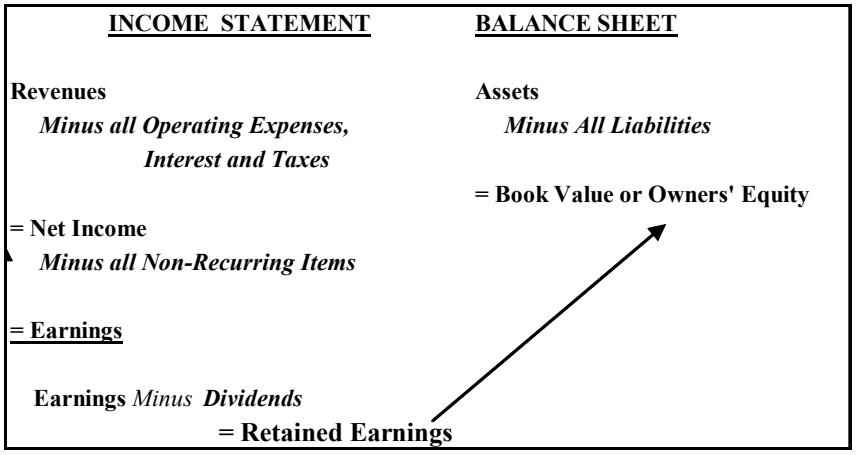
= Book Value or Owners' Equity

You can see that the Assets minus the Liabilities equals Book Value or Owners' Equity. We also know that Owners' Equity consists of the money brought in from issuing (selling) common stock *plus* all Retained Earnings. And Retained Earnings is all the profit ever made by the company over the years, which in turn, has been re-invested back into the company.

In accounting, the link between the Income Statement and the Balance Sheet is this *Retained Earnings* number. The profit (or loss) from the Income Statement is brought over to the Balance Sheet and added to Book Value (Owners' Equity) under the sub-heading of Retained Earnings. Let's go there.

Below is a simplified *accounting* Income Statement and Balance Sheet showing the link between the two statements.

ACCOUNTING STATEMENTS AND THE LINK BETWEEN THEM



This makes sense. If you make a profit and put that money back into the company in the form of Retained Earnings, the company now has more value and this increase in value shows up on the Balance Sheet. The Book Value (Owners' Equity) has increased due to the addition of new profit.

Retained Earnings is the Link between the Income Statement and the Balance Sheet.

OK so far? But we have a really, really biggggg problem which has just been carried over from the Income Statement to the Balance Sheet.

Remember those items unique (Non-Recurring) to the company which distorted Earnings as a comparable number? We said we want to use Net Income for our Return number rather than Earnings because Net Income is figured the same for each company and Earnings is not. Net Income does NOT include those items which are different for each company. This means that Net Income is the number which must be used to compare one company to another.

The Earnings number, which includes items unique to each individual company, should ***not*** be used as a comparison number between companies because the Earnings number contains items which ***are not*** part of the normal operations of the company. These Non-Recurring items ***do not*** allow for predictability according to Clean Surplus Accounting.

Very Important Bottom line: If the Earnings number is a "distorted" number for purposes of comparison because of items which are NOT part of ordinary operations, then when the Retained Earnings number is carried over to the Balance Sheet, won't Book Value become distorted relative to ordinary operations?

Absolutely! Yes, I know, pretty heavy stuff. But let's look at an example. Just remember that Clean Surplus uses Net Income as the Return portion of the ROE ratio. And it follows that in order to obtain Clean Surplus Retained Earnings for the Balance Sheet, we must subtract Dividends only from ***Net Income***. In this way, any distortion in Earnings due to Non-Recurring items **WILL NOT** be carried over to Owners' Equity.

THIS IS CLEAN SURPLUS AND THE LINK (NO DISTORTIONS) BETWEEN THE INCOME STATEMENT AND THE BALANCE SHEET

INCOME STATEMENT	**BALANCE SHEET**
Revenues	**Assets**
Minus Expenses	Minus Liabilities
Interest	**= Book Value or**
Taxes	**Owners' Equity**
= Net Income - Dividends = Retained Earnings	
Minus Non-Recurring Items	
= Earnings	
Minus Dividends = **Retained Earnings**	

This calculation of Clean Surplus Retained Earnings is one of the two most important segments in the development of predictability as was intended by the accounting profession relative to Clean Surplus.

GENERAL MOTORS

What Happened to General Motors? A Perfect Example of the Distortion of Book Value

Now let's look at an example of how the Book Value of a company can become extremely distorted when extraordinary events are reflected in its Earnings.

At the end of 1991, the stock of General Motors was valued at a Book Value of $42.89 per share. By the end of 1992, GM's valuation was reduced by a mind-boggling 80% to a Book Value of just $8.47 per share.

General Motors Book Value Change

1991	1992
$42.89	**$8.47**

How in the world did GM experience an 80% reduction in value in one year? It really didn't, except on paper. GM was forced to account for the *future* medical liabilities of their present workers upon the workers' retirement. GM was required by FASB (Financial Accounting Standards Board) Statement No.106 to disclose nonpension postretirement benefits, such as health care and life insurance benefits, as Future liabilities (see addendum to this chapter).

Companies in the same boat as General Motors were required to either take the write-off in equal increments over 20 years or take the total amount of write-off in just one year. GM chose the latter. GM deducted today (only on paper) for costs they would incur sometime in the future as their workers retired.

Let's go through the numbers. And of course, I am taking great literary license to simplify the process because GM had negative Net Income in 1992, which I'm not showing. Since I don't want to cloud the picture, I'm using numbers not totally correct, but the theme is the same and the reduction in value of 80% is totally accurate.

1992 Net Income per share	**$10.00**
Minus Future Liabilities	**($44.42)**
1992 Negative Earnings	**($34.42)**

GM had very negative bottom line Earnings in 1992 due to FUTURE Liabilities

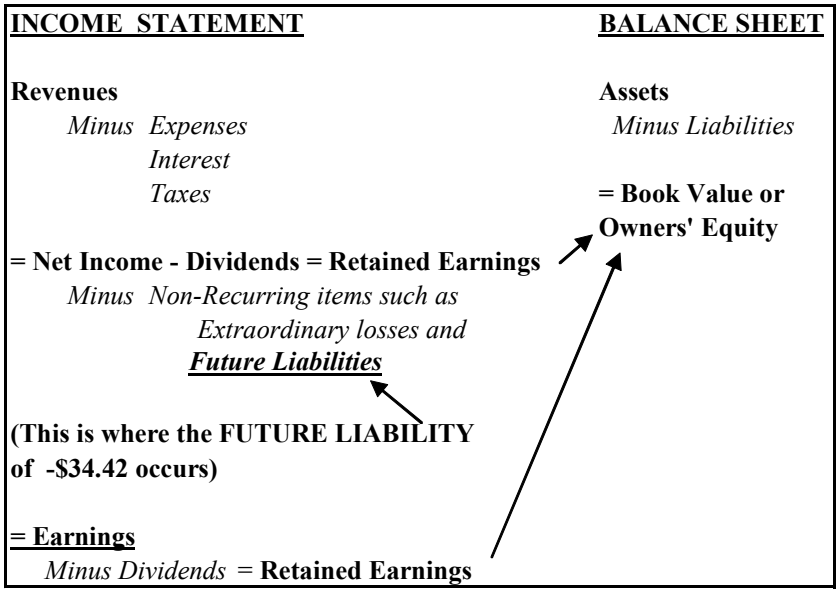
Please remember that the Future Liability was a paper transaction with no cash outflow. The money subtracted from GM's Net Income actually stayed within the company.

These 1992 negative Earnings of -$34.42 must now be carried over to the Balance Sheet and subtracted from all previous Retained Earnings, which in turn reduced Book Value (Owners' Equity) drastically. Let's go there.

1991 Per Share Book Value (Owners' Equity)	**$42.89**
1992 Retained Earnings (this is the big loss)	**($34.42)**
1992 New Book Value	**$8.47**

Please remember that Owners' Equity is comprised of the Common Stock sold by GM and all Retained Earnings. Since the traditional Accounting Retained Earnings is a negative (-$34.42) in this case, the -$34.42 must be subtracted from the previous total of Common Stock sold and all previous Retained Earnings up to this point. In GM's case, Book Value (Owners' Equity) was reduced by a whopping 80% to just $8.47. Also remember that this situation was not common to all companies.

Clean Surplus ***does not allow*** this discrepancy to occur. Let's see why.



You can see above that if the Clean Surplus Retained Earnings (Net Income minus Dividends, ***top arrow***) was carried over to the Balance Sheet, the -$34.42 paper loss ***would not have affected*** Owners' Equity, because the huge Future Liability paper loss occurred ***after*** the Clean Surplus Retained Earnings (***top arrow***) carryover to the Balance Sheet.

However, by using traditional Accounting Earnings or Earnings ***after*** Non-Recurring items as the tie-in between the Income Statement and Balance Sheet (***bottom arrow***), the negative $34.42 must be carried over to the Balance Sheet, and will in turn absolutely

and completely and totally and forever distort Book Value (Owners' Equity).

This Future Liability and the manner in which it was accounted for was unique to GM (and some other companies) at that particular time, and this event will distort the Book Value of GM forever into the future.

IMPORTANT; IMPORTANT; IMPORTANT

In traditional accounting, the Future Liabilities and other Non-Recurring items ***first distort Earnings*** as a comparison number and then this distortion which is included in Retained Earnings is carried over to the Balance Sheet where it then ***distorts the Owners' Equity or Book Value***. Thus, ***both*** accounting Earnings ***and*** accounting Book Value now contain an item which ***shows no predictability*** because it is a one-time write-off and is unique to a particular company at a particular time in the life of that company.

LET'S NOT FORGET THE MAIN QUESTION

The main question becomes this: did the assets of GM really decline by 80% practically overnight? No, they weren't reduced at all. The money stayed in the company. After all, this was a non-cash event. In the future, it will be a cash event over many years as workers retire, but today, nothing changed. However, the Balance Sheet showed that the Book Value or Owners' Equity was reduced an unimaginable 80% to just $8.47 per share with just the stroke of an accountant's pencil.

Traditional accounting is very complicated. Clean Surplus is as clean and simple and pure as newly fallen snow.

The Equity portion of the traditional Accounting ROE has been greatly distorted by a unique event that artificially distorted Earnings, which in turn greatly distorted (and artificially reduced) Book Value (Owners' Equity). This did not happen to most other companies at that particular time.

Bottom line: Due to the distortion caused by Non-Recurring items in the traditional Accounting Earnings which results in Accounting ***Retained*** Earnings being carried over to Book Value, it follows that Accounting Book Value (Owners' Equity) is also unique (not comparable) to each individual company. If this is true, and it is, then we've lost the second part of the ROE equation in that the Book Value (Owners' Equity) from the Balance Sheet is not configured the same way among all companies because of individual events which are unique to individual companies. ***This leads us to the conclusion that we cannot use either traditional Accounting Earnings or traditional Accounting Book Value as comparable numbers in our ROE calculation***.

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SUMMARY OF CHAPTER 8

Traditional Accounting Book Value (Owners' Equity) includes in its calculations all the items (from traditional Accounting Retained Earnings) that are unique to that individual company. Thus, traditional Accounting Book Value (Owners' Equity) is not configured the same for each company. Since Book Value (Owners' Equity) is not configured the same for each company, it CANNOT be used as a comparable statistic.

This leads us to the conclusion that we cannot use either traditional Accounting Earnings or traditional Accounting Book Value as comparable numbers in our Return On Equity (ROE) calculation.

ADDENDUM TO CHAPTER 8

The General Motors Story

For those of you who are interested in the Future Liabilities issue of General Motors and other companies, here's something you might be interested in.

Let us visit the actual ruling that caused GM's write down in Accounting Book Value. The following is quoted from a published dissertation. (*Belmonte, Clean Surplus Accounting: Relevance of Earnings and Book Value. Nova Southeastern University, 2002).*

"An example of a drastic change in book value from one year to another resulted in a change in the balance sheet book value of General Motors from $42.89 in 1991 to $8.47 in 1992 as reported by Value Line. Value Line's footnote attributed the drop in book value to a nonrecurring loss."

A page from Accounting: Text and Cases, Ninth Edition by Robert Anthony explains the drop in book value for General Motors to an accounting concept.

Beginning no later than 1993, companies are also required by FASB Statement No. 106 to make disclosures of ***nonpension postretirement benefits****, such as health care and life insurance benefits. Formerly, such expenses were recognized on a pay-as-you-go basis. Now, the substance of accounting for these benefits is similar to that for pensions: The total costs that will be incurred by retirees is estimated and a portion of the present value of these costs is charged as an expense in each year that an employee works. For health care costs, this requires estimating employees' needs for postretirement health care services as well as the future cost of such services. These are even more difficult and uncertain estimates than those required for pensions. For many companies this requirement resulted in identification of a huge obligation for previously unfunded*

and unrecognized future nonpension postretirement benefits that employees already had earned. Companies were given the choice of treating this obligation either as (1) a change in accounting principle (described later in this chapter), with the entire obligation treated as an expense of the period in which the change was made; or (2) on a delayed basis, amortizing the obligation on a straight-line basis over the average remaining service period of active plan participants or 20 years, whichever is longer. Many companies elected the first, "one-big-hit" approach; as an extreme case, for General Motors this approach reduced 1992 net earnings by $20.8 billion ($33.38 per share).

Until they were required to do so by FASB 106, many companies had not estimated the overhanging burden of future health care benefits. This led some companies to reduce such benefits, which in some cases led to labor disputes.

The two sources quoted above do not agree on the book value of GM. Value Line shows the decrease in book value to be $34.42, while Accounting: Text and Cases shows the write-down to be $33.38. However, a basic question arises. Did a drop of approximately $34 (almost 80%) per share in accounting balance sheet book value actually change the asset base upon which GM manufactures cars?"

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CHAPTER 9

How to Determine an Equitable Equity Number

The last several pages were pretty heavy in one way, but on the other hand, the concept is very much just plain common sense. Look at it this way. You are just one step away from being able to develop a portfolio that will outperform most of those professional money managers out there in investment land. ***Just one step away.*** Once you are finished with this book, the adoption of Clean Surplus to your stock portfolio will indeed seem second nature. And as I said to myself when I first learned the system, "This is so easy, why didn't I think of this method myself?"

LET'S REVIEW JUST A BIT

In Chapter 7 we learned that we could not use Earnings as a comparable number between different companies. This was because the Earnings number becomes distorted as a comparable number due to unique, Non-Recurring items on the Income Statement. These Non-Recurring items certainly must be accounted for, but in no way do they allow for the predictability that the investment community so dearly seeks.

In Chapter 8 we learned that if the Earnings number is distorted as a comparable number then Book Value (Owners' Equity) also becomes distorted as a comparable number between companies. The Earnings number from the Income Statement directly affects Book Value on the Balance Sheet because Retained Earnings (Earnings minus Dividends) is the tie-in between the two statements.

Thus, one distortion keeps on distorting. Or, one bad apple spoils all the others.

Bottom Line: Neither traditional Accounting Earnings nor traditional Accounting Book Value (Owners' Equity) can be used as comparable numbers. Thus, the ROE ratio, which consists of both traditional Accounting Earnings and traditional Accounting Book Value, cannot be used as a comparison ratio. Eat your heart out, Wall Street.

We've already solved the problem of the Return portion of the ROE ratio. Rather than using Earnings, we use Net Income as our Return number. Net Income is configured the same among all companies and is thus a comparable number.

However, we still have a problem with Book Value (Owners' Equity) which we are about to solve right now.

OUR NEW RETURN ON EQUITY EQUATION

In order to find a comparable Book Value or Owners' Equity, we must develop a Book Value (Owners' Equity) in the same manner as we did with our bank accounts. In other words, we must develop a Clean Surplus Book Value (Owners' Equity).

The Return (Earnings) On Equity (Book Value) from the accounting statements cannot be used as a good comparison ratio.

Between 1895 and 1937, there was concern in accounting circles of the inability of accounting statements to predict the operating efficiency and thus the future value of a company.

The discussion centered on how the accounting numbers should show what investors needed to know about a company and at the same time allow for some sort of ***predictive capability***.

The result was a surplus accounting statement showing Earnings before abnormal charges or Non-Recurring items (extraordinary write-offs and future liabilities), which is, of course, ***Net Income***. Thus, in Clean Surplus Accounting, Net Income becomes the "Return" number for the ROE calculation.

Book Value or Owners' Equity is not as easy. Surplus Accounting, which was later called Clean Surplus Accounting, calculates its own Owners' Equity true to the definition of Owners' Equity. Remember, Owners' Equity is the common stock issuance plus all Retained Earnings.

But Clean Surplus distinctly says that the only addition to the Retained Earnings account on the Balance Sheet should be Net Income minus Dividends from the Income Statement.

We can now begin to understand and use the true definition of Owners' Equity. But a picture is worth 10,000 words, more or less; so let's go to an example for simplification.

Owners' Equity is the common stock issuance plus all Retained Earnings. According to Clean Surplus, these Retained Earnings can only come from Net Income minus Dividends.

Let's examine two separate bank accounts (oh no, not again!), each beginning with $100. Let's also assume all Interest (Net Income) is re-invested back into both accounts.

	Bank A			**Bank B**		
YEAR	**EQUITY**	**INTEREST**	**ROE**	**EQUITY**	**INTEREST**	**ROE**
2002	$146.00	$14.00	**10.00%**	$142.00	$11.37	**8.00%**
2001	$133.00	$13.00	**10.00%**	$131.00	$11.00	**8.50%**
2000	$121.00	$12.00	**10.00%**	$120.00	$10.85	**9.00%**
1999	$110.00	$11.00	**10.00%**	$110.00	$10.45	**9.50%**
1998	$100.00	$10.00	**10.00%**	$100.00	$10.00	**10.00%**

Owners' Equity is defined as the amount of money the owners put into the bank account plus all the Retained Interest. Don't forget, the Interest (Net Income) belongs to the owners. Since the Interest is retained in the bank account, it is called ***Retained*** Interest (Retained Earnings).

This bank example shows how simply Clean Surplus works. Owners' Equity of today equals Owners' Equity of last period plus the Retained Profits of last period. (See the bank account example above.)

In Clean Surplus Accounting, Retained Profits is Net Income minus Dividends. OR, how much money with which we began the year plus how much we earned (and retained) gives us next year's beginning balance.

Yes, Clean Surplus Accounting is this simple because it is CLEAN. It is clean because we ***do not*** include in our calculations any future liabilities or extraordinary write-offs or any Non-Recurring items, which ***do not*** lend themselves to predictability.

We actually use Clean Surplus to figure the yearly returns on our bank account and our stock accounts. It's a wonder analysts don't use it to figure the return on a company's assets. Of course, those who read this book will use it. And after you finish this book, you will use it forever.

Looking to the above bank account examples, we can see that the Return On Equity for Bank A is a constant 10%. However, Bank B, because of some unknown reason, shows an ever-decreasing ROE.

The question is very simple. 1) All else being equal, which bank would you rather put your money in?

And the second question is equally simple. 2) Why can't we use the bank account method in the same manner with individual companies such as GE and GM as well as our bank accounts?

We can and we will because Clean Surplus Accounting allows us to do so. And you will see that Clean Surplus Accounting is the concept which makes us different from the rest of the investment world.

WHAT DOES WARREN BUFFETT SAY ABOUT ALL THIS?

What does Warren Buffett say about the shortcomings of Accounting Book Value? He simply says that accounting Book Value is meaningless as an indicator of a firm's intrinsic value.

I don't know about you, but Buffett pretty much says in just one sentence what I've been trying to get across to you for the past nine chapters. And I'll spend several more chapters showing you how Clean Surplus works in the real world.

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SUMMARY OF CHAPTER 9

1. Clean Surplus distinctly tells us that the only addition to the Retained Earnings Account comes from Net Income minus Dividends and not the traditional Earnings minus Dividends.

2. Clean Surplus uses the true definition of Owners' Equity as the Book Value (Owners' Equity). How much money did the company begin with through common stock sales and how much was added through retained profits? Thus, not only is Net Income configured the same among all companies, but because Clean Surplus uses Net Income minus Dividends to add to Book Value (Owners' Equity), then Book Value (Owners' Equity) is also configured the exact same way among all companies AND IS THUS COMPARABLE AMONG ALL COMPANIES.

3. However, the entire world uses the traditional Accounting Book Value in their Return On Equity calculation as a comparison model. This is why most of the entire world cannot outperform the market averages. They don't know an efficient method of comparing the operating efficiency of one company relative to another company. But we do!

CHAPTER 10

A Very Short Chapter on the Predictability of the Finance Valuation Models

Let's leave the numbers and ratios once again and give our minds a much needed rest. After the last several chapters, a rest is a good thing. So on the lighter side, I think it would be a good time to discuss the differences between the fields of Accounting, Finance and Investments.

The intention of this book is to separate common sense from the complicated worlds of Accounting and Finance when it comes to superior stock selection for our own personal portfolios or for the portfolios of clients. Accounting has its ratios and Finance has its valuation models. Neither discipline works nearly as well as Clean Surplus when it comes to analyzing the operating efficiency of one company relative to the operating efficiency of another company.

You see, Accounting is just as the word implies. It is a system that accounts for almost everything that happens to and/or within a company. And we need Accounting. I am not saying that Accounting should be changed, nor am I criticizing Accounting. I need it and you need it. It's just that we need something a bit more understandable and easier to work with when trying to determine the operating efficiency of a company. And the accounting profession understands that. After all, it was the Accounting profession that developed Clean Surplus in order to solve this problem. So yes, accountants, thank you very much.

Finance is different from Accounting. The world of Finance uses the numbers from Accounting to make future financial decisions for the company. Finance attempts to answer questions related to

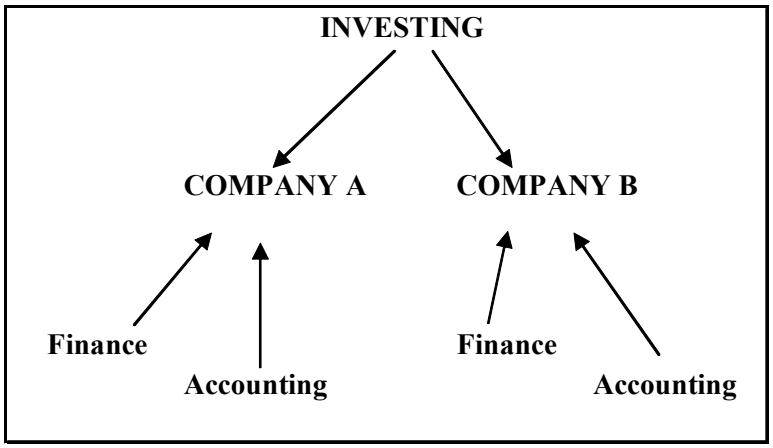
capital structure such as the optimal debt to equity ratio that should be maintained in a company. Capital structure is the amount of money borrowed through issuing bonds (and other types of debt) relative to the amount of money raised through the issuance of common stock.

Finance also determines which of the many projects a company should invest in for maximum return to the company and its shareholders. This process is part of the capital budgeting process. Capital budgeting also must consider the proper amount of money invested into each project, the cost of capital and how to raise that capital. So yes, there is a lot to the world of Finance.

Then there is the world of Investing. Many people think Finance is Investing. Let's put this common belief in the trash can before you become affected (infected) by it. Investing is forgoing gratification today for the potential of even greater gratification in the future. Thus, Investing is the discipline that must be able to determine which companies are capable of giving us greater gratification over the long term.

The Accounting and Finance disciplines were developed and continue to be developed to work ***within*** the company. Investing, on the other hand, deals with the comparison of one company to another. Since each company is unique, it is very difficult to accomplish this comparison using systems which weren't designed for comparison.

Accounting is different from Finance, which is different from Investing. Accounting and Finance were developed to work <u>within</u> the company while Investing must be able to rise above a particular company and compare an overall operating efficiency measure <u>between</u> many companies.



This inability of effectively comparing the operating efficiency of one company to another shows itself in the very few number of investment managers who are able to outperform the averages on a fairly consistent basis. Remember, only about 4% of the money managers can consistently outperform the market averages over a 10-year period on a risk-adjusted basis.

EFFICIENCY IS THE KEY

In order to invest in the stock market, you must master the science of selecting a portfolio of companies that are more efficient in their operations than the other companies out there in investing land.

There are three things you need to know about a company:

1. you need to know how efficient that company is in generating profits;

2. you need to know how consistent that company is relative to the generation of profits over many time periods; and finally,

3. you need to know how efficient other companies are in both areas so that you are able to compare them in order to select the most efficient and the most consistent companies for your portfolio.

The ratio most widely used to determine operating efficiency is the traditional Accounting Return On Equity ratio. BUT we know the traditional Accounting ratio doesn't work very well. In order to get on with your investing life you want to be able to tell the difference between the traditional Accounting Return On Equity and the Clean Surplus Return On Equity. I believe we covered this concept very well in the last several chapters. As we go on to the next chapter, you will see Clean Surplus in action and you will understand even more why you ***WANT TO USE CLEAN SURPLUS RETURN ON EQUITY ONLY***, just as we did with our bank accounts.

There is such a big difference between the traditional Accounting Return on Equity and the Clean Surplus Accounting Return on Equity that it is the difference between outperforming the market and not outperforming the market. Trust me on this one.

COLLEGE AND FINANCE VALUATION MODELS? THEY JUST DON'T WORK VERY WELL

As we learned above, there is a big difference between Accounting, Finance and Investing. The problem is that the academic world doesn't understand this difference. In fact, most of the Investing world is not aware of the difference between Investing and Finance. How do I know this? The Investment world continues to hire portfolio managers with Finance backgrounds and guess what? They cannot outperform the market averages on a continual basis. So folks, something is wrong with this picture.

The various Finance valuation models, which we will take approximately one or two seconds of our lives to discuss, were all developed with Finance and not Investing in mind. And guess what?

They don't work very well as investment tools. Let's go on and see if what I say is true.

In business schools across the country, we teach our students various stock valuation models, which were developed in order to determine the present and supposedly true value of a company. After all, if we were able to determine the true, present value of a company through the models, we could simply compare the model value of the company to the price the stock is presently selling for in the open market.

If a stock is selling for $50 a share and we determine, through one of the multitude of models, that it is presently worth $100 a share, we should immediately run out and buy as much of that stock as we possibly can. We can then go to the beach and wait until the market participants realize the stock is so greatly undervalued. Once this discrepancy in calculated value relative to the present price is discovered, everyone will then buy the stock until it reaches its full valuation of $100 a share. By that time, we'd be very rich because we originally purchased it for $50 a share. See how this works so well in my fantasy story?

What are these valuation models? Well, you asked, so I shall tell you. We have several versions of the dividend discount model: no growth, steady growth and variable growth. Please let us not forget the Capital Asset Pricing Model (CAPM), which calculates expected returns based on a measure of risk with risk determined by beta (what?). Then there are the discounted cash flow models, such as the sum of the discounted cash flows and the sum of the discounted 'free' cash flows. Of course, for any of these models, there may be several definitions for each variable within the model.

"Egads, whoa, stop, HOLD IT!!! What do you mean by several definitions of each variable within the various models? I don't even know what a variable is. What's going on here?"

I once attended a financial conference in Orlando, Florida. An academic gave an excellent lecture on Economic Value Added (EVA). For his research article, he polled executives from the Fortune 500 company list to ask their perception of the meaning of EVA. He received 168 different definitions. The same is true of some of the academic models.

Different meanings within the same model? Just a quick example. I mentioned Beta. Beta is a measure of risk. Roughly it is how a stock moves relative to the market.

For example, the market moves up 10% and your stock moves up 5% or 15% or down 10% at the same time the market moves up 10%. Beta tells us this relationship of movement relative to the market. The beta of the market is one. If a stock has a beta greater than one, it supposedly has a higher risk than the market. In turn, we expect the stock to return more than the return of the S&P 500 or Dow. If we take more risk, we expect a greater return.

Value Line calculates beta by using ***weekly data*** over a period of 5 years. One of the large brokerage companies calculates beta using ***monthly data*** over a 5-year period. And I have no idea over what time frame one of the on-line services calculates beta.

All I know is that at any one time, the beta for a single company is different, depending on the time frame used for the calculation of the company's beta. If this is so, and it is, how in the world can one use beta in a calculation and come up with a reasonable answer? The answer is ***you can't.*** Everyone involved in the calculation process will use different betas, depending on their source of beta, and of course, will come up with different answers.

Hey, my students continually give me different answers on tests and they are all using the ***same*** beta. And don't forget, my students are the future money managers of the world.

I can give you a very simple reason why I know these financial models don't work. If any of them did work, wouldn't all the academic professors of the world be as rich as Buffett?

How does Buffett view the academic models? Buffett pretty much feels that his position as the greatest investor ever is secure as long as our business schools continue teaching the models they now teach along with the efficient market hypothesis. So what does Buffett do? Ahh, read on.

You see, the models don't work and as a result, most of the money managers out there cannot outperform the averages. So we must determine for ourselves a nice simple method which we can use to select good companies for our portfolios. And this book gives us that method.

You see, not all analysts spend their lives futilely trying to determine the true value of a company. Some of them try to determine which companies earn a comparably high return on their asset (equity) base. If we can determine a proper Return On Equity model (ROE), we should be able to compare the operating efficiency of one company to that of another. ***The market will eventually reward the more efficient companies***. And we want to own these companies. Period.

The market will eventually reward the more efficient companies.

Bottom line: Let's not try to fool ourselves into believing that we should spend a lot of time trying to find a good valuation model, since none has been found since the beginning of time. Rather, let's try to find a very simple method of determining which companies are consistently more efficient in their operations than other companies we might be considering for purchase. The more efficient a company is, and the more consistent that company is in being efficient, the greater will be our reward if we own stock in that company.

This is a good start to our stock selection process, but there is more to the story. After all, if this were all you had to learn, this chapter would be the last chapter. We must now learn HOW the comparison process works. We must also learn how Buffett uses the process to determine a proper purchase price. And finally, we must learn about the predictability of the ROE as calculated by Clean Surplus Accounting. Yes folks, your financial future is contained in the next several chapters.

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SUMMARY OF CHAPTER 10

1) Accounting is different than Finance, which is different than Investing.

2) The valuation models just don't work very well. If they did, all the professors who teach Finance would be as rich as Buffett.

3) The key to investing is to find the companies which are consistently more efficient in their operations than other companies.

4) The market will eventually reward the more efficient companies, and these efficient companies are the companies we want to have in our portfolios.

CHAPTER 11

Clean Surplus ROE: The Only Comparable Efficiency Ratio

Developing the Tools to Determine the Probability of Predictability

You are now aware of a very straightforward method for calculating Return On Equity that is truly common to all stocks. We are calculating both the Return (Net Income) and the Owners' Equity the same way for each individual stock. We are comparing apples to apples and peaches to peaches.

Let's review by thinking once again of the bank account examples. Bank account A is earning more money in 2002 ($14) because it has a higher equity or asset base ($146). How did Bank A accumulate a higher equity (asset base) than Bank B when both began 1998 with the same amount of equity? Because Bank A earned more on its asset base. Since it earned a higher return and re-invested all the interest back into the account, Bank A was thus able to retain more dollars than Bank B.

Now here's the ultimate, most important, mind shattering, earth shaking, saber-rattling question in the entire world of investing. If you had the opportunity to buy the assets of Bank account A or Bank account B, which account would you be required to pay more for?

	Bank A			Bank B		
YEAR	EQUITY	INTEREST	ROE	EQUITY	INTEREST	ROE
2002	**$146.00**	**$14.00**	**10.00%**	**$142.00**	**$11.37**	**8.00%**
2001	$133.00	$13.00	10.00%	$131.00	$11.00	8.50%
2000	$121.00	$12.00	10.00%	$120.00	$10.85	9.00%
1999	$110.00	$11.00	10.00%	$110.00	$10.45	9.50%
1998	$100.00	$10.00	10.00%	$100.00	$10.00	10.00%

Now you know why some stocks sell for more than other stocks. They are earning more. How are they earning more? They are generating a higher return (ROE) on a larger and faster increasing asset base through the re-investment of their earnings. And if they have done this consistently in the past over a long period of time, we might logically expect them to continue to do so in the future.

My stocks are worth more than your stocks because I pick stocks with a high and very consistent ROE (Clean Surplus Accounting), and my stocks retain more profits and thus build the asset base faster than your stocks. The larger the asset base, the more products it can produce. The more products, the more sales. The more the sales, the more profits. The greater the profits, the higher the value of the company. Period!

If I must compare one company with another as to greater operating efficiency, I have a very simple and practical method to do so. And now, so do you.

CLEAN SURPLUS

OK everybody, ready to analyze real stocks? Let's begin with General Electric. We begin our analysis with Book Value from January of 1986. Why 1986? 1986 just happened to be the first year for which I had data and we would like to have at least ten years of data so we can see if the stock exhibits a pattern of consistency.

We begin with Book Value (Owners' Equity) from the Balance Sheet, or the traditional Accounting Book Value we are all

familiar with. The academic research terms this 'dirty' Book Value. Why do we begin with Balance Sheet Book Value? It's easier than going back to 1888 or so (yes, GE is a very old company) and trying to find beginning Book Value (Owners' Equity). So we begin with "dirty" Book Value (Owners' Equity) and clean it up.

GENERAL ELECTRIC

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY
2002	$7.16	$1.60	$0.72	$0.88	**22.36%**
2001	$6.39	$1.41	$0.64	$0.77	22.08%
2000	$5.67	$1.29	$0.57	$0.72	22.76%
1999	$5.09	$1.07	$0.49	$0.58	21.03%
1998	$4.58	$0.93	$0.42	$0.51	20.32%
1997	$4.11	$0.83	$0.36	$0.47	20.21%
1996	$3.70	$0.73	$0.32	$0.41	19.75%
1995	$3.33	$0.65	$0.28	$0.37	19.54%
1994	$3.00	$0.58	$0.25	$0.33	19.35%
1993	$2.71	$0.51	$0.22	$0.29	18.84%
1992	$2.48	$0.42	$0.19	$0.23	16.96%
1991	$2.22	$0.43	$0.17	$0.26	19.39%
1990	$1.97	$0.40	$0.16	$0.24	20.43%
1989	$1.75	$0.36	$0.14	$0.22	20.72%
1988	$1.56	$0.31	$0.12	$0.19	20.04%
1987	$1.41	$0.27	$0.11	$0.16	18.95%
1986	$1.28	$0.23	$0.10	$0.13	17.70%

Looking at the very bottom line, we begin by taking 1986 Net Income of $.23 and then subtract $.10 of Dividends. This leaves us with $.13 of retained earnings. We then add the retained earnings of 1986 ($.13) to the beginning 1986 Book Value ($1.28), which gives us beginning Book Value for 1987 of $1.41.

GENERAL ELECTRIC					
YEAR	OWNERS' EQUITY	NET INCOME	DIVIDENDS PAID	RETAINED EARNINGS	RETURN ON EQUITY
1987	$1.41	$0.27	$0.11	$0.16	18.95%
1986	**$1.28**	**$0.23**	$0.10	$0.13	**17.70%**

In order to calculate the ROE for 1986, we use the Net Income of $.23 (Return) and divide it by the Book Value (Owners' Equity) of 1986 ($1.28) to obtain a Return On Equity (ROE) for 1986 of 17.70%.

Remember the formula from the first chapter

In Clean Surplus Accounting,

Net Income minus Dividends = Clean Surplus Retained Earnings

And to find Book Value (Owners' Equity) for the present year, we must add last period's Retained Earnings (Net Income – Dividends) to last period's Book Value (Owners' Equity). Just think of the bank account examples. It's the exact same method.

$$\mathbf{BV_{1983} = BV_{1982} + (Net\ Income\text{-}Dividends)_{1982}}$$

OR

$$\mathbf{BV_{1983} = BV_{1982} + (Clean\ Surplus\ Retained\ Earnings)_{1982}}$$

Now you understand why I had you look at the bank account examples so many times. You calculate the Book Value (Owners' Equity) and ROE with stocks the exact same way you did with the bank accounts. Yes, it's clean and simple.

Remember, we are going through these calculations so we can calculate the Return On Equity, which is Net Income (Return) divided by the beginning year Clean Surplus Book Value (Owners' Equity). A high and consistent ROE tells us most of what we need to know about a stock.

I'm going to show you all 30 Dow stocks in the Top Dogs of the Dow chapter (Chapter 16), and we'll perform the simple analysis together on each of the 30 stocks. We will then see if the Clean Surplus ROE can predict future returns. (Oh yes it can!!!)

After all, we are looking to see if Clean Surplus Accounting and the ROE developed from Clean Surplus Accounting lend themselves to predictability. Rather than wait, I'll tell you right now. The ROE certainly does indeed lend itself to predictability.

I FORGET! WHAT ARE WE LOOKING FOR? LET'S REVIEW

We are trying to find a ***comparable*** Return On Equity ratio so that we may compare the operating efficiency of one company to the operating efficiency of another company. In order to find a comparable ROE for all companies, we must configure both the Return and the Equity in the same manner for each and every

company. Traditional Accounting ***does not*** allow us to do this. Clean Surplus Accounting absolutely ***does*** allow us to do this.

The Clean Surplus asset base is comprised of common stock sold to investors plus all Retained Earnings (Retained Profits), and the Clean Surplus Earnings number is really Net Income. Or as they said in 1895, earnings before abnormal charges.

What have we accomplished here? Net Income is configured *before* we adjust for individual company charges. Thus, Net Income is calculated the same among all companies.

Always remember that Book Value (Owners' Equity) under Clean Surplus is comprised of the money the company raised through common stock sold to investors plus all retained income.

If Owners' Equity is calculated in the same manner for all companies, then both the Owners' Equity and Net Income (from which Owners' Equity is partially derived) are common among all companies. If this is true, and it is, then the Return On Equity ratio as configured by Clean Surplus Accounting is truly a comparable method of determining operating efficiency. And most importantly, this method is common to all companies.

Return On Equity as configured by Clean Surplus Accounting is truly a comparable method of determining operating efficiency.

I'm sorry if I sound like I'm repeating myself, but I'm trying to make sure you understand the basic premise of investing, which is evidently lost on most professional money managers. O.K., here we go.

Let's now look at just the ROE of both General Electric and General Motors, with the ROE configured using Clean Surplus Accounting. We are looking only at the Clean Surplus ROEs for our comparison. We'll look at the entire worksheet in Chapter 16.

	GENERAL MOTORS ROE	GENERAL ELECTRIC ROE
Average ROE	**7.35%**	**20.10%**
2002	3.42%	22.41%
2001	4.65%	22.14%
2000	13.48%	22.40%
1999	15.23%	21.02%
1998	9.93%	20.31%
1997	16.83%	20.19%
1996	13.38%	19.73%
1995	19.91%	19.52%
1994	19.89%	19.33%
1993	7.14%	18.82%
1992	-13.44%	16.96%
1991	-19.02%	19.40%
1990	-7.63%	20.44%
1989	12.58%	20.72%
1988	14.83%	20.05%

When using Clean Surplus Accounting as we have above, we see that GE has a high average ROE (20.10%) and a relatively consistent ROE, while GM has a low average ROE (7.35%) and a very inconsistent ROE. Again, please be aware both ROEs were configured using Clean Surplus Accounting (bank account example), and not the traditional Accounting ROE that we are so familiar with.

When you consider that the ROE is a measure of operating efficiency, we come to an age-old question. Would you rather invest in a very efficient company such as GE, or would you rather invest in a very inefficient company such as GM?

Remember that the market hates inconsistency. We see that General Motors has a negative ROE of 19.02% in 1991 and a positive 19.89% in 1994. In some years it is making a lot of money and in some years it is losing a lot of money.

Now look at General Electric. The ROE is high and very consistent, with a bias toward an increasing ROE. The market likes consistency and the market rewards those companies that have a high and consistent ROE.

By the way, in the past ten years (as I write this), GE stock has risen from a split adjusted $6 per share to $24 per share for a 300% increase, not including dividends. GM's stock has gone from $35 to $33 for no increase except for dividends. Well, I guess what I said is true about the market rewarding a high and consistent ROE.

The market loves consistency and the market rewards those companies with a high and consistent ROE.

What you have discovered is a truly comparable method of determining operating efficiency. And this method is common to all companies.

The question we will answer a bit later in this book is whether the ROE is an indication of the future return of a portfolio. It certainly looks to be the case with GE and GM.

Bottom line is if the ROE is an indication of the future returns, we can then fill our portfolios with stocks that have high and consistent ROEs and the rest will take care of itself. The answer to the question of ROE being an indicator of future returns will make you smile.

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SUMMARY OF CHAPTER 11

1) In Clean Surplus Accounting, Net Income minus Dividends = Retained Earnings

$$BV_{1983} = BV_{1982} + (\text{Net Income-Dividends})_{1982}$$

OR

$$BV_{1983} = BV_{1982} + (\text{Clean Surplus Retained Earnings})_{1982}$$

2) Return On Equity, as configured by Clean Surplus Accounting, is truly a comparable method of determining operating efficiency.

3) The market loves consistency, and the market rewards those companies with a high and consistent ROE.

CHAPTER 12

What Buffett Looks for in a Company

How Clean Surplus Accounting Recognizes the Quality of a Company

I personally believe the numbers eventually tell us almost all we need to know about a company. My research work and my Top Dogs of the Dow Theory demonstrate the usage of numbers in valuation. It is my belief that most money managers think too much. They feel they must know everything there is to know about a company. I, on the other hand, believe you don't have to know who the CEO plays golf with. I don't believe you must know if the company has a day care center for the workers or if they have special parking lots or if the company has a politically correct working atmosphere.

The reason I don't worry about all of this is because if a company is doing everything right, then it will eventually show itself in the bottom line numbers. It will show up in the Return On Equity as configured by Clean Surplus Accounting.

However, for now, let's leave the numbers behind while we delve into the qualitative aspects of a company that Warren Buffett looks for in a "good" company.

Qualitative simply translates into those aspects (qualities) of a company that in many instances cannot be measured with specific numbers on the Income Statement or Balance Sheet. I just want you to remember as we go over this area that the Return On Equity as configured by Clean Surplus Accounting shows almost everything we are about to discuss. In other words, I believe that all the good (or bad) "stuff" that the analysts normally look for in a company

eventually flows down to the bottom line and shows itself sooner or later in the operating efficiency (Return On Equity) as configured by Clean Surplus.

So remember as we go through this chapter that it is my belief that all the subjective and qualitative aspects of a company eventually expose themselves in the bottom line numbers such as the ROE. However, let's look at these qualitative aspects of a company so we can begin to understand the "common sense" reasoning behind why some companies have a high and consistent ROE and other companies fail to achieve that high and consistent ROE.

BUFFETT

Buffett is known as a value investor. It is difficult to understand why Buffett has been termed a value investor and not a growth investor while having had large positions in such companies as McDonald's and Disney in the past and why he has growth companies such as Geico, Coke and American Express in his Berkshire portfolio at the present time. Once you begin to understand Buffett, you will soon determine he is actually a growth investor buying growth stocks at a very good value. This point is well proven through the use of Clean Surplus ROE. Let's discuss the types of businesses Buffett might consider for his portfolio. And it is these specific types of businesses that have the ability (with good and honest management) to possibly exhibit a high and consistent Clean Surplus ROE.

THE CONSUMER MONOPOLY VERSUS THE COMMODITY TYPE OF BUSINESS

Buffett divides the investment world into two main categories. He classifies these categories as the good and profitable consumer monopoly types of businesses and the not-so-profitable commodity

types of businesses. Once Buffett identifies a consumer monopoly company, he begins his financial calculations. If he decides to add a particular security to his portfolio, he will wait for an adverse market, industry or individual company condition to misprice that security and give him his predetermined purchase price.

Buffett is well known for his extraordinary patience. It is this patience that has rewarded him so very well over the years because he knows all too well that sooner or later he will be able to buy the stock of his choice at his predetermined price.

THE COMMODITY TYPE OF BUSINESS: COMPANIES BUFFETT AVOIDS

A commodity type of business is a business that manufactures and/or sells a non-differentiated product that is also manufactured and sold by one or several other companies. The airlines, car manufacturers, producers of cyclical products such as steel, oil, gas, and lumber are considered commodity companies by Buffett. In other words, a commodity type of business has considerable competition in the marketplace. For the most part, a commodity type business has very little or possibly no product differentiation except price. Please be aware not to confuse product differentiation with effective marketing or advertising.

A commodity type of business has lots of competition and very little product differentiation.

Because there is little or no product differentiation and because of immense competition, the only weapon employed by a commodity type of business is price reduction. As competition enters the market, prices must be lowered. As prices are lowered, profit margins may become almost non-existent.

Little product differentiation and intense competition lead to low profit margins.

However, commodity businesses do well when the economy is doing well. During an economic expansion, the demand outpaces supply and companies such as the auto manufacturers can make a lot of money. However, when the economy is not doing so well, these companies will fall from grace in a very short period of time.

Let's look at the ROE of General Motors and General Electric once again. Specifically look at GM. Isn't the ROE very inconsistent? When you see this type of inconsistency, you are usually looking at a cyclical and/or commodity type of company.

	GENERAL MOTORS ROE	**GENERAL ELECTRIC ROE**
Average ROE	**7.35%**	**20.10%**
2002	3.42%	22.41%
2001	4.65%	22.14%
2000	13.48%	22.40%
1999	15.23%	21.02%
1998	9.93%	20.31%
1997	16.83%	20.19%
1996	13.38%	19.73%
1995	19.91%	19.52%
1994	19.89%	19.33%
1993	7.14%	18.82%
1992	-13.44%	16.96%
1991	-19.02%	19.40%
1990	-7.63%	20.44%
1989	12.58%	20.72%
1988	14.83%	20.05%

Another shortfall of the commodity type of business is that they must use most of their profits to upgrade their manufacturing equipment in order to stay competitive. Thus, a company of this type cannot use the majority of its profits to increase the size of its manufacturing asset base. It must use profits just to remain competitive and upgrade the present asset base. If a company cannot ***add*** to its asset base, it cannot increase market share. If it doesn't

increase market share, it cannot increase sales. If it cannot increase sales, it cannot increase earnings per share. If it cannot increase earnings per share, the price of the stock will not increase.

General Motors is actually losing market share. Thus we know GM's Retained Earnings are NOT being used to increase the size of the asset base.

If Retained Earnings are not being used to increase the asset base, how can we expect Earnings to increase?

Still yet another shortfall is the heavy debt load of many of the commodity type of companies. Think again of General Motors. General Motors has approximately 77% long-term debt relative to total capitalization. GM could take all its profits for the next ten years and still not pay off its debt.

These are the types of companies Buffett avoids. They are not consistent in their earnings and for the most part, they cannot use Retained Earnings to grow the company, but instead must use their Retained Earnings just to stay competitive.

The only weapon a commodity type of company can use is price reduction.

How else can we identify these types of companies? They are identified by intense competition due to multiple companies producing the same product with very little brand loyalty towards that product. When demand slacks off, the only weapon these companies have against one another is price reduction.

Price reductions lead to lower profits. Lower profits lead to lower share prices.

Price reduction, in turn leads to low profit margins, low return on shareholders' equity and very inconsistent earnings.

THE CONSUMER MONOPOLY: THE TYPE OF BUSINESS BUFFETT LOVES

A consumer monopoly is a business which is entirely opposite of the commodity type of business. We can think of many companies that have brand loyalty or have had brand loyalty in the past.

When you were younger and were thirsty, you had a Coke. When you thought about chocolate, you asked for a Hershey bar. When you thought of a record player, you thought of RCA. As you grew older and began to shave, you thought of Gillette.

Has competition come into the market for some of these products? Certainly. Has the market changed the need for certain products? Certainly. Does anyone have a record player any longer? We have an entire generation who at this moment has no knowledge of vinyl records. But did RCA make several generations happy and did several generations of investors obtain great wealth by investing in RCA? I certainly know this to be true. Yes, consumer monopolies can last many, many years.

When a company develops brand loyalty for their particular product, they are building the goodwill of their company. Goodwill can add a great deal of value to a company and as a stockholder, you certainly know this to be a good thing. If you think back to the commodity type of businesses, you will be hard pressed to find a steel company (commodity type of company) with as much goodwill built into its stock price as Gillette or Coca Cola.

A Consumer Monopoly Has Brand Loyalty

Sometimes it is difficult to determine a consumer monopoly from a product alone. However, once we look into the financials of a company, we will be able to determine who is building a consumer monopoly and which consumer monopoly is losing its luster. We delve into the financials in other chapters, but for now, let's look at the attributes that identify the consumer monopoly.

Brand loyalty adds goodwill to a company.

A consumer monopoly will have an identifiable product or service. The company will probably maintain a low debt margin. Low debt is particularly important because if a company is generating a good profit, it is able to reinvest that money to build its investment (asset) base, upon which it can earn still more profits rather than using profits to pay interest on debt.

Goodwill adds to the Value of the Company.

If a company must enter into the debt markets, it very probably means it is not generating enough profits to grow the company sufficiently to warrant it a long-term investment. Buffett would much rather own a company with a little debt than a lot of debt.

Low Debt is a Good Thing.

One of the most important questions is ***does the company earn a high Return On Shareholders' Equity?*** In other words, is the company efficiently using the equity money investors have invested in the company?

The next question is does the company then use its Retained Earnings (profits re-invested back into the company) to grow its asset base and thus grow the company? Is the company earning the same high Return On Equity on the newly invested equity (Retained Earnings) as it did on its previously invested equity? And if the company is not adding to the asset base with Retained Earnings, is the company using that money to add value to shareholders by repurchasing some of its own outstanding shares?

Buying back shares allows profits to be distributed among fewer shares, which means more profits per share. This of course, increases the value of the remaining shares, which is a good thing for the remaining shareholders.

Bottom Line: A high ROE tells us the company is using its Retained Earnings in an efficient manner.

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SUMMARY OF CHAPTER 12

A well-run growth company will use its Retained Earnings to grow its asset base. The more the asset base grows, the more products the company produces. The more products, the more sales. The more sales, the more profit. The more profit, the higher the ROE. The higher the ROE, the higher the value of the stock. And folks, that's what this is all about.

1) A commodity type of business has lots of competition and very little product differentiation.

2) Little product differentiation and intense competition lead to low profit margins.

3) If Retained Earnings are not being used to increase the asset base, how can we expect the earnings to increase in the future? We can't.

4) The only weapon a commodity type of company can use is price reduction. Price reductions lead to lower profits. Lower profits lead to lower share prices.

5) A consumer monopoly has brand loyalty.

6) Brand loyalty adds goodwill to a company.

7) Goodwill adds to the value of the company.

8) Low debt is a good thing.

9) A high ROE tells us that the company is making efficient use of its asset base.

CHAPTER 13

Buy Low and Sell High

How Buffett Uses Clean Surplus Accounting to Determine the Future Target Price and the All-Important Purchase Price

The Purchase Price

Everyone knows the key to making money in the stock market is to buy low and sell high. In the past, we didn't have a clue as to what was high and what was low. By the time you have completed this chapter, you will learn how to calculate both a purchase price and a sell price in order to obtain your long-term required return. After all, this is how Warren Buffett became one of the richest individuals in the world.

In this chapter, I will show you, according to Mary Buffett and David Clark in their book entitled Buffettology, how Warren Buffett determines a 'target' price and a 'purchase' price. A slight problem is even Mary and David don't know that Warren Buffett uses Clean Surplus Accounting. But thank you, Mary and David, for showing the world the target price and purchase price calculations.

Warren Buffett uses Clean Surplus Accounting to determine the level of operating efficiency (ROE) and the consistency of that operating efficiency. The more consistent a company is in its operating efficiency, the better he (or anyone) is able to predict a future price. If he can effectively predict a future price, he can then determine when the value (market price) of the company gets to a low

enough level (purchase price) that will generate ***his*** required return over the next decade. The difference between his purchase price and his target price is his profit.

Possibly the most unique aspect of Warren Buffett is that he is extremely patient. He selects his security purchase price very, very carefully. Then he waits and waits until an opportunity arises that presents him with this previously calculated purchase price.

PATIENCE

I don't think there is another person in the world who is as patient as Buffett. How can he be so patient? He has other uses for his cash while he is waiting for the "right" price. For one thing, he engages in arbitrage. And he is not opposed to buying some preferred stock. In other words, he knows what to do with his idle (?) time and idle money.

Most of us do not have the time (nor the cash) to learn and then put into action what Warren does so successfully with his short-term cash. All we can do for the moment is determine what he does with his long-term cash, which is invest in good growth stocks at a good value (price). Or we can just determine what the best stocks are, buy them and let the very good company managers continue their good work. The market eventually recognizes good work and our good stocks will give us a very nice profit.

What is meant by management performing good work? Earning a very good return on shareholders' equity and reinvesting most of that profit back into the company, and then generating an equally good return on that re-invested capital. All we have to do is search out those stocks.

We will construct a superior performing portfolio with those stocks that will allow us a greater predictive ability in a later chapter. For now, let's look at examples and practice using those examples. Let's see how Warren Buffett uses Clean Surplus Accounting to determine when a company represents a good value.

BACK TO BASICS

Let's look at two bank accounts once again.

	BANK A			BANK B		
YEAR	**EQUITY**	**INTEREST**	**ROE**	**EQUITY**	**INTEREST**	**ROE**
2012	**$378.00**	**$37.80**	**10.00%**	**????**	**????**	**????**
2002	$146.00	$14.00	10.00%	$142.00	$11.37	8.00%
2001	$133.00	$13.00	10.00%	$131.00	$11.00	8.50%
2000	$121.00	$12.00	10.00%	$120.00	$10.85	9.00%
1999	$110.00	$11.00	10.00%	$110.00	$10.45	9.50%
1998	$100.00	$10.00	10.00%	$100.00	$10.00	10.00%

Bank Account A is acting very much like a bond. It is returning 10% per year on our money. If we owned a bond paying 10% and were able to reinvest our interest payments also at a rate of 10%, we would have Bank Account A.

If the bond paid 10% per year for the past 10 or 15 years, we could make a pretty good assumption that the bond may return 10% to us over the next 10 years.

The problem with the stock market is common stocks are just not as consistent as bonds. However, it is our job (not that difficult) to find the companies that do indeed earn a fairly consistent return on the invested equity capital.

A VERY IMPORTANT POINT

Notice the amount of money in Bank Account A in the year 2002. It is $146. We began in 1998 (five years previously) with just $100. Therefore, $46 of the $146 is retained interest (Retained Earnings).

What is so important is that in 2002, Bank A is returning 10% on the entire $146. This means that Bank A is earning 10% on the original $100 and also earning 10% on the re-invested capital of $46.

In other words, Bank A is earning a high return on the **re-invested** capital as well as the original capital.

Look at bank B. It is earning an ever-lower rate of return on the money in the account. This is not a good sign. It means that Bank B is not deploying its new (re-invested) capital as efficiently as Bank A.

BACK TO THE GOOD BANK

If we assume that the bank (or bond, or stock) will pay us 10% per year for the next 10 years, and we are reinvesting all of that money back into the account (retaining 100% of Earnings), then we can, with a certain degree of accuracy, project out and estimate how much money we will have in Bank A ten years from now.

How do we do this? We begin with the amount (equity) we have in Bank A in 2002, which is $146. We know, or are assuming with a certain degree of confidence, that the future rate of return on our capital will continue to be 10%. We know we are retaining all that we earn. Thus, we project this $146 out for 10 years at the growth rate of 10%.

	BANK A			**BANK B**		
YEAR	**EQUITY**	**INTEREST**	**ROE**	**EQUITY**	**INTEREST**	**ROE**
2012	**$378.00**	**$37.80**	**10.00%**	**????**	**????**	**????**
2002	$146.00	$14.00	10.00%	$142.00	$11.37	8.00%
2001	$133.00	$13.00	10.00%	$131.00	$11.00	8.50%
2000	$121.00	$12.00	10.00%	$120.00	$10.85	9.00%
1999	$110.00	$11.00	10.00%	$110.00	$10.45	9.50%
1998	$100.00	$10.00	10.00%	$100.00	$10.00	10.00%

(Only if you're really interested, the actual calculation is: $146 x (1+ (.10 x 1.0) ^10. It is the amount of $146 which we multiply by 1 plus the interest rate (10% or .10) times the retention rate (re-invested rate) of 100% (or 1.0) all raised ^ to the 10th power. The 10th power represents compounding over the time period of 10 years.)

Of course, we use a computer spread sheet, put the formula in once and save the formula to all the stocks in my program database. Got to love computers.

The above calculation gives us the amount of money (equity) we will have in Bank A in the year 2012. If we know with some certainty the amount (asset base) we will have in the bank in 2012 ($378), and we assume our rate of return is still going to be 10%, we can then calculate our interest (Earnings) in the year 2012.

The earnings or interest we will earn in 2012 will be the amount we have in the bank in 2012 ($378) times the 10% which we feel Bank A will still be earning for us at that time. Well, 10% times $378 gives us interest (earnings) of $37.80, which is the amount we will earn in the year 2012 in Bank A.

BANK ACCOUNT B

Let's look at Bank Account B. It has a decreasing rate of return. The big question is how in the world will we be able to figure out what we will have in the bank in the year 2012 if we don't know what the rate of return on our invested money will be over the next 10 years? The answer is we don't know. We don't have a good consistent rate of return upon which we are able to base our projections. If we can't make a good assumption because of inconsistency, then why even think of investing in Bank B when Bank A is just around the corner? And yet some people will invest in Bank B because they feel somehow, by some grace of Lady Luck, it will turn around and earn much more than Bank A.

Watch that word turnaround. Buffett has been heard to say that turnarounds seldom turn. Why even take the chance? Especially when you have no clue as to the probability of a turnaround. Buffett loves

probabilities and yet he won't take many chances like that, so why should we?

A REAL STOCK

Let's look at a real stock. Let's begin with our favorite example.

GENERAL ELECTRIC

	2012 OE	NET INC.	10-YR AVG. P/E RATIO	TARGET PRICE 2012	REQUIREI RETURN	BUY PRICE
2012	**$21.15**	**4.35**	**23.0**	**$100**	**12.60%**	**$31**

YEAR	OE	NET INC.	DIV. PAID	RETAINEI EARNING	RETURN ON EQUITY	10-YR AVG ROE	AMOUNT RETAINED	10-YEAR AVG RET'N
2002	$7.14	$1.60	$0.72	$0.88	**22.41%**		**55.00%**	
2001	$6.37	$1.41	$0.64	$0.77	**22.14%**		**54.61%**	
2000	$5.67	$1.27	$0.57	$0.70	**22.40%**		**55.12%**	
1999	$5.09	$1.07	$0.49	$0.58	**21.02%**		**54.21%**	
1998	$4.58	$0.93	$0.42	$0.51	**20.31%**		**54.84%**	
1997	$4.11	$0.83	$0.36	$0.47	**20.19%**		**56.63%**	
1996	$3.70	$0.73	$0.32	$0.41	**19.73%**		**56.16%**	
1995	$3.33	$0.65	$0.28	$0.37	**19.52%**		**56.92%**	
1994	$3.00	$0.58	$0.25	$0.33	**19.33%**		**56.90%**	
1993	$2.71	$0.51	$0.22	$0.29	**18.82%**	**20.59%**	**56.86%**	**55.72%**

We see that GE has a pretty consistent ROE. In fact, the ROE is steadily increasing, which is of course a good thing. The most important aspect of these calculations is that the more consistent a stock's ROE, then the more accurate our projections will be.

The most important part of all these calculations is the more consistent a stock's ROE, then the more accurate our projections will be.

Buffett likes to take averages over periods of 10 years. He will take the past 10-year average of the ROE, which in the case of GE is 20.59%.

The next question to ask, is GE putting all of its earnings back into the company? The answer is no. It is paying some of the earnings out in the form of dividends. Net Income minus the Dividends gives us the Clean Surplus Retained Earnings or the amount of the Net Income GE is putting ***back*** into the company.

To figure this rate of reinvestment or ***retention rate***, we simply divide the Retained Earnings by the total Net Income. For 2002 (see below), this is Retained Earnings of $.88 divided by Net Income of $1.60 ($.88/$1.60 = 55%) which gives us a retention rate of 55.00%. The retention rate is the ***percentage*** of the Earnings (Net Income) retained or put back into the company. You can see this in the column entitled "Amount Retained."

Buffett then takes the average retention rate of, you guessed it, the past 10 years, which is 55.72%.

GENERAL ELECTRIC								
YEAR	OE	NET INC.	DIV. PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YR AVG ROE	AMOUNT RETAINED	10-YEAR AVG RET'N
2002	$7.14	$1.60	$0.72	$0.88	**22.41%**	**20.59%**	**55.00%**	**55.72%**

Let's catch up here for a moment. GE has an average 10-year ROE of 20.59%. Of that amount, GE has averaged, over the past 10 years, a retention rate of 55.72%. So we know GE's 10-year ROE on invested equity (20.59%) and how much of those earnings that GE is retaining (55.72%) or putting back into the company. Remember, these are all 10-year averages.

Why does Buffett use 10-year averages? I don't know, but it could be that over any 10-year period, the economy goes through

recessions and also economic expansions. As the economy goes through these cycles, ***expectations*** about a company's future will rise and fall with the mood of all of us. Thus, he probably feels that over a 10-year period, we see the average of at least one complete economic cycle, and of course, the ensuing mood swings that accompany both the good and bad times. Hey, makes sense to me.

THE P/E RATIO

Speaking about mood swings, the price-to-earnings ratio (P/E ratio) reflects these mood swings. The price to earnings ratio reflects investor expectations about the future earnings of the company and these expectations rise and fall with the performance of the economy, both actual and perceived.

A few years ago, everyone was happy and investors expected earnings to go to the sky. The growth of some stocks was expected to rise exponentially (like, more than go to the sky). These fantastic expectations were reflected in the very high P/E ratios at that time.

However, as I write this, the mood shift has taken a 180-degree turn. Everyone is now focused on all the negatives in the world and that mental depression is being reflected in the stock market. The news seemingly cannot get any worse and people are selling into each and every rally. The stocks are going down and down as expectations about future earnings continue to decrease. As stock prices decline, the P/E ratio declines.

The price-to-earnings ratio reflects investor expectations about the future earnings of the company, and these expectations rise and fall with the performance of the economy, both actual and perceived.

The bottom line on the P/E ratio is that it represents a certain multiple of earnings for which the stock is selling. This multiple is different for each company and each industry and each cycle in the economy (whew!). The P/E ratio is based on the price of a stock that

reflects the perceived growth of earnings, either up or down for whatever reason or reasons.

Please be aware that the P/E ratio is configured differently by the different reporting sources. One source uses present price relative to the trailing 12-months of earnings, while another source will use the past 6 months of actual earnings and the next 6 months of its own projected earnings.

Different sources calculate the P/E Ratio in different ways. Value Line uses recent price divided by the latest six months' earnings per share plus estimated earnings for the next six months. Other sources use the trailing 12 months' earnings.

BACK TO THE FUTURE

Please remember to look at the spreadsheet of GE as I go on with the numbers. We discussed how to obtain a future earnings projection. Just reviewing a bit, we take the Owners' Equity of 2002 ($7.14) and project that out 10 years by using the return on that equity (past 10-year average of 20.60%) and also the retention rate (past 10-year average of 55.72%). This calculation gives us 2012 Owners' Equity of $21.15.

In order to obtain 2012 Net Income, we multiply 2012 OE ($21.15) by the past 10-year average of ROE (20.60%), which gives us 2012 Net Income of $4.35.

Once we calculate 2012 Net Income, we then multiply the Net Income ($4.35) by the past average 10-year P/E ratio (23) to give us our ***expected*** price in 10 years of $100. ($4.35 x 23 = $100). This $100 becomes our approximate 10-year projected target price.

GENERAL ELECTRIC									
	2012 OE	NET INC.	10-YR AVG. P/E RATIO	TARGET PRICE 2012	REQUIRED RETURN	BUY PRICE			
2012	$21.15	4.35	23.0	$100	12.60%	$31			
YEAR	OE	NET INC.	DIV. PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YR AVG ROE	AMOUNT RETAINED	10-YEAR AVG RET'N	
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2000	$5.67	$1.27	$0.57	$0.70	**22.40%**		**55.12%**		
1999	$5.09	$1.07	$0.49	$0.58	**21.02%**		**54.21%**		
1998	$4.58	$0.93	$0.42	$0.51	**20.31%**		**54.84%**		
1997	$4.11	$0.83	$0.36	$0.47	**20.19%**		**56.63%**		
1996	$3.70	$0.73	$0.32	$0.41	**19.73%**		**56.16%**		
1995	$3.33	$0.65	$0.28	$0.37	**19.52%**		**56.92%**		
1994	$3.00	$0.58	$0.25	$0.33	**19.33%**		**56.90%**		
1993	$2.71	$0.51	$0.22	$0.29	**18.82%**	**20.59%**	**56.86%**	**55.72%**	

LET'S DISCOUNT BACK – THE ALL IMPORTANT PURCHASE PRICE

Once we obtain the 10-year future target price, we can then discount that future price back to the present.

What? We just forecasted a price 10 years out; why do we want to get back to the present?

We've got to figure out the purchase price or value at which we want to purchase the stock today. You see, if we can assume with a fair degree of certainty what the future price will be in 10 years, we still must calculate the price to purchase today which will generate for us our required return. **And that purchase price is based on the *return we require* per year over the next 10 years**.

This is such an important concept and represents the pure genius of Warren Buffett. Everyone in the entire world is trying to put a value on a stock, and of course as I've mentioned several times

before, the academic pricing models do not work very well if at all. If they did work, all the professors in all the universities who teach these models would be as rich as Buffett.

You see, by using Buffett's method, we are not putting a value on the company relative to its worth (we can't); we are putting a value on a stock relative to what it is worth **to us**. We should purchase GE at a price of $31 per share today ***if we want a total return of 15% per year,*** which would include 2.4% in dividends and 12.6% in stock appreciation.

The more consistent the stock in the past, the more comfortable we are with our projections for the future.

Remember that old saying, buy low and sell high? Well, we just figured out the high price, which is the 2012 target price. Now, we've got to figure out the purchase price, which is the "low" part of that very famous saying.

Let's say we desire a 15% rate of return. Why did I say 15%? Well, in a case study of Warren E. Buffett found in the college text book by Robert Bruner, Case Studies in Finance, he (Brunner) suggests that Buffett's required rate of return is 15%. So let's use 15%.

Let's use General Electric once again. Right now, the stock is trading at approximately $29. It is paying a dividend of $.72 a share, which represents a 2.4% dividend return. Thus, if we want a 15% per year return, we are already receiving 2.4% in dividends. Therefore, the stock must appreciate (price increase only) just 12.6% per year (15%-2.4%). Please remember that a stock's total return is price appreciation ***plus*** dividends.

In order to calculate our purchase price, we must put the required return of 12.6% in the Required Return box of our spreadsheet. The computer will automatically discount back the future price 10 years at the rate of 12.6%, and give us a Buy Price of approximately $31 per share.

GENERAL ELECTRIC

	2012 OE	NET INC.	10-YR AVG. P/E RATIO	TARGET PRICE 2012	REQUIRED RETURN	BUY PRICE
2012	**$21.15**	**4.35**	**23.0**	**$100**	**12.60%**	**$31**

YEAR	OE	NET INC.	DIV. PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YR AVG ROE	AMOUNT RETAINED	10-YEAR AVG RET'N
2002	$7.14	$1.60	$0.72	$0.88	**22.41%**		**55.00%**	
2001	$6.37	$1.41	$0.64	$0.77	**22.14%**		**54.61%**	
2000	$5.67	$1.27	$0.57	$0.70	**22.40%**		**55.12%**	

(If you really need to know the formula, it is the future price ($100) divided by 1.126^{10}. Or the future price divided by 1 plus the 12.6% (.126) raised to the 10^{th} power. The 10^{th} power represents the number of years we are discounting. Yep, 10 years.)

As you can now see, the purchase price of GE should be approximately $31 per share. This means that if GE continues to generate a return on equity of approximately 20% and continues to reinvest approximately 55 or 56% of those earnings back into the company for growth, the 10-year future price (target price) will be $100 per share. Discount the future price of $100 per share back by 12.6% (required appreciation), and we obtain a purchase price of $31 per share.

Bottom line here is if the assumptions are correct, and in the past they have been, and we could purchase GE at $31 a share, we should see GE at approximately $100 a share in 10 years. This price appreciation plus the dividends will generate a total of 15% yearly rate of return for us.

Now you understand the importance of the purchase price. The purchase price is the basis for the return that a stock will generate for us over the next 10 years. Let me repeat.

The all-important purchase price determines what our total future return will be, which equates to price appreciation plus dividends.

IMPORTANT NOTE: APPROXIMATELY

As you can see, I use numbers like 12.6% and $100 target price and retention rate of 55.72%. Please don't get hung up on the decimal places or exact numbers. Buffett says that it is better to be approximately correct than precisely wrong. The future of the economics of the world, country and individual company can only be approximated. If the past has been consistent than we are assuming the future will be consistent. So "approximately" is the word of the day.

The other side of the market (other than economics) is the human emotion. I can tell you this with exactness. Human emotion can take those precise numbers and make them look rather silly.

Put both economics and human emotion together and think about this for a moment. Think about how much you were worth in 1999 and how much you were worth at the end of 2002. I would say your worth is not ***exactly*** the same.

So maybe you might think about how I handle the situation and do what Warren Buffett suggests. It's better to be approximately correct than precisely wrong. And I leave it at that.

LET'S LOOK AT GENERAL MOTORS

General Motors is also part of the Dow Jones 30 Industrials. However, the story on GM is different from that of GE. General Motors is a cyclical stock. How do we know this even if we didn't know anything at all about GM? Let's take a look.

GENERAL MOTORS

	2012 OE	NET INC.	10-YR AVG. P/E RATIO	TARGET PRICE 2012	REQUIRED RETURN	BUY PRICE
2012	**$152**	**18.86**	**10.0**	**$189**	**9.70%**	**$75**

YEAR	OE	NET INC.	DIV. PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YR AVG ROE	AMOUNT RETAINED	10-YEAR AVG RET'N
2002	$70.17	$2.40	$2.00	$0.40	**3.42%**		**16.67%**	
2001	$68.96	$3.21	$2.00	$1.21	**4.65%**		**37.69%**	
2000	$62.53	$8.43	$2.00	$6.43	**13.48%**		**76.28%**	
1999	$56.00	$8.53	$2.00	$6.53	**15.23%**		**76.55%**	
1998	$52.76	$5.24	$2.00	$3.24	**9.93%**		**61.83%**	
1997	$46.87	$7.89	$2.00	$5.89	**16.83%**		**74.65%**	
1996	$42.75	$5.72	$1.60	$4.12	**13.38%**		**72.03%**	
1995	$36.57	$7.28	$1.10	$6.18	**19.91%**		**84.89%**	
1994	$31.17	$6.20	$0.80	$5.40	**19.89%**		**87.10%**	
1993	$29.84	$2.13	$0.80	$1.33	**7.14%**	**12.39%**	**62.44%**	**65.01%**

And please remember what Warren Buffett says. Look at the ROE. The ROE will tell you all you need to know about earnings.

HIGH ROE

We are looking for a high and consistent ROE. First let's discuss the high ROE. Just what is a high ROE? The ROE of the two most widely used market averages, the Dow 30 industrials and the S&P 500, is approximately 13.38% as I write this. We want to fill our portfolio with stocks that have a higher ROE than the average of 13.38%. If we can achieve this (easy), we should be able to structure a portfolio that outperforms the market averages over the long term. In the chapter (Chapter 15) based on my dissertation research, the results on the S&P 500 show that over the time period of the study, all the portfolios structured with ROEs higher than the average ROE of all the stocks in the S&P 500, outperformed the market averages over the following 4-year time periods. ***I said ALL the portfolios.***

By the way, one of the differences between investing and gambling is investing means putting the odds on your side. In order to outperform the averages, we want to put the odds on our side. Thus, we must begin with a superior performing portfolio (above average ROE) as configured by Clean Surplus Accounting.

The average 10-year ROE of General Electric was a bit over 20%. The ROE of General Electric is certainly above the market average of 13.38%. General Motors, on the other hand, has a 10-year average ROE of 12.4%. This ROE is lower than the market averages. Out of the two stocks, General Electric is the more efficiently operated company as measured by Clean Surplus ROE.

Please note on GM I placed a required return of just under 10% rather than 15%. This is because as I write this, GM is paying a dividend of just over 5%. Thus, 10% appreciation plus 5% in dividends will give us our 15% percent per year return.

CONSISTENCY

The next aspect of ROE we want to consider is consistency. We can look at the ROE of General Electric over time and see that it looks relatively consistent with a bias toward an increasing ROE. However, we really don't know what consistent is. And consistent could really fall in the eye of the beholder. But one thing we can do is compare.

Look at the ROE of General Motors. I'm not sure what the definition of inconsistent is, but I see GM in 1994 with an ROE of over 19%, which is good, but then in 1998 the ROE was 9.93%, in 2001 the ROE was down to 4.65%, and 2002 was projected to be even lower. As I said, I'm not sure what inconsistent is, but I'm pretty sure the ROE of GM would fit the bill of ***inconsistent.***

What does ***inconsistent*** mean relative to the accuracy of our projections? For one, we have a very poor chance of accurately projecting the equity 10 years into the future. We really have no idea what the ROE will be over the next 10 years. In the past, the ROE has been all over the place, and "all over the place" seems very inconsistent to me. If the ROE has been very inconsistent in the past, we can assume it will be very inconsistent in the future.

If we cannot project the equity into the future with any degree of accuracy, we cannot project the future earnings. If we cannot project the future earnings then we cannot project the future price.

Here comes the important part. If we cannot project the future target price with any degree of certainty, we cannot discount back to the present to determine a proper purchase price. And in Buffett's world, the purchase price is all-important.

Yes, our computer spreadsheet does give us a purchase price for GM, but the question becomes one of probabilities. What is the probability that the future numbers are anywhere near accurate when GM has exhibited very inconsistent numbers in the past? Inconsistency does not breed accuracy.

If we cannot accurately project the future price due to past inconsistency, we cannot discount back to the present to determine a proper purchase price. And in Buffett's world, the purchase price is all-important.

COMPARE

Let's review our findings.

	GENERAL MOTORS ROE	GENERAL ELECTRIC ROE
Average ROE	**7.35%**	**20.10%**
2002	3.42%	22.41%
2001	4.65%	22.14%
2000	13.48%	22.40%
1999	15.23%	21.02%
1998	9.93%	20.31%
1997	16.83%	20.19%
1996	13.38%	19.73%
1995	19.91%	19.52%
1994	19.89%	19.33%
1993	7.14%	18.82%

General Electric has a high and relatively consistent ROE and the ROE is increasing as the years go on. General Motors has a low and very inconsistent ROE. The really big question becomes which stock would you rather have in your portfolio? Let's ask the blind kid.

THE BLIND KID – A SEA STORY

I want to share with you a little sea story. This story will help you think about avoiding stocks with an inconsistent ROE.

Whenever I want my students to remember an important point, I tell them a sea story to help them along. It falls in the category of learning by association. What is a sea story? A sea story is one that may not be totally correct. Sort of like the "fish that got away" story.

I was the first Director of the Student Managed Investment program at a university on the water in Palm Beach, Florida. Hey, I agree. Lucky me. But just remember the definition of luck. When opportunity meets preparation.

One of the students in my class was blind. Actually, he could see if he put something directly against his face, but he was declared legally blind. You know, I really respected that kid, but that's yet another sea story.

When I showed overhead projections on a screen, I would give him a copy of the projection sheet, which I had enlarged (a lot) prior to class so he knew what was going on during our classroom sessions. I must say, he had better listening skills than most.

We continually had guests coming to our class, as it was a pilot program and several businesses from the community donated money in order to sponsor the project. Several of the "important" people visiting our class from time to time were involved with trust departments run by the area banks. I don't have to tell you that most of them had General Motors in their portfolios. How do I know? Many of them showed me the stocks on their master lists from which they used to select stocks for their clients' portfolios.

I would give my best presentation when guests came to visit. I would perform a complete analysis and comparison on both GE and

GM. Finally, just to be a little critical and a little antagonistic, I would ask the blind kid about GE and GM.

I would call out in my most sincere and authoritative teaching voice, "Hey Billy, tell me about General Electric and General Motors."

My visually impaired student would always sit in the seat directly in front of me. When I asked this question, he would smile from one ear to the other. You see, no one paid much attention to the blind kid, so here was his chance to shine. He would smile, shake his head from side to side and say, "General Electric should be in our portfolio and General Motors should be in somebody else's portfolio."

A LESSON TO BE LEARNED

Of course, you know what I'm going to ask you. If a blind kid could see the difference, then what's your problem?

I mentioned previously that over one of my test periods, GE appreciated 300% while GM actually depreciated slightly except for dividends over that same time period. Looking at the differing ROEs of both stocks, we are beginning to see that the level and consistency of the ROE seems to have a direct relation to the future total returns. The ROE of General Electric was much higher than the ROE of General Motors and in turn, General Electric returned a much higher total return over the years relative to General Motors.

Why has General Electric been such a good performer? I don't know. Why has General Motors been a serious under performer? I don't know and I really don't care. General Electric is in my portfolio and General Motors is in someone else's portfolio.

SO YOU SEE, FOLKS

You see, folks, the ROE tells us so very much about a stock. In the previous chapter, we discussed many of the qualities Buffett looks for in a stock. Well, I can tell you one thing right now. If the ROE is not high and consistent, then you shouldn't even think about going any further in your analysis on that stock. A high and consistent ROE should be your very first filter in analyzing a stock. End of story!

OK, I will tell you why certain analysts recommend General Motors from time to time. General Motors is a cyclical stock. It doesn't make much money in bad times, but in good times, it can make a lot of money. So if you can time the cycles, then you can do well with a stock like GM.

But always remember this. Most of the money managers cannot outperform the averages on a yearly basis. Out of those who do outperform in one year, there is a 67% chance they will NOT outperform the following year. So you tell me. Who out there is in cycle with the cycles?

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SUMMARY OF CHAPTER 13

1) The key to purchasing a stock at your required rate of return is patience. A lot of PATIENCE.

2) The two most important elements of all our calculations are the level and consistency of a stock's ROE. The higher the level, the greater the expected return on that stock. The more consistent a stock's ROE, then the more accurate will be our overall projections.

3) The price to earnings ratio (P/E) reflects investor expectations about the future earnings of the company, and these expectations rise and fall with the performance of the economy, both actual and perceived.

4) The more consistent the stock in the past, the more comfortable we are with our projections for the future.

5) If we cannot accurately project the future price due to past inconsistency, we cannot discount back to the present to determine a proper purchase price. And in Buffett's world, the purchase price is all-important.

6) The all-important purchase price determines what our total future return will be. Total return equates to price appreciation plus dividends.

7) The modern-day followers of Clean Surplus ROE do not try to determine a value for a company. But they do value the company relative to the total return they themselves require from that company over the next ten years.

CHAPTER 14

Beyond Buffett: The Dow Jones 30 Industrials

The Predictability of Clean Surplus Accounting Relative to the Dow 30

The results from many years of research work made me a true believer in the use of Clean Surplus Accounting as a predictor of future value. It was after I completed my research and garnered my results that I discovered Warren Buffett uses Clean Surplus Accounting in some of his analyses. But Buffett uses Clean Surplus Accounting in a different manner than I did in my initial research.

As we discussed in the last chapter, Buffett uses Clean Surplus Accounting to determine a target price for a stock ten years into the future. He then discounts this 10-year target price back to the present using his required rate of return, which is said to be 15%. This process allows Buffett to determine the purchase price needed go give the buyer that 15% yearly rate of return.

Over the next several chapters, let's approach Clean Surplus from the point of view of the predictability of entire portfolios. We will test the Dow Jones Industrial Average in this chapter and then test the S&P 500 in Chapter 15. Let's see if we can use Clean Surplus as was originally intended by the founding fathers of Clean Surplus Accounting.

I mentioned in the Foreword that once I attended a lecture (1995) in which a form of Clean Surplus was used as a stock selection method. I ran home and sat in front of my computer for the next four and a half months formulating spreadsheets on the Dow 30 stocks. Of course, at the time I didn't know this method was called Clean Surplus Accounting and neither did the lecturer. I gathered the

necessary data from the Dow 30 stocks for the period 1982 to 1995. The questions I wanted answered were very simple:

1. Do stocks with a high Return On Equity (ROE) as configured by Clean Surplus Accounting outperform stocks with low ROEs, and

2. Could I construct a portfolio of stocks from the Dow 30 Industrials, which would outperform the Dow 30 Industrial Average?

WHY WORK WITH THE DOW 30?

You are all asking why I chose the Dow Jones 30 Industrials from which to select stocks when most money managers use the S&P 500 as a benchmark of performance. The reason is very simple. The Dow 30 is comprised of 30 stocks and the S&P 500 is comprised of 500 stocks. Let's see; research 30 stocks or research 500 stocks? I decided to begin with 30 stocks.

Another question arises as to whether money managers should benchmark their results against the Dow or the S&P 500? Most managers question how 30 stocks could possibly represent the entire universe of stocks and just naturally figure that 500 stocks would better represent "the Market."

If you go to an on-line service such as bigcharts.com and play around a bit, you can overlay the performance of the S&P 500 against the Dow. As you can see, over time they match one another pretty closely.

This is a good time to bring on a saying that Yogi Berra conjured up one day. I'm just kidding! Warren Buffett is believed to have said the following: it is better to be approximately right than precisely wrong. Notice I didn't use quotation marks because I could be only approximately correct as to who said it first and exactly what was said.

The answer to the question is that we'll use either market average as long as we can beat either average. If we outperform one, we will outperform the other over time.

I achieved such great results with the tests on the Dow that I eventually continued on and tested the S&P 500 stocks as well. See the next chapter for the results on the S&P 500.

CONSTRUCTING THE PORTFOLIO: MY FIRST RESEARCH INTO CLEAN SURPLUS

My first work began in 1995. That year, I began gathering data from 1982 on the Dow 30 in order to obtain several years of numbers with which to construct the Clean Surplus ROE of each Dow stock over a period of time.

Please remember that with Clean Surplus you are developing a Book Value (Owners' Equity) different from the traditional Accounting Book Value. But as a starting point in your calculations, you begin with Accounting Book Value for the first year since it is all we have. As you proceed with developing the ROE year after year, you are "cleaning up" the "dirty" Book Value. Thus, you would like several years of ROE BEFORE you begin with your stock selection process. With this first work, I used Accounting Book Value from the beginning of 1982, and cleaned the Accounting Book Value up over the next several years until 1987 when I began the stock selection based on Clean Surplus ROE.

If you analyze data over several time periods, you are using a method known as time series analysis. By contrast, comparing something today to something else today is called cross-sectional analysis.

Time Series Analysis:
Comparisons Over Several Time Periods

Cross-Sectional Analysis:
Comparisons During the Same Time Period

METHODOLOGY

Methodology is simply the method or methods (parameters, rules) used for data gathering and data analysis.

For this initial work, I used cross-sectional analysis. I wanted to compare the ROE of each of the Dow 30 stocks one year at a time beginning in 1987.

The Power of ROE
Please be aware that throughout this book, we discuss the consistency of ROE over many time periods. However, this first work deals with just a single year's ROE.

I initiated my back-testing for the stock selection process beginning with the year of 1987 by selecting eight stocks from the Dow, with the highest 1986 ROEs as configured by the Clean Surplus Accounting method. These 8 stocks would make up my portfolio for the entire year of 1987.

I did this for each year thereafter. I calculated the 1986 ROEs of all 30 stocks on January 1st of 1987. These stocks were then selected for the first portfolio, beginning the first trading day of January of 1987.

Why did I select eight stocks? Well, eight stocks comprised a bit over 25% of the Dow 30 stocks. Also, in my first year of selection (1986 ROE for 1987 portfolio), there was a large gap in ROE between the 8th and 9th stock. Thus, a division between the eighth stock and the ninth stock seemed a good beginning parameter.

I began stock return calculations for 1987 based on 1986 ROE for several reasons. The first reason was I only had access to data beginning in 1982 and I needed several years to "clean up" the traditional Accounting Book Value. Thus, beginning 1982 through the end of 1986 gave me approximately five years to clean up my book value.

Please be aware that fourth quarter results are not available January 1st. Thus, fourth quarter results are estimates. But those estimates for the large cap stocks are fairly accurate.

1987, THE YEAR OF THE ANOMALY

Another reason I began forming my portfolio in 1987 was that I wanted to include the great market crash of 1987. 1987 was definitely a year of an anomaly. On Monday, October 19, 1987, the Dow fell 22%. This day is now infamous and known in history as Black Monday.

A 22% decline in one day is certainly out of the ordinary. And it certainly doesn't adhere to an efficient market.

But the term, "anomaly" is an academic word meaning you have no clue as to what happened or why it happened. Actually, it's something you can't explain. OK, like very much out of the normal. Here's an easy way to remember the meaning of anomaly.

TO TAKE YOU WHERE NO MAN HAS EVER GONE BEFORE

Remember that one Star Trek adventure when Captain Kirk and Spock were tooling around the universe and came upon a huge cloud of space stuff? The space stuff was more than just a cloud, it was a living thing. Do you remember what they called it? Since they had no name for a living space cloud and since they couldn't explain a living space cloud, they simply called it "The Anomaly."

For those of you who didn't see that particular episode, our heroes made friends with the cloud and went on to make many, many more adventures. And now, beam us back to earth, Scotty.

BUFFETT THE ANOMALY

The academic world calls Warren Buffett an anomaly because he doesn't fit into the academic theory of the efficient market hypothesis. No one is supposed to outperform the market consistently over time, but indeed Buffett has. Since he doesn't fit into what is supposed to be, he is termed an anomaly. So when I run into the office of the head of finance at the university where I teach and I shout out something intelligent like, "Warren Buffett rocks," well, with just a wave of his all-knowing department head hand, he condescendingly dismisses me by saying Buffett is merely an anomaly.

Like, oh yes that certainly explains it! Is that how I'm supposed to describe Warren Buffett, the God of investing, to my students? Just dismiss whatever doesn't fit into the academic world as merely an anomaly? And since anomalies can't be explained, just dismiss his wonderful 30 some-odd years of success as pure chance?

Sorry, I got carried away, but I get emotional when people insinuate that Warren Buffett is just "merely" lucky. Ok, ok, back to our work and Clean Surplus Accounting because once you finish with this book, you'll see that Buffett is not lucky, he is just very, very good at what he does.

MORE PARAMETERS: THE SIMPLE RULES

The other parameters of this research were pretty simple. Each year on January 1st, I would calculate the ROEs of all 30 Dow stocks for the previous year. I would then select the eight Dow Stocks with

the highest ROEs for my portfolio for the coming year. Remember, this is cross-sectional analysis.

The strategy was to hold those stocks for the entire year. This meant no selling just before market crashes or corrections and no buying at market bottoms. After all, this is research and not marketing.

The only time I could change stocks was on January 1st and all stocks chosen must be held for the entire year until the next January 1st.

Just a side note here. If you have a New Year's hangover, the compilations will take you about four hours. If you awake fresh and ready to go, this work could take you 2 hours. If you want to go to my website, it will take you 2 minutes. Of course, as I write this, I don't have a website, but I probably will by the time I finish this manuscript. Oh gosh, and what shall we name the website? This book is called *Buffett and Beyond* and a 5,000 word article I once wrote is entitled, *Buffett and Beyond*. Hmmmm. Let me think about this. Maybe we'll have a "name the website contest."

The Test Periods

The Portfolio of 8 Dow stocks for any one year was selected by taking the 8 Dow stocks with the highest ROEs for the previous year. Fourth quarter of the previous year was comprised of estimated earnings and dividends, as these numbers are not known with absolute certainty on January 1st.

The 1987 portfolio consisted of the eight stocks out of the Dow 30 with the highest ROEs of 1986.

The calculations were performed on the first day of the year. Thus on January 1st of 1987, the 1986 ROEs were calculated. The eight stocks with the highest ROEs became the 1987 portfolio.

All eight stocks were held for the entire year.

THE RESULTS

Let's observe the results. Notice I show these results up to the end of 2002. This means I back-tested from 1987 to 1995, but from 1996 to 2002 the portfolio was constructed going forward.

YEARS	YEAR	DOW 30	S&P 500	DOW TOP 8	Returns Greater than S&P 500
16	2002	-15.73%	-22.37%	-18.10%	4.27%
15	2001	-5.45%	-12.47%	2.60%	15.07%
14	2000	-4.70%	-9.04%	1.15%	10.19%
13	1999	27.06%	21.04%	18.97%	-2.07%
12	1998	18.03%	28.66%	27.81%	-0.85%
11	1997	24.82%	33.35%	41.00%	7.65%
10	1996	28.71%	22.95%	26.93%	3.98%
9	1995	36.67%	37.54%	50.32%	12.78%
8	1994	5.03%	1.32%	5.16%	3.84%
7	1993	16.87%	10.06%	5.50%	-4.56%
6	1992	7.39%	7.62%	11.91%	4.29%
5	1991	24.19%	30.48%	43.93%	13.45%
4	1990	-0.73%	-3.12%	5.29%	8.41%
3	1989	32.09%	31.69%	42.53%	10.84%
2	1988	16.03%	16.40%	16.74%	0.34%
1	1987	5.66%	3.55%	18.15%	14.60%
AVERAGE RETURNS		**DOW 30 13.50%**	**S&P 500 12.35%**	**DOW TOP 8 18.74%**	

In this 16-year time frame, the 8 Dow stock portfolio underperformed the Dow just three times in 1993, 1999 and 2002. Over the 16-year time frame, the 8 Dow stock portfolio returned an average of 18.74% with only one negative year, while the Dow returned just 13.5%, having negative performances in four years.

Notice that the 8-stock portfolio returned on average 38% more than the Dow and over 51% more per year than the S&P 500.

Here's a very interesting point. Over the three horrible years of 2000, 2001 and 2002, the 8-stock portfolio lost 14.3% while the Dow lost 25.9% and the S&P 500 lost 43.9%. Also, the 8-stock portfolio was negative in just one year while the S&P and the Dow were negative in 3 consecutive years.

The results show that the 8-stock portfolio makes more in most good years and loses less in bad years. So if you are in the stock market for the long term, you now know a very good stock selection strategy. More in the next chapter for you non-believers.

COMPOUNDED RETURNS

An analysis of returns just wouldn't be complete if we didn't show a chart of how an initial investment of $100,000 would look with the above returns, so here we are. Please be aware we are not allowing for any possible income tax consequences.

YEARS	YEAR	DOW 30	S&P 500	DOW TOP 8
16	**2002**	**$658,012**	**$522,651**	**$1,286,085**
15	2001	$780,838	$673,259	$1,570,311
14	2000	$825,847	$769,175	$1,530,518
13	1999	$866,576	$845,619	$1,513,117
12	1998	$682,021	$698,628	$1,271,848
11	1997	$577,837	$543,003	$995,108
10	1996	$462,936	$407,201	$705,750
9	1995	$359,674	$331,193	$556,015
8	1994	$263,170	$240,797	$369,888
7	1993	$250,566	$237,660	$351,738
6	1992	$214,397	$215,937	$333,401
5	1991	$199,644	$200,648	$297,919
4	1990	$160,757	$153,777	$206,989
3	1989	$161,939	$158,729	$196,589
2	1988	$122,597	$120,532	$137,928
1	1987	$105,660	$103,550	$118,150
BEGINNING AMT.		**$100,000**	**$100,000**	**$100,000**

Reading from bottom to the top, we can see that the Dow Top 8 stocks could have made an awful lot of money. Almost twice as much as investing in the Dow and almost 150% more than investing in the S&P 500. Please keep in mind that these eight stocks are part of the Dow 30. They are the eight most efficient stocks in the Dow Jones 30 Industrials. And as we can see, they are among the best performing stocks in the Dow.

This little exercise shows that stocks with high ROEs are certainly rewarded by the stock market participants. This little exercise shows that people who are able to select stocks with high Clean Surplus ROEs should be rewarded very nicely, thank you.

IS THERE A CORRELATION BETWEEN THE ROEs AND THE RETURNS OF A STOCK?

There are a lot of systems which when back-tested seem to outperform the averages. Why are our results meaningful?

When you perform research, you are not only obtaining results either positive or negative, but you are searching for **A REASON** that you are obtaining those results. And this reasoning is the answer to all our questions.

During our 16-year test time frame, the Dow 30 stocks had an average ROE of about 14% while the total returns of the Dow over this time period were 13.5%. You see, the ROE is very close to the total returns.

During this same time period of 16 years, the 8-Dow stock portfolio had an ROE over 20% while the yearly total returns of this 8-stock portfolio were 18.74%.

	ROE	**Total Returns**
Dow 30	**14.00%**	**13.50%**
Dow 8 Stock Portfolio	**22.00%**	**18.74%**

In other words, the ROEs of both the Dow 30 and the 8-stock portfolio had a strong correlation to the total returns of each.

You really can't understand the true meaning of this just yet. But once I realized there was a correlation between the ROE and total future returns, a multitude of questions came into my head.

Is it possible to merely look at the ROE (Clean Surplus Accounting) of a portfolio and conclude that the ROE is an indicator of future returns? In other words, would a portfolio with an ROE of 20% earn a total return of approximately 20% per year in the future? Would a portfolio with an ROE of 20% return more than a portfolio of stocks that averaged a 10% ROE? And finally, would this system work on portfolios of stocks other than the Dow stocks?

My later dissertational research on the S&P 500 would answer the above questions, but at the time I worked on the Dow stocks, I wasn't even thinking about a dissertation. Remember that in 1995 I was already "old" and I was in the 4th year of a 1 1/2 year Master's program.

Back to the real question***: is there a correlation between the ROE and the future returns of a portfolio?*** In other words, does the ROE as configured by Clean Surplus Accounting show predictability as was intended by the founding fathers of Clean Surplus Accounting?

During the time frame of 1987 through 2001, there was a very high correlation between Clean Surplus ROE and total returns of the Dow 30 Stocks.

Note 1: Please don't confuse the ROE of a stock or of a portfolio with the total returns. Clean Surplus ROE is a comparable efficiency ratio and total return is comprised of price appreciation plus dividends.

Note 2: The ROE of a portfolio is the average ROE of all the stocks making up that portfolio.

GETTING PUBLISHED IN AN ACADEMIC JOURNAL

As I mentioned earlier, it took 4½ months to calculate the above work on the Dow 30 from the years of 1987 through 1995. I added the later years (1996-2002) yes, later. I wrote a research article describing the above results for a financial journal and guess what words of wisdom were sent back to me?

They said something like, well, this is nice, but you really should perform your calculations using the 500 stocks in the S&P 500 index.

Folks, my heart was broken. I saw my life flash in front of me. I may really have come upon something fantastic and I wanted the entire world to know about it, but the academic community didn't want any part of it, at least not in the form I was communicating to them. But I felt the research work must go on, and somehow I must tell the world that there is indeed a measure of predictability in Clean Surplus Accounting. The next several chapters will tell us more. Much more!

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SUMMARY OF CHAPTER 14

1) Time Series Analysis: Comparison of data over several time periods.

2) Cross-Sectional Analysis: Comparison of data during the same time period.

3) A portfolio of eight stocks selected from the Dow 30 using high ROEs as configured by Clean Surplus Accounting was able to almost double the dollar returns of the Dow 30 average over our 16-year test period.

4) During the time frame of 1987 through 2002, there was a very high correlation between Clean Surplus ROE and the total returns of the Dow 30 stocks.

CHAPTER 15

Beyond Buffett: The S&P 500

The Predictability of Clean Surplus Accounting Relative to the S&P 500

At the beginning of the Doctoral program, the folks running the institutions of higher education tell all the students to begin thinking about the subject of their dissertation. We call it the "BIG D." It's not divorce and it's not Dallas, it's the horrible thought of several more years of research. It's the "BIG D."

Just to bring you up to date on the academic parameters, a Doctoral program or a Ph.D. program is all about research. As I mentioned in the Foreword, the difference between a Ph.D. and a Doctor is the Ph.D. develops the theory and the Doctor tries to put that theory into practical use. Just to confuse things, both these academic designations carry the title of Doctor. The Ph.D. is just a bit more of a theoretical degree.

Many universities don't want Doctors teaching their students. They would rather employ teachers that have the Ph.D. designation. I once had an instructor tell me that the university was in existence to teach the theoretical. Anything practical should be taught in technical schools. Oh yes, I was as shocked as those of you reading this.

Please don't forget that I began my Doctoral education while in my 50s. I went to a school where most of the students were middle-aged, with half of them coming from the teaching profession and the other half coming from industry. They were successful people in business who wanted the Holy Grail of degrees and to also learn some theory they could possibly put to practical use.

Why did I just tell you all this? I wanted to write my dissertation on a subject which I could use in real life and not just any subject to make my professors happy. I really wanted to take the

theory, apply it, and construct a better portfolio for myself. Or to put it another way, use my education in order to make money. I guess I'm just a selfish, capitalistic individual.

The dissertation is a very large research paper usually completed after all the Doctoral coursework is completed. The dissertation is several hundred pages of research along with many, many pages of supporting documentation. It is based on existing research work, and the job of the Ph.D. or Doctoral candidate is to add to that body of knowledge.

My problem was I didn't know of any research performed on the method I had come into contact with so I couldn't add to the body of knowledge. I didn't even know the name of the method.

FINALLY – A LEAD – CLEAN SURPLUS ACCOUNTING – BUFFETT – GRAHAM – OHLSON

I know I talked about the following in the Foreword, but many of you probably didn't read the Foreword so I think it is worth mentioning once again. By the way, the Foreword is a pretty good sea story in its own right.

I searched for about a year and a half and finally found some information on the "phantom" method. It was called Clean Surplus Accounting and folks, I am being totally speculative on the following.

A paper was published in 1989 by James Ohlson on how the Clean Surplus relation can be used in security valuation. Ohlson wrote his paper while at Columbia University. Does anyone remember where Warren Buffett went to school for his Master's degree? And does anyone remember who he studied under while getting his Master's degree? Warren Buffett went to Columbia University and studied under Benjamin Graham, who is known as the Father of Security Analysis.

Again, I'm not implying anything here, but the three of these gentlemen attending the same school certainly makes for good cocktail party conversation.

THE RESULTS OF THE RESEARCH

The following is an excerpt of an article I recently wrote regarding the test results of a section of my dissertation work.

"The purpose of this test is to determine if portfolios constructed using a high average ROE with Equity (Book Value) configured using Clean Surplus Accounting are able to outperform the S&P 500 Index."

The purpose of this test is to determine if portfolios constructed using a high average ROE with Equity (Book Value) configured using Clean Surplus Accounting are able to outperform the S&P 500 Index.

METHODOLOGY

As I said in the last chapter, methodology is a neat word, which summarizes the rules, framework, parameters or system(s) set in place before the testing begins. Here are the rules for the research on Clean Surplus ROE and the S&P 500. Yes, ***Beyond Buffett***.

A spreadsheet was developed for each security used in this test, such as the spreadsheets we structured for the observations of General Electric and General Motors in earlier chapters. The yearly Net Income (Earnings before extraordinary write-offs and future liabilities) and Dividends were used for all stocks in order to obtain Clean Surplus Book Value (Owners' Equity).

The securities used began with the S&P 500 as of December 1982. This list was narrowed due to several limitations. Securities not included in the sample consist of any security which did not include data for the entire sample period of 1982 through 1998. Any companies which merged or were dropped from the index were eliminated from the sample. The final sample consisted of 351 securities.

For the first test period, an 8-year time series average of the ROE of each stock was calculated by the Clean Surplus Accounting method, beginning in 1982 and continuing through 1989.

The total return calculations of each stock were calculated for the following four years. Thus, we obtain an 8-year average ROE and we are trying to see if this average ROE has any bearing on the following four years of total returns (price appreciation plus dividends).

The 4-year returns began with the last day of March in order to fully incorporate into the price all earnings announcements for the previous year's fourth quarter. All fourth quarter earnings results are announced by the end of the following first quarter, with most of the announcements occurring during January of the first quarter. Thus, all announcements are fully incorporated into security value by the end of the first quarter of the year.

For the second test period, an 8-year period of average ROEs was calculated from 1986 through the end of 1993, followed by a 4-year period of total returns, beginning March end 1994 through March end of 1998.

First Test Period

Average ROE of the 8-year period 1982-1989, followed by average yearly returns over the following four years, from the end of March 1990 to the end of March 1994.

Second Test Period

Average ROE of the 8-year period 1986-1993, followed by average yearly returns over the following four years, from the end of March 1994 to the end of March 1998.

Notice the Difference

In the following S&P 500 tests, I used an average ROE over eight years to try and predict the average yearly total return over the following four years. With the Dow tests of the previous chapter, I used a one-year ROE to select a portfolio which would outperform the Dow averages over the following one year.

Standardized Against the Market

The term "market returns" is meant to be the returns of the S&P 500 for the purposes of this study. The average ROE of all the S&P stocks in the study becomes the market ROE.

Portfolio Construction

1. The 351 securities were sorted in descending order of their 8-year average ROEs for the first period of 1982-1989. Portfolios consisting of ten stocks each were selected, beginning with the 10 stocks exhibiting the ten highest average ROEs. The second portfolio consisted of the stocks with the next ten highest ROEs. The average ROE of each 10-stock portfolio was used as a predictor against the total return of each portfolio for the subsequent four years of 1990-1994.

2. A second selection of portfolios chosen in the above manner was used with average ROEs of the 8-year period of 1986 through 1993 as a predictor of total returns for the period from March end 1994 through March end 1998.

3. All stocks and portfolios were adjusted for risk. Risk was determined by beta (the most widely accepted measure of investment risk) obtained from Value Line. Total returns were divided by beta to obtain risk-adjusted returns.

The main purpose of this research is to determine if portfolios constructed with stocks of above-average ROEs as calculated by the Clean Surplus Method can outperform the S&P 500 Index.

RESULTS: FIRST TEST PERIOD

Below are the portfolio results of the ***first test period***. These results shown below include fourteen portfolios all of which had an average portfolio ROE greater than the average ROE of all the S&P 500 stocks in the test. In other words, they are portfolios with above-average ROEs.

Each portfolio's average ROE (the average of the ROEs of the stocks in each portfolio) from 1982 through 1989 is followed by the risk-adjusted ***average per year return*** of March end 1990 through March end 1994.

The S&P returned ***10.35%*** per year during this time frame. **Every one of the portfolios with above average ROEs outperformed the S&P 500.**

PORTFOLIO	8-YR Average ROE 1982-1989	YEARLY RISK ADJUSTED RETURNS 3/31/90-3/31/94	YEARLY S&P RETURNS 3/31/90-3/31/94	RETURNS ABOVE S&P
			10.35%	
1	53.53%	26.14%		15.79%
2	31.86%	13.73%		3.38%
3	26.97%	15.89%		5.54%
4	24.59%	26.86%		16.51%
5	22.51%	16.42%		6.07%
6	21.41%	18.04%		7.69%
7	20.68%	18.26%		7.91%
8	19.96%	14.59%		4.24%
9	19.55%	26.23%		15.88%
10	18.95%	16.89%		6.54%
11	18.39%	17.62%		7.27%
12	17.82%	23.49%		13.14%
13	17.34%	25.84%		15.49%
14	16.40%	20.61%		10.26%

RESULTS: SECOND TEST PERIOD

The results of the second test period are below. Each portfolio's average ROE from 1986 through 1993 is followed by the risk-adjusted ***average per year return*** of March end 1994 through March end 1998.

The S&P returned **28.66%** per year during this time frame. **Every portfolio which had an average ROE above the total average portfolio ROE, outperformed the S&P 500**.

PORTFOLIO	8-YR Average ROE 1986-1993	YEARLY RISK ADJUSTED RETURNS 3/31/94-3/31/98	YEARLY S&P RETURNS 3/31/94-3/31/98	RETURNS ABOVE S&P
			28.66%	
1	39.89%	39.01%		10.35%
2	31.27%	37.78%		9.12%
3	27.03%	49.49%		20.83%
4	23.94%	37.68%		9.02%
5	21.87%	31.89%		3.23%
6	20.75%	51.54%		22.88%
7	20.13%	45.43%		16.77%
8	19.44%	55.10%		26.44%
9	18.89%	36.79%		8.13%
10	18.25%	34.21%		5.55%
11	17.64%	33.26%		4.60%
12	16.71%	36.86%		8.20%
13	16.13%	42.52%		13.86%
14	15.35%	33.09%		4.43%

Survivorship Bias

There may be a survivorship bias. Many portfolios outperformed the S&P during the test periods. However, 500 stocks (the entire index) began in 1982, but just 351 securities survived the entire test period. It may be assumed that the securities which did not survive the entire test period were laggard performers, which, of course, is probably why many (if not all) of them are not in the index today.

Large Cap Bias

The S&P 500 is a large cap (large capitalization) index. Thus, we cannot be certain that this strategy works well with smaller issues with less than an 8-year history of earnings.

SUMMARY OF RESULTS

This initial work shows that the level of portfolio ROE with Owners' Equity configured by Clean Surplus Accounting does indeed have a direct relation to the level of future total returns. The portfolios selected from the S&P 500 with higher average ROEs than the average portfolio did indeed outperform the market averages. In these test periods, **all portfolios** with above average ROEs as configured by Clean Surplus Accounting, **outperformed** the S&P 500 index.

I don't know about you, but these tests show some pretty interesting results relative to predictability. These results show that the system works in average markets (first test period) and super bull markets as in the second test period.

The previous chapter on the Dow research (especially years 2000, 2001 and 2002) indicates that the predictability of better performance also holds true in horrible markets. Not that the stocks always have positive returns, but the returns of portfolios with higher than average ROE stocks (Clean Surplus) do better than portfolios of stocks with lower than average ROEs when the ROEs are configured by the Clean Surplus method.

Note: Only portfolios with higher than average ROEs are shown in this chapter.

The research work shows that the ROE as configured by Clean Surplus Accounting does have a direct correlation to the total returns of portfolios over two 4-year periods.

Other Work

Work was also performed with portfolios of thirty stocks each. The results for the larger portfolios were even more predictable and much more consistent than with the portfolios of ten securities. For the statisticians reading this, the tests on larger portfolios of thirty securities showed a 79%-80% correlation of portfolio ROEs and future total returns.

The research work shows that portfolios of thirty securities exhibit greater predictability than portfolios constructed of ten securities, when predictability of total returns is correlated to Return On Equity as configured by Clean Surplus Accounting.

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SUMMARY OF CHAPTER 15

1) Time Series Analysis: Comparison of data over several time periods.

2) Cross-Sectional Analysis: Comparison of data during the same time period.

3) The purpose of the tests on the S&P 500 stocks was to determine if portfolios constructed using a high average ROE with Equity (Book Value) configured using Clean Surplus Accounting were able to outperform the S&P 500 Index.

4) This research shows that the ROE as configured by Clean Surplus Accounting does have a direct, positive correlation with the total returns of portfolios over two 4-year time periods.

5) The research shows that portfolios of thirty securities exhibit greater predictability than portfolios constructed of ten securities, when predictability is correlated to Return On Equity as configured by Clean Surplus Accounting.

6) During these test periods, ALL PORTFOLIOS with ROEs greater than the average ROE of the S&P 500 stocks, outperformed the S&P 500 relative to total returns. I said, ALL PORTFOLIOS.

CHAPTER 16

Top Dogs of the Dow

This is the chapter you've been waiting for. I will show you, in the following pages, how to structure your own portfolio using the methods and results you learned in the previous chapters.

Let's look at the results once again of my eight Dow stock portfolio over the past sixteen years. This portfolio of Dow stocks will be forever known, from this point on as the **TOP DOG** portfolio. You've heard of the Dogs of the Dow and now you will be blessed with the TOP DOGS of the Dow. I mean like why would you want to buy the worst stocks in the Dow Average when you can have the best stocks in the Dow which you now know as the **TOP DOGS of the Dow**.

Please remember these results for the eight Dow stocks were obtained by selecting the eight stocks each year which had the highest ROEs for the previous one year.

The research on the S&P 500 stocks was different, as stocks were selected because of their ***average*** ROE over the ***previous eight years***. Thus I chose two slightly different methods within the Clean Surplus methodology, but both exhibiting very, very exciting results.

Of course, each of you will develop the method with which you become most comfortable. Sometimes a stock may be the ninth or tenth stock on your list, such as Procter and Gamble or Coke, but you still want them in your portfolio. The choice is yours. However, as long as you stick to the basics, you will structure a very fine portfolio indeed. Let's look at the returns of the Top Dogs of the Dow once again.

YEAR	YEAR	DOW 30	S&P 500	DOW TOP 8	Returns Greater than S&P 500
16	2002	-15.73%	-22.37%	-18.10%	4.27%
15	2001	-5.45%	-12.47%	2.60%	15.07%
14	2000	-4.70%	-9.04%	1.15%	10.19%
13	1999	27.06%	21.04%	18.97%	-2.07%
12	1998	18.03%	28.66%	27.81%	-0.85%
11	1997	24.82%	33.35%	41.00%	7.65%
10	1996	28.71%	22.95%	26.93%	3.98%
9	1995	36.67%	37.54%	50.32%	12.78%
8	1994	5.03%	1.32%	5.16%	3.84%
7	1993	16.87%	10.06%	5.50%	-4.56%
6	1992	7.39%	7.62%	11.91%	4.29%
5	1991	24.19%	30.48%	43.93%	13.45%
4	1990	-0.73%	-3.12%	5.29%	8.41%
3	1989	32.09%	31.69%	42.53%	10.84%
2	1988	16.03%	16.40%	16.74%	0.34%
1	1987	5.66%	3.55%	18.15%	14.60%
AVERAGE RETURNS		**DOW 30 13.50%**	**S&P 500 12.35%**	**DOW TOP 8 18.74%**	

I don't know about you, but I think the returns of the Top Dog portfolio is absolutely tremendous considering you only have to do a little bit of work such as look at my website once a year.

An average yearly return of 18.74% over the average yearly Dow return of 13.50% represents a per year return of 38.8% more than the Dow (18.74%-13.50% divided by 13.50% is 38.8%). Relative to the S&P 500 returns of 12.35% over this time period, we are speaking about an extra return of almost 52% per year over the S&P 500.

THE COMPOUNDED RETURNS

Let's take a look at the compounded dollar results of the returns from the Dow, the S&P 500 and the Top Dog portfolio over the past 16 years.

Please remember that from now on, the 8-stock portfolio will forever be known as the Top Dogs of the Dow. Remember it this way. If you want to be a Top Dog of investing, you really should select stocks which are the Top Dogs.

We are assuming you began with $100,000 and were not required to pay taxes.

YEAR	YEAR	DOW 30	S&P 500	DOW TOP 8
16	**2002**	**$658,012**	**$522,651**	**$1,286,085**
15	2001	$780,838	$673,259	$1,570,311
14	2000	$825,847	$769,175	$1,530,518
13	1999	$866,576	$845,619	$1,513,117
12	1998	$682,021	$698,628	$1,271,848
11	1997	$577,837	$543,003	$995,108
10	1996	$462,936	$407,201	$705,750
9	1995	$359,674	$331,193	$556,015
8	1994	$263,170	$240,797	$369,888
7	1993	$250,566	$237,660	$351,738
6	1992	$214,397	$215,937	$333,401
5	1991	$199,644	$200,648	$297,919
4	1990	$160,757	$153,777	$206,989
3	1989	$161,939	$158,729	$196,589
2	1988	$122,597	$120,532	$137,928
1	1987	$105,660	$103,550	$118,150
BEGINNING AMT.		**$100,000**	**$100,000**	**$100,000**

When you look at the compounded returns, you can see that the compounded dollar returns were almost twice as much as the dollar returns on the Dow and almost two and a half times that of the compounded dollar returns from investing in the S&P 500 over this

sixteen-year time period. Do you think we are on to something here? Let's talk more about the strategy.

THE STRATEGY

I am most impressed with the results for 2000, 2001 and 2002, which have seen the most tumultuous markets I've ever been involved with. Over this 3-year time period, the 8-stock portfolio declined a total 14.43%, while the Dow declined almost twice that or 25.88%, and the S&P 500 declined a whopping 43.88%. And please note that the Top Dog portfolio had a loss in just 2002 while the Dow and the S&P had losses in all three years.

We should all be equally impressed with the results of 1987, the year of the great one-day market crash. The Dow return was a positive 5.66%, the S&P 3.55% and the Top Dog (top 8 stocks) portfolio was up 18.15%. Just remember, 1987 saw a lot of market participants go bankrupt because of their use (misuse) of derivatives. Derivatives are a wonderful tool to hedge portfolios. However, the other side of hedging is gambling.

Let's use the strategy we've learned up to this point to construct a portfolio for today. The Top Dogs of the Dow strategy is relatively simple if you'll just follow me throughout this chapter.

We (I) will construct spreadsheets for each stock in the Dow Jones 30 Industrials. The spreadsheets will be constructed just as our bank account examples and the examples you observed using General Electric and General Motors. In other words, the spreadsheets will be constructed using Clean Surplus Accounting.

As you read the rules below, we'll look at two years of data for General Electric.

GENERAL ELECTRIC					
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY
1987	$1.41	$0.27	$0.11	$0.16	18.95%
1986	$1.28	$0.23	$0.10	$0.13	17.70%

1. We will take the Owners' Equity for each stock in the Dow 30 at the beginning of our first year. This is **$1.28** for GE in 1986.

2. We will use the Net Income (not Earnings) for each year. The first year Net Income (1986) for GE is **$0.23**.

3. From the Net Income, we will deduct any Dividends **($.10)** paid out during the year. Net Income ($.23) minus Dividends ($.10) will give us Clean Surplus Retained Earnings (RE) of **$.13**.

4. We will add the Clean Surplus Retained Earnings **($0.13)** to Equity for 1986 **($1.28)** in order to obtain next year's **(1987)** beginning Equity. **($1.28 + $0.13 = $1.41).**

Here is the formula once again:

$$\mathbf{BV_{1983} = BV_{1982} + (NI\text{-}D)_{1982}}$$

or

$$\mathbf{BV_{1983} = BV_{1982} + (Clean\ Surplus\ Retained\ Earnings)_{1982}}$$

Please remember that Clean Surplus Retained Earnings is Net Income minus Dividends. Also remember that Book Value (BV) is used synonymously with Owners' Equity (OE).

5. In order to obtain Return On Equity (ROE) for any one year, we divide the Net Income by the Owners' Equity (BV), or the amount we made during the year divided by the amount we began the year with. This gives us the ROE for that year**. For 1986, ($.23/$1.28 = 17.70%).**

GENERAL ELECTRIC					
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY
1987	$1.41	$0.27	$0.11	$0.16	18.95%
1986	$1.28	$0.23	$0.10	$0.13	17.70%

6) We will perform this calculation for as many years as we have data available. We now have ROE over many time periods or as I mentioned before, a time series ROE calculated by the use of Clean Surplus Accounting.

WHAT ARE WE LOOKING FOR?

The question becomes, what stocks were selected each year for the "portfolio" stocks in our eight Dow stock portfolio? In other words, what are the eight Top Dogs of the Dow?

Remember, our portfolio was constructed by selecting from the Dow the 8 stocks that had the highest ROEs for the previous year as configured by Clean Surplus Accounting.

You may find spreadsheets to be daunting at first, but you can obtain information from my web site and also have access to an easy

to use computer program that analyzes thousands of stocks using the format you've already learned.

Let's get on with the individual Dow stocks so you can put Clean Surplus into practical use. Remember, we are looking for the stocks with the highest ROEs from 2002 in order to form our 2003 portfolio.

After we examine all 30 Dow Stocks, we will construct a summary sheet and select the eight stocks with the highest ROEs for our Top Dogs of the Dow Portfolio. Once you see the list, you will want to begin to use your own decision making capabilities within the framework of Clean Surplus.

I would like to make one more point before we go on. The research on Clean Surplus tells us to look for a high and consistent ROE. Warren Buffett tells us to look for a high and consistent ROE. Mary Buffett tells us that Warren likes to look at a 10-year history. My research on the S&P 500 analyzed ROEs of stocks using an 8-year average of ROE.

Even though we will be forming a Top Dog portfolio using only the previous year's ROE in this chapter, toward the end of the chapter I will also bring to your attention the past 10-year average ROE. I would like you to begin thinking about a high level of ROE and a consistent level of ROE because it is this consistency that identifies a company that has been doing everything right in the past and will have the greatest chance of continuing above average performance into the future. After all, we are developing long-term portfolios.

The average ROE of all Dow 30 stocks together was 13.38% at the end of 2002. We know for sure we want to select stocks from the Dow with ROEs above the average. We will "eye-ball" each of the 30 stocks. After that, we will look at all 30 stocks together and see which ones had the highest ROEs for 2002.

Ready? Let's analyze the Dow 30 stocks.

ALCOA						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$14.30	$1.00	$0.60	$0.40	**6.99%**	
2001	$13.44	$1.46	$0.60	$0.86	10.86%	
2000	$12.13	$1.81	$0.50	$1.31	14.92%	
1999	$11.12	$1.41	$0.40	$1.01	12.68%	
1998	$10.29	$1.21	$0.38	$0.83	11.76%	
1997	$9.45	$1.09	$0.25	$0.84	11.53%	
1996	$8.99	$0.79	$0.33	$0.46	8.79%	
1995	$8.11	$1.11	$0.23	$0.88	13.69%	
1994	$8.04	$0.27	$0.20	$0.07	3.36%	
1993	$8.14	$0.10	$0.20	-$0.10	1.23%	**9.58%**
1992	$8.06	$0.28	$0.20	$0.08	3.47%	
1991	$7.87	$0.41	$0.22	$0.19	5.21%	
1990	$7.43	$0.82	$0.38	$0.44	11.04%	
1989	$6.44	$1.33	$0.34	$0.99	20.65%	
1988	$5.38	$1.22	$0.16	$1.06	22.68%	
1987	$5.01	$0.52	$0.15	$0.37	10.38%	
1986	$4.98	$0.18	$0.15	$0.03	3.61%	

Dow 30 Average ROE for 2002 13.38%

Alcoa

One-year ROE	6.99%
10-year Average ROE	9.58

We don't have to go much further. Alcoa's ROE is lower than the Dow average both on a one-year performance and a 10-year performance. The ROE is inconsistent, ranging from 1.23% in 1993 to a 1988 high of 22.68%. This maker of aluminum is just not shinning very bright at this time. Not a TOP DOG.

AMERICAN EXPRESS						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$15.79	$2.00	$0.32	$1.68	**12.67%**	
2001	$14.83	$1.28	$0.32	$0.96	8.63%	
2000	$13.08	$2.07	$0.32	$1.75	15.83%	
1999	$11.57	$1.81	$0.30	$1.51	15.64%	
1998	$10.28	$1.59	$0.30	$1.29	15.47%	
1997	$9.20	$1.38	$0.30	$1.08	15.00%	
1996	$8.20	$1.30	$0.30	$1.00	15.85%	
1995	$7.46	$1.04	$0.30	$0.74	13.94%	
1994	$6.87	$0.89	$0.30	$0.59	12.95%	
1993	$6.43	$0.77	$0.33	$0.44	11.98%	**13.80%**
1992	$6.32	$0.44	$0.33	$0.11	6.96%	
1991	$5.93	$0.70	$0.31	$0.39	11.80%	
1990	$5.53	$0.71	$0.31	$0.40	12.84%	
1989	$4.92	$0.90	$0.29	$0.61	18.29%	
1988	$4.37	$0.81	$0.26	$0.55	18.54%	
1987	$4.33	$0.29	$0.25	$0.04	6.70%	
1986	$3.80	$0.76	$0.23	$0.53	20.00%	

Dow 30 Average ROE for 2002 **13.38%**

American Express

One-year ROE	12.67%
10-year Average ROE	13.80%

American Express is pretty much an average performer. The 10-year ROE is just a touch higher than the Dow 30 10-year average ROE. Buffett seems to like this stock, but probably because he bought it very low.

American Express does not fit our TOP DOG criteria. Sorry, Warren.

AT&T

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$14.64	-$0.35	$0.15	-$0.50	**-2.39%**	
2001	$16.12	-$1.33	$0.15	-$1.48	-8.25%	
2000	$15.05	$1.77	$0.70	$1.07	11.76%	
1999	$14.19	$1.74	$0.88	$0.86	12.26%	
1998	$13.13	$1.94	$0.88	$1.06	14.78%	
1997	$12.18	$1.83	$0.88	$0.95	15.02%	
1996	$10.75	$2.31	$0.88	$1.43	21.49%	
1995	$10.84	$0.79	$0.88	-$0.09	7.29%	
1994	$9.63	$2.09	$0.88	$1.21	21.70%	
1993	$8.41	$2.10	$0.88	$1.22	24.97%	**11.86%**
1992	$7.38	$1.91	$0.88	$1.03	25.88%	
1991	$7.99	$0.27	$0.88	-$0.61	3.38%	

Dow 30 Average ROE for 2002 **13.38%**

AT&T

One-year ROE	-2.39%
10-year Average ROE	11.86%

Can you hear me now? Back in the good ole' days when Ma Bell was a monopoly, this bluest of blue chips was in everyone's stock portfolio. However, since competition was allowed to grace the telecommunications industry followed by someone inventing satellites and phones that didn't need wires, this huge company just couldn't adjust fast enough. At the present time they're in a fight for their lives because E.T. now has more than one way to phone home.

Until Ma Bell gets its act together, you might think of this company as just another wrong number.

BOEING

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$23.13	$3.10	$0.68	$2.42	**13.40%**	
2001	$21.02	$2.79	$0.68	$2.11	13.27%	
2000	$18.77	$2.84	$0.59	$2.25	15.13%	
1999	$17.14	$2.19	$0.56	$1.63	12.78%	
1998	$16.55	$1.15	$0.56	$0.59	6.95%	
1997	$16.48	$0.63	$0.56	$0.07	3.82%	
1996	$15.61	$1.42	$0.55	$0.87	9.10%	
1995	$15.53	$0.58	$0.50	$0.08	3.73%	
1994	$14.77	$1.26	$0.50	$0.76	8.53%	
1993	$13.44	$1.83	$0.50	$1.33	13.62%	**10.03%**
1992	$11.65	$2.29	$0.50	$1.79	19.66%	
1991	$9.87	$2.28	$0.50	$1.78	23.10%	
1990	$8.45	$1.90	$0.48	$1.42	22.49%	
1989	$7.86	$0.98	$0.39	$0.59	12.47%	
1988	$7.31	$0.89	$0.34	$0.55	12.18%	
1987	$6.93	$0.69	$0.31	$0.38	9.96%	
1986	$6.25	$0.95	$0.27	$0.68	15.20%	

Dow 30 Average ROE for 2002 **13.38%**

Boeing

One-year ROE	13.40%
10-year Average ROE	10.03%

Boeing has had its ups and downs. Its ROE has been all over the place just like the planes they manufacture. Some may think it is a high flyer, but I don't think so. Land this baby in some other portfolio. Not a TOP DOG.

CITIGROUP

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$15.67	$3.05	$0.70	$2.35	**19.46%**	
2001	$13.52	$2.75	$0.60	$2.15	20.34%	
2000	$11.42	$2.62	$0.52	$2.10	22.94%	
1999	$9.68	$2.15	$0.41	$1.74	22.21%	
1998	$8.44	$1.33	$0.09	$1.24	15.76%	
1997	$6.85	$1.59	$0.00	$1.59	23.21%	
1996						
1995						
1994						
1993						**N/A**
1992						
1991						
1990						
1989						
1988						
1987						
1986						

Dow 30 Average ROE for 2002 **13.38%**

Citigroup

One-year ROE	19.46%
10-year Average ROE	Not Applicable

Citigroup has a short history due to its several mergers. Remember Traveler's Group and then Citicorp? Well, now they are Citigroup.

My work (not shown), includes the other companies just mentioned, and this company in one form or another has always had an ROE in the very high teens and low 20s.

It always seems to keep its ROE above the Dow average. So yes, this stock can be considered a contender for TOP DOG status. It will be near the top group on our summary sheet.

CATERPILLAR						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$29.34	$2.20	$1.40	$0.80	**7.50%**	
2001	$28.41	$2.32	$1.39	$0.93	8.17%	
2000	$26.74	$3.02	$1.35	$1.67	11.29%	
1999	$25.39	$2.63	$1.28	$1.35	10.36%	
1998	$22.43	$4.11	$1.15	$2.96	18.32%	
1997	$19.01	$4.37	$0.95	$3.42	22.99%	
1996	$16.25	$3.54	$0.78	$2.76	21.78%	
1995	$13.99	$2.86	$0.60	$2.26	20.44%	
1994	$11.96	$2.35	$0.32	$2.03	19.65%	
1993	$10.43	$1.68	$0.15	$1.53	16.11%	**15.66%**
1992	$11.12	-$0.54	$0.15	-$0.69	-4.86%	
1991	$11.72	-$0.34	$0.26	-$0.60	-2.90%	
1990	$11.50	$0.52	$0.30	$0.22	4.52%	
1989	$10.57	$1.23	$0.30	$0.93	11.64%	
1988	$9.24	$1.52	$0.19	$1.33	16.45%	
1987	$8.50	$0.87	$0.13	$0.74	10.24%	
1986	$8.18	$0.45	$0.13	$0.32	5.50%	

Dow 30 Average ROE for 2002 **13.38%**

Caterpillar

One-year ROE	7.50%
10-year Average ROE	15.66%

Caterpillar is one of those cyclical stocks. See how the ROE goes from negative to extremely positive? However, we don't like inconsistency, as it lends itself to a lot of volatility. Sorry big Cat, but just crawling along these past few years won't get you into the playground with the Top Dogs.

COCA-COLA

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$9.92	$1.77	$0.80	$0.97	**17.84%**	
2001	$9.04	$1.60	$0.72	$0.88	17.70%	
2000	$8.24	$1.48	$0.68	$0.80	17.96%	
1999	$7.58	$1.30	$0.64	$0.66	17.15%	
1998	$6.76	$1.42	$0.60	$0.82	21.01%	
1997	$5.68	$1.64	$0.56	$1.08	28.87%	
1996	$4.78	$1.40	$0.50	$0.90	29.29%	
1995	$4.03	$1.19	$0.44	$0.75	29.53%	
1994	$3.43	$0.99	$0.39	$0.60	28.86%	
1993	$2.93	$0.84	$0.34	$0.50	28.67%	**23.69%**
1992	$2.49	$0.72	$0.28	$0.44	28.92%	
1991	$2.12	$0.61	$0.24	$0.37	28.77%	
1990	$1.81	$0.51	$0.20	$0.31	28.18%	
1989	$1.56	$0.42	$0.17	$0.25	26.92%	
1988	$1.35	$0.36	$0.15	$0.21	26.67%	
1987	$1.19	$0.30	$0.14	$0.16	25.21%	
1986	$1.06	$0.26	$0.13	$0.13	24.53%	

Dow 30 Average ROE for 2002 **13.38%**

Coca Cola

One-year ROE	17.84%
10-year Average ROE	23.69%

Coke had been a TOP DOG for many, many years. However, between 1997 and 1999, the ROE fell dramatically, but has since been very steady. The 10-year ROE is beautiful. It looks to be a contender as a TOP DOG based on the 2002 ROE. Let's wait for our summary sheet so we can compare it to the other 29 Dow stocks.

DISNEY						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$8.72	$0.55	$0.21	$0.34	**6.31%**	
2001	$7.95	$0.98	$0.21	$0.77	12.33%	
2000	$7.26	$0.90	$0.21	$0.69	12.40%	
1999	$6.81	$0.66	$0.21	$0.45	9.69%	
1998	$6.11	$0.90	$0.20	$0.70	14.73%	
1997	$5.36	$0.92	$0.17	$0.75	17.16%	
1996	$4.76	$0.74	$0.14	$0.60	15.55%	
1995	$4.04	$0.84	$0.12	$0.72	20.79%	
1994	$3.46	$0.68	$0.10	$0.58	19.65%	
1993	$3.00	$0.54	$0.08	$0.46	18.00%	**14.66%**
1992	$2.56	$0.51	$0.07	$0.44	19.92%	
1991	$2.22	$0.40	$0.06	$0.34	18.02%	
1990	$1.77	$0.50	$0.05	$0.45	28.25%	
1989	$1.38	$0.43	$0.04	$0.39	31.16%	
1988	$1.09	$0.32	$0.03	$0.29	29.36%	
1987	$0.88	$0.24	$0.03	$0.21	27.27%	
1986	$0.76	$0.15	$0.03	$0.12	19.74%	

Dow 30 Average ROE for 2002 **13.38%**

Disney

One-year ROE	6.31%
10-year Average ROE	14.66%%

Disney was definitely a TOP DOG for many years. However, between 1995 and 1996, it began to act a little Goofy as the ROE fell from 20.79% to 15.55%. From there Disney's ROE has been falling faster than Snow White after she choked on that apple. We can see Disney is really struggling to be just an average performing stock.

I saw an interesting Disney documentary recently. It showed new theme parks and new this and new that. But for all the money Disney is reinvesting, the ROE shows that Disney is just not getting a good return on this newly employed capital. The documentary made me want to buy Disney stock. The ROE tells us Disney is turning into a real Mickey Mouse operation.

DUPONT						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$24.83	$1.95	$1.40	$0.55	**7.85%**	
2001	$25.04	$1.19	$1.40	-$0.21	4.75%	
2000	$23.71	$2.73	$1.40	$1.33	11.51%	
1999	$22.51	$2.58	$1.38	$1.20	11.46%	
1998	$21.34	$2.54	$1.37	$1.17	11.90%	
1997	$18.96	$3.61	$1.23	$2.38	19.04%	
1996	$16.84	$3.24	$1.12	$2.12	19.24%	
1995	$14.95	$2.91	$1.02	$1.89	19.46%	
1994	$13.82	$2.04	$0.91	$1.13	14.76%	
1993	$13.47	$1.23	$0.88	$0.35	9.13%	**12.91%**
1992	$13.09	$1.25	$0.87	$0.38	9.55%	
1991	$12.64	$1.29	$0.84	$0.45	10.21%	
1990	$11.75	$1.70	$0.81	$0.89	14.47%	
1989	$10.71	$1.77	$0.73	$1.04	16.53%	
1988	$9.86	$1.47	$0.62	$0.85	14.91%	
1987	$9.24	$1.17	$0.55	$0.62	12.66%	
1986	$8.69	$1.06	$0.51	$0.55	12.20%	

Dow 30 Average ROE for 2002 **13.38%**

Dupont

One-year ROE	7.85%
10-year Average ROE	12.91%

Here is another stock underperforming the average Dow ROE. Both the one-year ROE and the 10-year average ROE are below the 13.38% average of the Dow. Dupont is not a contender for a TOP DOG position.

EASTMAN KODAK

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$42.79	$2.70	$1.80	$0.90	**6.31%**	
2001	$42.26	$2.30	$1.77	$0.53	5.44%	
2000	$39.32	$4.70	$1.76	$2.94	11.95%	
1999	$36.05	$5.03	$1.76	$3.27	13.95%	
1998	$33.48	$4.33	$1.76	$2.57	12.93%	
1997	$31.72	$3.52	$1.76	$1.76	11.10%	
1996	$28.82	$4.50	$1.60	$2.90	15.61%	
1995	$26.75	$3.67	$1.60	$2.07	13.72%	
1994	$25.44	$2.91	$1.60	$1.31	11.44%	
1993	$24.88	$2.56	$2.00	$0.56	10.29%	**11.28%**
1992	$23.62	$3.26	$2.00	$1.26	13.80%	
1991	$25.57	$0.05	$2.00	-$1.95	0.20%	
1990	$23.66	$3.91	$2.00	$1.91	16.53%	
1989	$24.03	$1.63	$2.00	-$0.37	6.78%	
1988	$21.62	$4.31	$1.90	$2.41	19.94%	
1987	$19.81	$3.52	$1.71	$1.81	17.77%	
1986	$20.33	$1.11	$1.63	-$0.52	5.46%	

Dow 30 Average ROE for 2002 **13.38%**

Eastman Kodak

One-year ROE	6.31%
10-year Average ROE	11.28%

Again, another stock with a low one-year and 10-year ROE. Kodak is just not getting a good return on its Owners' Equity. From whatever angle you snap this picture; Kodak just can't earn a good return on its investments.

EXXONMOBIL						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$13.29	$1.60	$0.92	$0.68	**12.04%**	
2001	$12.02	$2.18	$0.91	$1.27	18.14%	
2000	$10.49	$2.41	$0.88	$1.53	22.97%	
1999	$10.14	$1.19	$0.84	$0.35	11.74%	
1998	$9.65	$1.31	$0.82	$0.49	13.58%	
1997	$8.82	$1.64	$0.81	$0.83	18.59%	
1996	$8.20	$1.40	$0.78	$0.62	17.07%	
1995	$7.67	$1.28	$0.75	$0.53	16.69%	
1994	$7.48	$0.92	$0.73	$0.19	12.30%	
1993	$7.15	$1.05	$0.72	$0.33	14.69%	**15.78%**
1992	$6.90	$0.96	$0.71	$0.25	13.91%	
1991	$6.46	$1.11	$0.67	$0.44	17.18%	
1990	$6.09	$0.99	$0.62	$0.37	16.26%	
1989	$5.76	$0.91	$0.58	$0.33	15.80%	
1988	$5.34	$0.96	$0.54	$0.42	17.98%	
1987	$4.96	$0.86	$0.48	$0.38	17.34%	
1986	$4.55	$0.86	$0.45	$0.41	18.90%	

Dow 30 Average ROE for 2002 **13.38%**

Exxon Mobil

One-year ROE	12.04%
10-year Average ROE	15.78%

We can look at the one-year and 10-year ROE and say this stock overall is "fairly" consistent. But on the other hand, it can reach a high ROE of 20.97% as in 2000 and a low ROE of 11.74% just a year previous. The ROE is about average, but this oil giant has outperformed the Dow over the years. Maybe it's because of its relative consistency or because of oil price increases or anticipated oil increases from time to time. We'll see in the summary if it can gas up and slide its way onto our TOP DOG list.

GENERAL ELECTRIC						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$7.16	$1.65	$0.72	$0.93	**23.05%**	
2001	$6.39	$1.41	$0.64	$0.77	22.08%	
2000	$5.67	$1.29	$0.57	$0.72	22.76%	
1999	$5.09	$1.07	$0.49	$0.58	21.03%	
1998	$4.58	$0.93	$0.42	$0.51	20.32%	
1997	$4.11	$0.83	$0.36	$0.47	20.21%	
1996	$3.70	$0.73	$0.32	$0.41	19.75%	
1995	$3.33	$0.65	$0.28	$0.37	19.54%	
1994	$3.00	$0.58	$0.25	$0.33	19.35%	
1993	$2.71	$0.51	$0.22	$0.29	18.84%	**20.69%**
1992	$2.48	$0.42	$0.19	$0.23	16.96%	
1991	$2.22	$0.43	$0.17	$0.26	19.39%	
1990	$1.97	$0.40	$0.16	$0.24	20.43%	
1989	$1.75	$0.36	$0.14	$0.22	20.72%	
1988	$1.56	$0.31	$0.12	$0.19	20.04%	
1987	$1.41	$0.27	$0.11	$0.16	18.95%	
1986	$1.28	$0.23	$0.10	$0.13	17.70%	

Dow 30 Average ROE for 2002 **13.38%**

General Electric

One-year ROE	22.34%
10-year Average ROE	20.69%

Here's GE once again. Notice the consistency along with a nice high one-year and 10-year ROE. I have a feeling this stock will be on our final TOP DOG list. As a matter of fact, with the ROE far above the Dow average of 13.38%, this is the highest ROE we've seen so far. However, we will see even higher ROEs. Read on.

GENERAL MOTORS						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$66.98	$6.30	$2.00	$4.30	**9.41%**	
2001	$67.21	$1.77	$2.00	-$0.23	2.63%	
2000	$62.53	$6.68	$2.00	$4.68	10.68%	
1999	$56.00	$8.53	$2.00	$6.53	15.23%	
1998	$52.76	$5.24	$2.00	$3.24	9.93%	
1997	$46.87	$7.89	$2.00	$5.89	16.83%	
1996	$42.75	$5.72	$1.60	$4.12	13.38%	
1995	$36.57	$7.28	$1.10	$6.18	19.91%	
1994	$31.17	$6.20	$0.80	$5.40	19.89%	
1993	$29.84	$2.13	$0.80	$1.33	7.14%	**12.50%**
1992	$36.09	-$4.85	$1.40	-$6.25	-13.44%	
1991	$46.54	-$8.85	$1.60	-$10.45	-19.02%	
1990	$53.63	-$4.09	$3.00	-$7.09	-7.63%	
1989	$50.30	$6.33	$3.00	$3.33	12.58%	
1988	$45.98	$6.82	$2.50	$4.32	14.83%	
1987	$43.45	$5.03	$2.50	$2.53	11.58%	
1986	$41.84	$4.11	$2.50	$1.61	9.82%	

Dow 30 Average ROE for 2002 **13.38%**

General Motors

One-year ROE	9.41%
10-year Average ROE	12.50%

And here is the exact opposite of GE. GM's ROE is both low and very inconsistent. The ROE tells me this stock's price will rise and fall and eventually not increase very much. Definitely not on the TOP DOG list.

HOME DEPOT						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$5.84	$1.57	$0.20	$1.37	**26.88%**	
2001	$4.72	$1.29	$0.17	$1.12	27.33%	
2000	$3.78	$1.10	$0.16	$0.94	29.10%	
1999	$2.89	$1.00	$0.11	$0.89	34.60%	
1998	$2.26	$0.71	$0.08	$0.63	31.42%	
1997	$1.80	$0.52	$0.06	$0.46	28.89%	
1996	$1.42	$0.43	$0.05	$0.38	30.28%	
1995	$1.12	$0.34	$0.04	$0.30	30.36%	
1994	$0.86	$0.29	$0.03	$0.26	33.72%	
1993	$0.66	$0.22	$0.02	$0.20	33.33%	**30.59%**
1992	$0.50	$0.18	$0.02	$0.16	36.00%	
1991	$0.38	$0.13	$0.01	$0.12	34.21%	
1990	$0.29	$0.10	$0.01	$0.09	34.48%	
1989	$0.23	$0.07	$0.01	$0.06	30.43%	
1988	$0.18	$0.05	$0.00	$0.05	27.78%	
1987	$0.14	$0.04	$0.00	$0.04	28.57%	
1986	$0.12	$0.02	$0.00	$0.02	16.67%	

Dow 30 Average ROE for 2002 **13.38%**

Home Depot

One-year ROE	26.88%
10-year Average ROE	30.59%

Yes, all we can say is wow! A very high and relatively consistent ROE although decreasing little by little as time goes on. From my full worksheet on this company, I know it is re-investing 88.27% of its earnings. This tells us that Home Depot is not only making a very high return on Owners' Equity, but it is putting 88% of its earnings back into the company in order to grow. I bet this baby is a TOP DOG.

HEWLETT-PACKARD						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$12.86	$0.78	$0.32	$0.46	**6.07%**	
2001	$12.29	$0.89	$0.32	$0.57	7.24%	
2000	$10.88	$1.73	$0.32	$1.41	15.90%	
1999	$9.70	$1.50	$0.32	$1.18	15.46%	
1998	$8.56	$1.44	$0.30	$1.14	16.82%	
1997	$7.33	$1.48	$0.25	$1.23	20.19%	
1996	$6.27	$1.27	$0.21	$1.06	20.26%	
1995	$5.29	$1.16	$0.18	$0.98	21.93%	
1994	$4.65	$0.77	$0.13	$0.64	16.56%	
1993	$4.18	$0.58	$0.11	$0.47	13.88%	**15.43%**
1992	$3.83	$0.44	$0.09	$0.35	11.49%	
1991	$3.51	$0.38	$0.06	$0.32	10.83%	
1990	$3.18	$0.38	$0.05	$0.33	11.95%	
1989	$2.79	$0.44	$0.05	$0.39	15.77%	
1988	$2.41	$0.42	$0.04	$0.38	17.43%	
1987	$2.13	$0.31	$0.03	$0.28	14.55%	
1986	$1.91	$0.25	$0.03	$0.22	13.09%	

Dow 30 Average ROE for 2002 **13.38%**

Hewlett Packard

One-year ROE	6.07%
10-year Average ROE	15.43%

Hewlett has a low one-year ROE, but has seen periods of brilliance when it had ROEs of 20% or so. 20% is far above the Dow average of 13.38%. However, this stock is not very consistent. And remember what I said about consistency? The market loves consistency and hates inconsistency. If a stock is inconsistent, the market does not know how to value the company. Thus, you will see volatility and we all hate volatility.

HONEYWELL

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$23.32	$2.00	$0.75	$1.25	**8.58%**	
2001	$22.02	$2.05	$0.75	$1.30	9.31%	
2000	$19.94	$2.83	$0.75	$2.08	14.19%	
1999	$17.94	$2.68	$0.68	$2.00	14.94%	
1998	$16.22	$2.32	$0.60	$1.72	14.30%	
1997	$14.72	$2.02	$0.52	$1.50	13.72%	
1996	$13.36	$1.81	$0.45	$1.36	13.55%	
1995	$12.20	$1.55	$0.39	$1.16	12.70%	
1994	$11.18	$1.34	$0.32	$1.02	11.99%	
1993	$10.31	$1.16	$0.29	$0.87	11.25%	**12.45%**
1992	$9.60	$0.96	$0.25	$0.71	10.00%	
1991	$9.37	$0.63	$0.40	$0.23	6.72%	
1990	$8.98	$0.84	$0.45	$0.39	9.35%	
1989	$8.58	$0.85	$0.45	$0.40	9.91%	
1988	$8.25	$0.78	$0.45	$0.33	9.45%	
1987	$8.14	$0.56	$0.45	$0.11	6.88%	
1986	$7.84	$0.75	$0.45	$0.30	9.57%	

Dow 30 Average ROE for 2002 **13.38%**

Honeywell

One-year ROE	8.58%
10-year Average ROE	12.45%

Here is yet another stock that is underperforming the Dow average ROE of 13.38%. Remember when GE wanted to buy Honeywell several years ago and there was high investor resentment? Well, now you know why. Can you imagine a great company like GE buying a very low-performing company like Honeywell? Just flip back to the ROE of Home Depot and compare Home Depot's ROE to the ROE of Honeywell. Now you're beginning to see the difference.

INTEL

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$7.45	$0.53	$0.08	$0.45	**7.11%**	
2001	$7.00	$0.53	$0.08	$0.45	7.57%	
2000	$5.54	$1.53	$0.07	$1.46	27.62%	
1999	$4.42	$1.17	$0.05	$1.12	26.47%	
1998	$3.56	$0.89	$0.03	$0.86	25.00%	
1997	$2.62	$0.97	$0.03	$0.94	37.02%	
1996	$1.91	$0.73	$0.02	$0.71	38.22%	
1995	$1.44	$0.49	$0.02	$0.47	34.03%	
1994	$1.08	$0.37	$0.01	$0.36	34.26%	
1993	$0.77	$0.32	$0.01	$0.31	41.56%	**27.89%**
1992	$0.61	$0.16	$0.00	$0.16	26.23%	
1991	$0.49	$0.12	$0.00	$0.12	24.49%	
1990	$0.39	$0.10	$0.00	$0.10	25.64%	
1989	$0.32	$0.07	$0.00	$0.07	21.88%	
1988	$0.26	$0.06	$0.00	$0.06	23.08%	
1987	$0.23	$0.03	$0.00	$0.03	13.04%	
1986	$0.26	-$0.03	$0.00	-$0.03	-11.54%	

Dow 30 Average ROE for 2002 **13.38%**

Intel

One-year ROE	7.11%
10-year Average ROE	27.89%

Here's where things get tough. Look at this great ROE until just 2001. Wow, what do you do in a situation such as this? Will it come back to its glory years? Because if it does, then this stock could go to the moon once again. It was a TOP DOG until just recently. Let's wait and see what we can do when we look at our summary sheet. But think of this: Intel had very nice earnings. There were so many companies in the tech arena that never had earnings. Intel is still alive. The companies that had no earnings are dead in the water.

IBM						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$38.81	$3.90	$0.59	$3.31	**10.05%**	
2001	$34.97	$4.35	$0.51	$3.84	12.44%	
2000	$31.04	$4.44	$0.51	$3.93	14.30%	
1999	$27.79	$3.72	$0.47	$3.25	13.39%	
1998	$24.94	$3.29	$0.44	$2.85	13.19%	
1997	$22.32	$3.01	$0.39	$2.62	13.49%	
1996	$19.89	$2.76	$0.33	$2.43	13.88%	
1995	$17.38	$2.76	$0.25	$2.51	15.88%	
1994	$16.40	$1.23	$0.25	$0.98	7.50%	
1993	$16.81	-$0.01	$0.40	-$0.41	-0.06%	**11.41%**
1992	$17.40	$0.62	$1.21	-$0.59	3.56%	
1991	$17.69	$0.92	$1.21	-$0.29	5.20%	
1990	$16.27	$2.63	$1.21	$1.42	16.16%	
1989	$15.19	$2.26	$1.18	$1.08	14.88%	
1988	$13.83	$2.46	$1.10	$1.36	17.79%	
1987	$12.75	$2.18	$1.10	$1.08	17.10%	
1986	$11.90	$1.95	$1.10	$0.85	16.39%	

Dow 30 Average ROE for 2002 **13.38%**

IBM

One-year ROE	10.05%
10-year Average ROE	11.41%

Here's Big Blue! As you can see, Big Blue is not doing well and has become, well, just plain blue. It simply cannot earn a good return for investors. This stock has outperformed the Dow over the past five years, but going back longer than that, it has not. Over a 20-year period IBM has performed a bit less than the Dow. I hate to say this about Big Blue, but it is now a less-than-average stock. Not a TOP DOG.

INTERNATIONAL PAPER						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$34.95	$1.05	$1.00	$0.05	**3.00%**	
2001	$35.51	$0.44	$1.00	-$0.56	1.24%	
2000	$34.35	$2.16	$1.00	$1.16	6.29%	
1999	$34.10	$1.33	$1.08	$0.25	3.90%	
1998	$34.10	$1.00	$1.00	$0.00	2.93%	
1997	$34.07	$1.03	$1.00	$0.03	3.02%	
1996	$33.58	$1.49	$1.00	$0.49	4.44%	
1995	$30.00	$4.50	$0.92	$3.58	15.00%	
1994	$29.11	$1.73	$0.84	$0.89	5.94%	
1993	$28.68	$1.27	$0.84	$0.43	4.43%	**5.02%**
1992	$27.85	$1.67	$0.84	$0.83	6.00%	
1991	$26.71	$1.98	$0.84	$1.14	7.41%	
1990	$24.31	$3.24	$0.84	$2.40	13.33%	
1989	$21.22	$3.86	$0.77	$3.09	18.19%	
1988	$18.57	$3.29	$0.64	$2.65	17.72%	
1987	$17.37	$1.80	$0.60	$1.20	10.36%	
1986	$16.69	$1.28	$0.60	$0.68	7.67%	

Dow 30 Average ROE for 2002 **13.38%**

International Paper

One-year ROE	3.00%
10-year Average ROE	5.02%

International Paper has a lot of trouble earning anywhere near the average ROE for its investors. Over the past 10 years, IP has appreciated 30% while the Dow has appreciated 180%. This lack of performance is due to the very low ROE. Again we see a cyclical stock in this paper tiger.

JOHNSON & JOHNSON

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$10.04	$2.25	$0.80	$1.45	**22.41%**	
2001	$8.83	$1.91	$0.70	$1.21	21.63%	
2000	$7.75	$1.70	$0.62	$1.08	21.94%	
1999	$6.81	$1.49	$0.55	$0.94	21.88%	
1998	$5.96	$1.34	$0.49	$0.85	22.48%	
1997	$5.18	$1.21	$0.43	$0.78	23.36%	
1996	$4.46	$1.09	$0.37	$0.72	24.44%	
1995	$3.85	$0.93	$0.32	$0.61	24.16%	
1994	$3.35	$0.78	$0.28	$0.50	23.28%	
1993	$2.91	$0.69	$0.25	$0.44	23.71%	**22.93%**
1992	$2.51	$0.62	$0.22	$0.40	24.70%	
1991	$2.15	$0.55	$0.19	$0.36	25.58%	
1990	$1.82	$0.48	$0.15	$0.33	26.37%	
1989	$1.55	$0.41	$0.14	$0.27	26.45%	
1988	$1.31	$0.36	$0.12	$0.24	27.48%	
1987	$1.11	$0.30	$0.10	$0.20	27.03%	
1986	$1.08	$0.12	$0.09	$0.03	11.11%	

Dow 30 Average ROE for 2002 **13.38%**

Johnson and Johnson

One-year ROE	22.41%
10-year Average ROE	22.93%

Look at this consistency in ROE. Look how close the one-year ROE is to the 10-year ROE. With this consistency and relatively high ROE, I can tell you that Johnson and Johnson is a TOP DOG. JNJ has appreciated 340% to the Dow's 180% over the past decade. Put Band-Aids on another company because I want this baby in my Top Dog portfolio.

McDONALD'S						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$13.00	$1.38	$0.24	$1.14	**10.62%**	
2001	$11.87	$1.36	$0.23	$1.13	11.46%	
2000	$10.63	$1.46	$0.22	$1.24	13.73%	
1999	$9.44	$1.39	$0.20	$1.19	14.72%	
1998	$8.36	$1.26	$0.18	$1.08	15.07%	
1997	$7.37	$1.15	$0.16	$0.99	15.60%	
1996	$6.41	$1.11	$0.15	$0.97	17.33%	
1995	$5.55	$0.99	$0.13	$0.86	17.85%	
1994	$4.83	$0.84	$0.12	$0.72	17.41%	
1993	$4.21	$0.73	$0.11	$0.62	17.36%	**15.12%**
1992	$3.66	$0.65	$0.10	$0.55	17.78%	
1991	$3.16	$0.59	$0.09	$0.50	18.70%	
1990	$2.70	$0.55	$0.09	$0.46	20.41%	
1989	$2.29	$0.49	$0.08	$0.41	21.44%	
1988	$1.93	$0.43	$0.07	$0.36	22.34%	
1987	$1.63	$0.36	$0.06	$0.30	22.15%	
1986	$1.37	$0.31	$0.06	$0.26	22.63%	

Dow 30 Average ROE for 2002 **13.38%**

McDonald's

One-year ROE	10.62%
10-year Average ROE	15.12%

Just look at the ROE pre-1991. What a great stock back then! Great ROE. But as time goes on, the ROE begins to decline and decline. It is earning less and less on newly invested monies as indicated by the declining ROE.

Once a TOP DOG, but no longer, it has underperformed the Dow over the past decade and will continue to be an underperformer in the future. Mickee Dee has turned into just plain chopped meat.

MICROSOFT

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$8.06	$1.87	$0.00	$1.87	**23.20%**	
2001	$6.26	$1.80	$0.00	$1.80	28.75%	
2000	$4.56	$1.70	$0.00	$1.70	37.28%	
1999	$3.17	$1.39	$0.00	$1.39	43.85%	
1998	$2.28	$0.89	$0.00	$0.89	39.04%	
1997	$1.62	$0.66	$0.00	$0.66	40.74%	
1996	$1.19	$0.43	$0.00	$0.43	36.13%	
1995	$0.90	$0.29	$0.00	$0.29	32.22%	
1994	$0.65	$0.25	$0.00	$0.25	38.46%	
1993	$0.45	$0.20	$0.00	$0.20	44.44%	**36.41%**
1992	$0.30	$0.15	$0.00	$0.15	50.00%	
1991	$0.20	$0.10	$0.00	$0.10	50.00%	
1990	$0.13	$0.07	$0.00	$0.07	53.85%	
1989	$0.09	$0.04	$0.00	$0.04	44.44%	
1988	$0.06	$0.03	$0.00	$0.03	50.00%	
1987	$0.04	$0.02	$0.00	$0.02	50.00%	
1986	$0.03	$0.01	$0.00	$0.01	33.33%	

Dow 30 Average ROE for 2002 **13.38%**

Microsoft

One-year ROE	23.20%
10-year Average ROE	36.41%

This is one of those stocks that Buffett has trouble in the determination of market position ten years from now. This is because Buffett does not know what the entire industry will look like in the future. Even though the one-year ROE is high at 22.58%, the ROE is declining. But Microsoft may very well continue to be on our TOP DOG list at the end of this chapter.

3M COMPANY						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$33.35	$5.25	$2.48	$2.77	**15.74%**	
2001	$32.17	$3.58	$2.40	$1.18	11.13%	
2000	$29.85	$4.64	$2.32	$2.32	15.54%	
1999	$27.88	$4.21	$2.24	$1.97	15.10%	
1998	$26.34	$3.74	$2.20	$1.54	14.20%	
1997	$24.58	$3.88	$2.12	$1.76	15.79%	
1996	$22.87	$3.63	$1.92	$1.71	15.87%	
1995	$21.52	$3.23	$1.88	$1.35	15.01%	
1994	$20.10	$3.18	$1.76	$1.42	15.82%	
1993	$18.85	$2.91	$1.66	$1.25	15.44%	**14.96%**
1992	$17.63	$2.82	$1.60	$1.22	16.00%	
1991	$16.56	$2.63	$1.56	$1.07	15.88%	
1990	$15.06	$2.96	$1.46	$1.50	19.65%	
1989	$13.56	$2.80	$1.30	$1.50	20.65%	
1988	$12.07	$2.55	$1.06	$1.49	21.13%	
1987	$10.99	$2.01	$0.93	$1.08	18.29%	
1986	$10.19	$1.70	$0.90	$0.80	16.68%	

Dow 30 Average ROE for 2002 13.38%

3 M Company (formerly Minnesota Mining and Manufacturing)

One-year ROE	15.74%
10-year Average ROE	14.96%

One thing you've got to say about MMM, it has been pretty consistent over the past ten years. Its ROE is a bit above the averages. We would expect it to perform about even with the Dow in price appreciation and over the past ten years, that's exactly what it has done. A very consistent, average stock.

J.P. MORGAN CHASE

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$22.21	$1.20	$1.36	-$0.16	**5.40%**	
2001	$22.76	$0.81	$1.36	-$0.55	3.56%	
2000	$21.18	$2.86	$1.28	$1.58	13.50%	
1999	$18.09	$4.18	$1.09	$3.09	23.11%	
1998	$16.23	$2.82	$0.96	$1.86	17.38%	
1997	$14.38	$2.68	$0.83	$1.85	18.64%	
1996	$13.48	$1.65	$0.75	$0.90	12.24%	
1995	$12.11	$2.02	$0.65	$1.37	16.68%	
1994	$11.00	$1.66	$0.55	$1.11	15.09%	
1993						**13.96%**
1992						
1991						
1990						
1989						
1988						
1987						
1986						

Dow 30 Average ROE for 2002 13.38%

J.P. Morgan Chase

One-year ROE	5.40%
10-year Average ROE	N/A

Morgan merged with Chase Manhattan on December 31, 2000. I was also only able to obtain statistical information since 1994. Even though we do not have a full 10-year ROE history, we can look at the ROE and honestly say we have no clue as to where this stock is headed. Definitely not a candidate for a TOP DOG nomination. Go bank on some other stock.

MERCK						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$13.54	$3.13	$1.41	$1.72	**23.12%**	
2001	$11.77	$3.14	$1.37	$1.77	26.68%	
2000	$10.08	$2.90	$1.21	$1.69	28.77%	
1999	$8.73	$2.45	$1.10	$1.35	28.06%	
1998	$7.53	$2.15	$0.95	$1.20	28.55%	
1997	$6.46	$1.92	$0.85	$1.07	29.72%	
1996	$5.57	$1.60	$0.71	$0.89	28.73%	
1995	$4.84	$1.35	$0.62	$0.73	27.89%	
1994	$4.22	$1.19	$0.57	$0.62	28.20%	
1993	$3.57	$1.17	$0.52	$0.65	32.77%	**28.25%**
1992	$2.97	$1.06	$0.46	$0.60	35.69%	
1991	$2.44	$0.92	$0.39	$0.53	37.70%	
1990	$2.00	$0.76	$0.32	$0.44	38.00%	
1989	$1.64	$0.63	$0.27	$0.36	38.41%	
1988	$1.34	$0.51	$0.21	$0.30	38.06%	
1987	$1.11	$0.37	$0.14	$0.23	33.33%	
1986	$0.95	$0.27	$0.11	$0.16	28.42%	

Dow 30 Average ROE for 2002 **13.38%**

Merck

One-year ROE	23.12%
10-year Average ROE	28.25%

The poor drug companies. We want to see them make money, but when we go to the drug counter, we want the government to do something to alleviate those high costs of prescription drugs.

Merck faces a lot of competition from the generic drug companies. However, Saint Merck (as it is referred to by the analysts) has an ROE that is to be envied. But even so, Merck has underperformed the averages the past two years as investment money allocated for the drug companies has gone to the generics.

PHILIP MORRIS

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$15.91	$4.60	$2.44	$2.16	**28.91%**	
2001	$14.26	$3.87	$2.22	$1.65	27.14%	
2000	$12.53	$3.75	$2.02	$1.73	29.93%	
1999	$11.18	$3.19	$1.84	$1.35	28.53%	
1998	$10.66	$2.20	$1.68	$0.52	20.64%	
1997	$9.68	$2.58	$1.60	$0.98	26.65%	
1996	$8.59	$2.56	$1.47	$1.09	29.80%	
1995	$7.64	$2.17	$1.22	$0.95	28.40%	
1994	$6.83	$1.82	$1.01	$0.81	26.65%	
1993	$6.35	$1.35	$0.87	$0.48	21.26%	**26.79%**
1992	$5.31	$1.82	$0.78	$1.04	34.27%	
1991	$4.44	$1.51	$0.64	$0.87	34.01%	
1990	$3.68	$1.28	$0.52	$0.76	34.78%	
1989	$3.09	$1.01	$0.42	$0.59	32.69%	
1988	$2.69	$0.74	$0.34	$0.40	27.51%	
1987	$2.30	$0.65	$0.26	$0.39	28.26%	
1986	$1.99	$0.52	$0.21	$0.31	26.13%	

Dow 30 Average ROE for 2002 **13.38%**

Philip Morris (Now Altria)

One-year ROE	28.91%
10-year Average ROE	26.79%

Altria pays a dividend of over 6% and earns almost $5 per share. As you can see by the very high ROE, Mighty Mo (MO is the stock symbol) can earn some serious money. Of course, there is always legislation hanging over the tobacco companies and increasing competition from the generic cigarette brands.

However, our strategy is looking for a high ROE and Altria certainly fills the bill. I think we have a TOP DOG here, even with all the problems plaguing the tobacco industry we constantly read about every day.

PROCTER & GAMBLE						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$20.13	$3.59	$1.52	$2.07	**17.83%**	
2001	$18.41	$3.12	$1.40	$1.72	16.95%	
2000	$16.74	$2.95	$1.28	$1.67	17.62%	
1999	$15.03	$2.85	$1.14	$1.71	18.96%	
1998	$13.48	$2.56	$1.01	$1.55	18.99%	
1997	$12.10	$2.28	$0.90	$1.38	18.84%	
1996	$10.75	$2.15	$0.80	$1.35	20.00%	
1995	$9.59	$1.86	$0.70	$1.16	19.40%	
1994	$8.66	$1.55	$0.62	$0.93	17.90%	
1993	$7.80	$1.41	$0.55	$0.86	18.08%	**18.46%**
1992	$7.01	$1.31	$0.52	$0.79	18.69%	
1991	$6.27	$1.23	$0.49	$0.74	19.62%	
1990	$5.68	$1.03	$0.44	$0.59	18.13%	
1989	$5.17	$0.89	$0.38	$0.51	17.21%	
1988	$4.76	$0.75	$0.34	$0.41	15.76%	
1987	$4.53	$0.57	$0.34	$0.23	12.58%	
1986	$4.33	$0.53	$0.33	$0.20	12.24%	

Dow 30 Average ROE for 2002 **13.38%**

Procter and Gamble

One-year ROE	17.83%
10-year Average ROE	18.46%

Consistency is the key here. It's very nice to see the one-year and 10-year ROE so close. P&G has come a long way from making soap and candles. This stock could very well be a serious TOP DOG contender.

SBC COMMUNICATIONS

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$16.74	$2.30	$1.07	$1.23	**13.74%**	
2001	$15.41	$2.35	$1.02	$1.33	15.25%	
2000	$14.16	$2.26	$1.01	$1.25	15.96%	
1999	$12.83	$2.30	$0.97	$1.33	17.93%	
1998	$11.72	$2.05	$0.94	$1.11	17.49%	
1997	$10.78	$1.84	$0.90	$0.94	17.07%	
1996	$9.91	$1.73	$0.86	$0.87	17.46%	
1995	$9.19	$1.55	$0.83	$0.72	16.87%	
1994	$8.61	$1.37	$0.79	$0.58	15.91%	
1993	$8.17	$1.20	$0.76	$0.44	14.69%	**16.24%**
1992	$7.81	$1.09	$0.73	$0.36	13.96%	
1991	$7.56	$0.96	$0.71	$0.25	12.70%	
1990	$7.33	$0.92	$0.69	$0.23	12.55%	
1989	$7.07	$0.91	$0.65	$0.26	12.87%	
1988	$6.81	$0.88	$0.62	$0.26	12.92%	
1987	$6.52	$0.87	$0.58	$0.29	13.34%	
1986	$6.19	$0.86	$0.53	$0.33	13.89%	

Dow 30 Average ROE for 2002 **13.38%**

SBC Communications

One-year ROE	13.74%
10-year Average ROE	16.24%

Both the one-year and 10-year ROE are above the Dow average ROE and the ROE is fairly consistent. This stock should be an above-average performer, but not too sure if it will make our final eight. We'll have to wait until we formulate our entire list to see if this stock should be in our TOP DOG portfolio.

UNITED TECHNOLOGIES						
YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$24.96	$4.40	$0.96	$3.44	**17.63%**	
2001	$22.03	$3.83	$0.90	$2.93	17.39%	
2000	$19.31	$3.55	$0.83	$2.72	18.38%	
1999	$18.42	$1.65	$0.76	$0.89	8.96%	
1998	$16.59	$2.53	$0.70	$1.83	15.25%	
1997	$15.10	$2.11	$0.62	$1.49	13.97%	
1996	$13.92	$1.73	$0.55	$1.18	12.43%	
1995	$13.00	$1.43	$0.51	$0.92	11.00%	
1994	$12.32	$1.16	$0.48	$0.68	9.42%	
1993	$11.94	$0.83	$0.45	$0.38	6.95%	**13.14%**
1992	$11.49	$0.90	$0.45	$0.45	7.83%	
1991	$11.36	$0.58	$0.45	$0.13	5.11%	
1990	$10.43	$1.38	$0.45	$0.93	13.23%	
1989	$9.53	$1.30	$0.40	$0.90	13.64%	
1988	$8.66	$1.26	$0.39	$0.87	14.55%	
1987	$7.88	$1.13	$0.35	$0.78	14.34%	
1986	$7.55	$0.68	$0.35	$0.33	9.01%	

Dow 30 Average ROE for 2002 **13.38%**

United Technologies

One-year ROE	17.63%
10-year Average ROE	13.14%

This stock's ROE has been improving over the years. There is still some inconsistency, such as in the years 1999, 1994, 1993 and 1991. Nevertheless, it should be an above-average performer, and thus a possible (?) contender for the TOP DOG list.

WALMART

YEAR	OWNERS' EQUITY	NET INCOME	DIV PAID	RETAINED EARNINGS	RETURN ON EQUITY	10-YEAR AVG. ROE
2002	$8.78	$1.80	$0.30	$1.50	**20.50%**	
2001	$7.55	$1.50	$0.27	$1.23	19.87%	
2000	$6.38	$1.40	$0.23	$1.17	21.94%	
1999	$5.29	$1.28	$0.19	$1.09	24.20%	
1998	$4.45	$0.99	$0.15	$0.84	22.25%	
1997	$3.81	$0.78	$0.14	$0.64	20.47%	
1996	$3.25	$0.67	$0.11	$0.56	20.62%	
1995	$2.75	$0.60	$0.10	$0.50	21.82%	
1994	$2.25	$0.59	$0.09	$0.50	26.22%	
1993	$1.81	$0.51	$0.07	$0.44	28.18%	**22.61%**
1992	$1.42	$0.44	$0.05	$0.39	30.99%	
1991	$1.11	$0.35	$0.04	$0.31	31.53%	
1990	$0.86	$0.29	$0.04	$0.25	33.72%	
1989	$0.65	$0.24	$0.03	$0.21	36.92%	
1988	$0.48	$0.19	$0.02	$0.17	39.58%	
1987	$0.36	$0.14	$0.02	$0.12	38.89%	
1986	$0.27	$0.10	$0.01	$0.09	37.04%	

Dow 30 Average ROE for 2002 **13.38%**

Wal-Mart

One-year ROE	20.50%
10 year Average ROE	22.61%

Welcome to Wal-Mart, shoppers. Now here's a company that should be a TOP DOG. It is the world's largest retailer with more than 1,647 discount stores, 1,066 supercenters and 500 Sam's Clubs. On the numbers side, Wal-Mart sports a nice high ROE and relatively consistent ROE since 1995. This stock is definitely an above-average performer.

TOP DOGS OF THE DOW

	STOCK	2002 ROE		STOCK	2002 ROE
1	**Philip Morris**	**28.91%**	16	Exxon Mobile	12.04%
2	**Home Depot**	**26.88%**	17	McDonald's	10.62%
3	**Microsoft**	**23.20%**	18	Int'l Bus. Machines	10.05%
4	**Merck**	**23.12%**	19	General Motors	9.41%
5	**General Electric**	**23.05%**	20	Honeywell	8.58%
6	**Johnson & Johnson**	**22.41%**	21	Dupont	7.85%
7	**Walmart**	**20.50%**	22	Caterpillar	7.50%
8	**Citigroup**	**19.46%**	23	Intel	7.11%
9	Coca Cola	17.84%	24	Alcoa	6.99%
10	Procter & Gamble	17.83%	25	Disney	6.31%
11	United Technologies	17.63%	26	Eastman Kodak	6.31%
12	3M Company	15.74%	27	Hewlett-Packard	6.07%
13	SBC Communications	13.74%	28	J.P. Morgan Chase	5.40%
14	Boeing	13.40%	29	Int'l Paper Co.	3.00%
15	American Express	12.67%	30	AT&T	-2.39%

You are looking at a summary of the 30 Dow stocks arranged from the highest ROEs to the lowest ROEs using the last year (2002) ROEs, with the ROEs configured by Clean Surplus Accounting,

When you look at the list of the Dow arranged in this manner, you are able to see very easily the percentage return each company is earning on the amount of money (Owners' Equity) invested into that company over the past year of 2002.

The question related to the formation of a portfolio is very important. In fact, your future depends on it. You want to fill your portfolio with the most efficient stocks. The most efficient stocks are those stocks which are earning a greater return on the money investors have put into that company, which means those stocks with the highest Clean Surplus ROEs.

Would you rather invest in the first and second stocks on the list, which are Philip Morris (now Altria) and Home Depot, or the last two stocks on the list, which are International Paper and AT&T?

Philip Morris and Home Depot are earning returns of over 26% on the money investors have put into the company over the years, while International Paper and AT&T are earning less than a 3% return on the amount of money investors have put into those companies.

In other words, would you rather invest in a bank that is earning 26% on its money or would you rather invest in a bank earning 2.5% on its money?

When you think about it this way, the answer is easy. You want to invest in the most efficient bank when it comes to banks and you want to invest in the most efficient companies when it comes to stocks. That just about says it all, doesn't it?

SECURITY SELECTION

The strategy I've been using since 1987 has been to select the eight stocks with the highest ROEs for the previous year. For the 2003 portfolio, we would select the 8 stocks with the highest ROEs ending 2002. The 2003 portfolio would consist of Philip Morris (Altria), Home Depot, Microsoft, Merck, General Electric, Johnson & Johnson, Wal-Mart and Citigroup.

For those of you who would like more diversification in your portfolio, you would simply add the next several stocks. In this case we could add Coca Cola, Procter and Gamble, United Technologies, etc. Just remember, as you select stocks closer to the average of 13.38% (the average ROE of the Dow at this time), your portfolio should still outperform the Dow while adding more diversity.

HIGH ROE AND CONSISTENT ROE

The research on Clean Surplus Accounting mentions that in order to increase the ability to predict, you must search for both a high and consistent ROE. In Mary Buffett's book on Warren Buffett, she says that Warren looks for a high and consistent ROE. Warren also wants stocks with at least a 10-year history of a high and consistent ROE.

In my Top Dog strategy, we discussed selecting stocks with just the previous year's ROE being high. We didn't take into consideration consistency. However, let's look at the stocks we selected for 2003 based on 2002 ROE and see if they have been consistent over the years.

	STOCK	2002 ROE	3-YR AVG. ROE	5-YR AVG. ROE	10-YR AVG. ROE
1	PHILIP MORRIS	28.91%	28.66%	27.03%	26.79%
2	HOME DEPOT	26.88%	27.77%	29.87%	30.59%
3	MICROSOFT	23.20%	29.75%	34.42%	36.41%
4	MERCK	23.12%	26.19%	27.04%	28.25%
5	GENERAL ELECTRIC	23.05%	22.63%	21.85%	20.69%
6	JOHNSON & JOHNSON	22.41%	21.99%	22.07%	22.93%
7	WALMART	20.50%	20.77%	21.75%	22.61%
8	CITIGROUP	19.46%	20.92%	20.14%	N/A

Yes, it just so happens that these top eight stocks have been pretty consistent over their 3, 5 and 10-year average ROEs. This, of course, is a very good thing. Consistency allows greater predictability than does inconsistency. And the securities with high and consistent ROEs outperform stocks with low and inconsistent ROEs. This was definitely proven in my work on the S&P 500 portfolios discussed in an earlier chapter.

Bottom line here is that stocks that have had high ROEs in the past have a greater chance of having a high ROE in the future. And

my work shows that stocks with high ROEs over time, outperform stocks with low ROEs.

STOCKS WITH LOW ROEs

Just for a moment, let's look at the stocks at the bottom of the Dow list. Buffett is known to say something like, "Turnarounds seldom turn." Maybe we can begin to understand what he means by this statement.

	STOCK	2002 ROE	3-YR AVG. ROE	5-YR AVG. ROE	10-YR AVG. ROE
24	ALCOA	6.99%	10.93%	11.44%	9.58%
25	DISNEY	6.31%	10.34%	11.09%	14.66%
26	EASTMAN KODAK	6.31%	7.90%	10.12%	11.28%
27	HEWLETT-PACKARD	6.07%	9.74%	12.30%	15.43%
28	J.P. MORGAN CHASE	5.40%	7.49%	12.59%	N/A
29	INT'L PAPER CO.	3.00%	3.51%	3.47%	5.02%
30	AT&T	-2.39%	0.37%	5.63%	11.86%

These bottom stocks had low ROEs ten years ago and they continue to have low ROEs at the end of 2002. In other words, some stocks take a very long time to come back, if ever. And this list has several stocks which are household names. Unless we look at the ROE as calculated by Clean Surplus Accounting, we just might be tempted to buy some of these stocks. However, we can see that none of the stocks on this list are earning a decent return on the money shareholders have invested into them.

A LITTLE BIT OF RESEARCH ON THE DOW STOCKS

The following set of statistics shows the group of Dow stocks (as of the end of 2002) arranged in order of their ***10-year average ROEs*** as configured by Clean Surplus Accounting. The ROEs are sorted from the highest 10-year average ROE to the lowest 10-year average ROE just as we did on the previous pages with the one-year ROEs.

I then calculated the 10-year total returns (Appreciation plus Dividends) of each stock. I created three portfolios of ten stocks each. Of course, there are only thirty stocks in the Dow so three portfolios was the maximum number of portfolios we could construct.

The ten stocks with the highest ROEs comprised the first portfolio. The stocks with the next ten highest ROEs comprised the second portfolio and the last ten stocks made up the third portfolio. As you can see, the portfolios of stocks with the higher ROEs outperformed the portfolios of stocks with lower ROEs over this 10-year period.

I just want to caution you that some of the stocks you see in this Dow list, such as Intel, Microsoft and Home Depot were not in the Dow the entire ten years. Thus, you are not looking at pure research in this section. We are using this section as a guide to show the power of the Clean Surplus ROE.

10-STOCK PORTFOLIOS AND THEIR 10-YEAR RETURNS

		10-YR ROE	10-Yr Stock Returns		10 stock Portfolio Avg. Returns
1	Philip Morris	36.35%	1148.86%	1	
2	Home Depot	30.76%	409.51%	2	
3	Microsoft	28.25%	204.64%	3	
4	Merck	28.05%	946.63%	4	
5	General Electric	26.76%	142.67%	5	
6	Johnson & Johnson	23.72%	247.87%	6	
7	Walmart	22.88%	498.31%	7	
8	Citigroup	22.61%	346.60%	8	
9	Coca Cola	20.69%	525.81%	9	
10	Procter & Gamble	18.44%	346.28%	**10**	**481.72%**
11	United Technologies	18.14%	361.19%	1	
12	3M Company	16.33%	248.93%	2	
13	SBC Communications	15.83%	329.43%	3	
14	Boeing	15.61%	134.98%	4	
15	American Express	15.19%	165.80%	5	
16	Exxon Mobile	14.87%	285.62%	6	
17	McDonald's	14.75%	82.37%	7	
18	Int'l Bus. Machines	14.43%	216.58%	8	
19	General Motors	13.80%	589.72%	9	
20	Honeywell	13.10%	598.07%	**10**	**301.27%**
21	Dupont	12.77%	196.89%	1	
22	Caterpillar	12.60%	255.43%	2	
23	Intel	12.31%	168.49%	3	
24	Alcoa	12.20%	-36.27%	4	
25	Disney	11.43%	212.54%	5	
26	Eastman Kodak	11.15%	102.25%	6	
27	Hewlett-Packard	10.03%	165.02%	7	
28	J.P. Morgan Chase	10.03%	358.93%	8	
29	Int'l Paper Co.	9.83%	360.81%	9	
30	AT&T	4.98%	93.17%	**10**	**187.73%**

As you can see, the portfolios with the highest ROEs over ten years performed better than the other two 10-stock portfolios over the same time period of ten years. Another feather in the hat of Clean Surplus. And since Clean Surplus makes sense, the above results place another feather in the hat of common sense.

Let's see if the same results hold true with smaller portfolios consisting of just 8 stocks.

8-STOCK PORTFOLIOS AND THEIR 10-YEAR RETURNS

		10-YR ROE	10-Yr Stock Returns		8 stock Portfolio Avg. Returns
1	Philip Morris	36.35%	1148.86%	1	
2	Home Depot	30.76%	409.51%	2	
3	Microsoft	28.25%	204.64%	3	
4	Merck	28.05%	946.63%	4	
5	General Electric	26.76%	142.67%	5	
6	Johnson & Johnson	23.72%	247.87%	6	
7	Walmart	22.88%	498.31%	7	
8	Citigroup	22.61%	346.60%	**8**	**493.14%**
9	Coca Cola	20.69%	525.81%	1	
10	Procter & Gamble	18.44%	346.28%	2	
11	United Technologies	18.14%	361.19%	3	
12	3M Company	16.33%	248.93%	4	
13	SBC Communications	15.83%	329.43%	5	
14	Boeing	15.61%	134.98%	6	
15	American Express	15.19%	165.80%	7	
16	Exxon Mobile	14.87%	285.62%	**8**	**299.75%**
17	McDonald's	14.75%	82.37%	1	
18	Int'l Bus. Machines	14.43%	216.58%	2	
19	General Motors	13.80%	589.72%	3	
20	Honeywell	13.10%	598.07%	4	
21	Dupont	12.77%	196.89%	5	
22	Caterpillar	12.60%	255.43%	6	
23	Intel	12.31%	168.49%	7	
24	Alcoa	12.20%	-36.27%	**8**	**258.91%**
25	Disney	11.43%	212.54%	1	
26	Eastman Kodak	11.15%	102.25%	2	
27	Hewlett-Packard	10.03%	165.02%	3	
28	J.P. Morgan Chase	10.03%	358.93%	4	
29	Int'l Paper Co.	9.83%	360.81%	5	
30	AT&T	4.98%	93.17%	**6**	**215.45%**

Even with the construction of smaller portfolios, we can see that the portfolios with the highest ROEs outperformed the portfolios with lower ROEs in every instance. Please note that the last portfolio consisted of just six stocks (we ran out of stocks), but even so, the portfolio consisting of the lowest ROEs performed at the bottom of all groups.

Again, all thirty stocks have not been in the Dow the entire ten years, but this work is a nice guide showing you the power of the great returns generated by the most efficient companies.

The chapter on the S&P 500 (Chapter 15) was indeed pure research, which was overseen by four academics (Ph.D.s) other than myself. Chapter 14, which researched the Dow 30 since 1987, also took into consideration stocks as they were added and deleted from the Dow. Again, good research.

However, the point of Clean Surplus Return On Equity and the correlation between ROE and future returns is very real as proven by the extensive research in this book. Clean Surplus was developed in order to aid in predictability. The research I've discussed in this book shows that indeed, Clean Surplus ROE helps us immensely in determining some sort of predictability for the future total returns of stocks.

Using all the examples in this book, most readers feel the process makes practical sense. The research shows that more times than not, the process is indeed, very, very useful when using Clean Surplus ROE as a predictive tool.

Many money managers attending my seminars are already trained in deciphering a multitude of statistics on individual companies. I merely smile at them and say that Clean Surplus Accounting ROE should be the very **first** statistic they analyze. If a company does not have a high level of efficiency (high ROE) and a consistent level of efficiency year after year, then no other statistic is going to make a lame duck fly. It's just that simple.

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SUMMARY OF CHAPTER 16

1) Stocks chosen for your portfolio should exhibit a high level and a consistent level of operating efficiency. This means stocks should exhibit a high level and a consistent level of ROE, with ROE configured using Clean Surplus Accounting.

2) This chapter supports research work shown in previous chapters that ROE as configured by Clean Surplus Accounting does indeed have a direct, positive relationship in the future total returns of portfolios whose stocks exhibit high and consistent ROEs.

CHAPTER 17

What Have You Learned? A Summary

I'm sure by now you are well aware there is a lot of information in this book. I have shared with you my many years of academic research. You learned how Warren Buffett uses Clean Surplus Accounting to project a stock's price ten years into the future. You then learned how he discounts that future, target price back to the present, which in turn determines his all-important purchase price.

Using a combination of Buffett's method and my research work, you are now aware that you need to fill your portfolios with stocks that have a high and consistent ROE, with that ROE configured by Clean Surplus Accounting.

Let's review what you have learned but first please remember that in order to compare one company to another, we must first use numbers that are calculated the exact same way between all companies. Only then can we construct a truly comparable operating efficiency ratio.

1) The Return on Equity (ROE) ratio is a ratio used to measure the operating efficiency of a company.

2) It is the most widely accepted ratio used for comparing the operating efficiency of one company relative to the operating efficiency of another company.

3) However, most of the investing, financial and accounting professions calculate the ratio in a manner not conducive to the comparison of operating efficiencies ***between***

different companies. In other words, they use the traditional Accounting ROE which does not lend itself to predictability.

4) Most finance professionals use Earnings from the Income Statement for the Return portion of ROE and Book Value from the Balance Sheet for the Equity portion of the ROE ratio.

5) However, the Earnings number from the Income Statement contains non-recurring items, which are unique only to an individual company. These non-recurring items do not lend themselves to predictability because they do not occur in a predictable fashion.

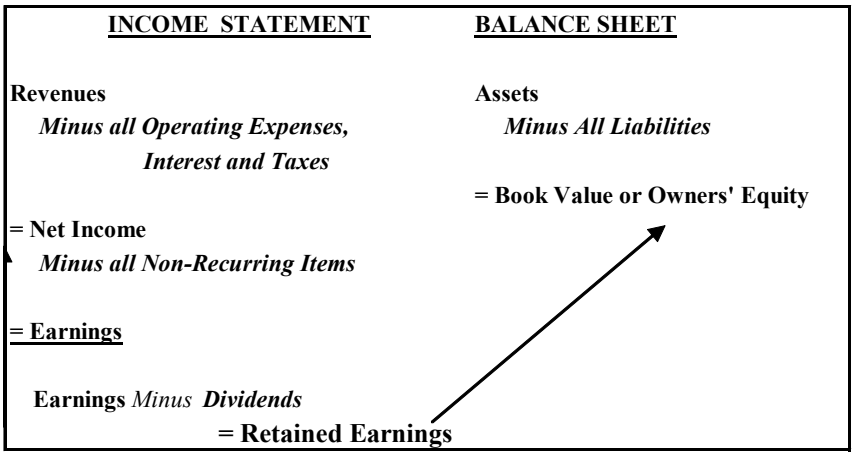
6) The Earnings number is the tie-in between the Income Statement and the Balance Sheet. The Balance Sheet contains the Book Value (Owners' Equity).

7) If the Earnings number becomes distorted because of non-recurring items, then the Earnings number will in turn distort the Book Value (Owners' Equity) on the Balance Sheet.

8) If parts of a ratio (Earnings and Book Value) contain individual company items which are unique to one company and not common to all companies, then that ratio cannot be used for comparison of one company to another company.

9) Most of the investing world is using the wrong ROE and therefore most of the investing world cannot consistently outperform the market averages.

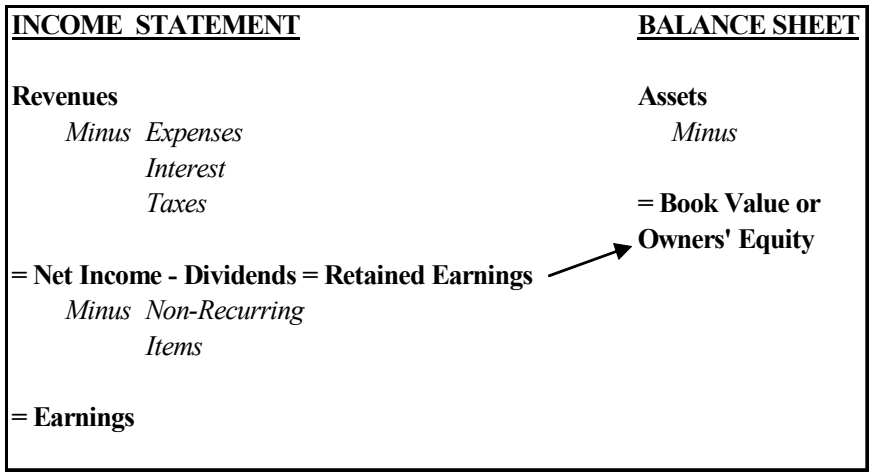
TRADITIONAL ACCOUNTING



10) Clean Surplus Accounting is designed to leave out items which do not lend themselves to predictability.

11) Clean Surplus Accounting uses Net Income (Earnings before non-recurring items) rather than Earnings for the return portion of ROE. Net Income is calculated in the same manner from company to company and does not contain items unique to one individual company and not another. Thus, it is a purer, more comparable number and certainly lends itself to predictability.

CLEAN SURPLUS ACCOUNTING



12) Clean Surplus Accounting calculates Book Value (Owners' Equity) using the true definition of Owners' Equity. Owners' Equity is calculated the same for all companies, only if it is calculated as the amount of money investors have put into the company through issuing common stock and adding all ***Clean Surplus*** retained earnings (profits). And Clean Surplus retained earnings is Net Income minus Dividends.

REMEMBER THE BANK ACCOUNT: THIS IS CLEAN SURPLUS ACCOUNTING

YEAR	EQUITY	INTEREST	ROE
2002	$146.00	$14.00	10.00%
2001	$133.00	$13.00	10.00%
2000	$121.00	$12.00	10.00%
1999	$110.00	$11.00	10.00%
1998	$100.00	$10.00	10.00%

13) Clean Surplus ROE thus configures both the Return (Net Income) and Equity (Owners' Equity) in the ROE ratio the exact same way for all companies.

14) If Clean Surplus ROE is configured in the exact same way for all companies, and it is, then Clean Surplus ROE and only Clean Surplus ROE can be used as a truly comparable efficiency ratio among all companies.

15) Published academic research work (Clean Surplus Accounting: Value Relevance of Book Value and Earnings, 2002) indicates there is a high correlation (association, connection, relationship) between the Clean Surplus ROE of a portfolio and the total future returns of that portfolio.

16) The published research contained in this book further shows that every portfolio which had a higher than average ROE outperformed the S&P 500 Index during the research test period.

THE TOP DOGS OF THE DOW STRATEGY – THE REASONING BEHIND A GREAT STRATEGY

I would like to show you once again how the Top Dogs strategy (hypothetical portfolio) has performed over the past sixteen years. I would also like to point out that this strategy is a common sense (cents) strategy. We are selecting those stocks out of an index, in this case the Dow Jones 30 Industrials, which have the ***highest return*** on the money that investors have put into those companies. The companies that return a greater amount of money and consistently generate a greater return on the amount of money invested into those companies, are the most efficient companies in the Dow 30 Index.

YEAR	DOW 30	S&P 500	TOP DOGS	Returns Greater than S&P 500
2002	-15.73%	-22.37%	-18.10%	4.27%
2001	-5.45%	-12.47%	2.60%	15.07%
2000	-4.70%	-9.04%	1.15%	10.19%
1999	27.06%	21.04%	18.97%	-2.07%
1998	18.03%	28.66%	27.81%	-0.85%
1997	24.82%	33.35%	41.00%	7.65%
1996	28.71%	22.95%	26.93%	3.98%
1995	36.67%	37.54%	50.32%	12.78%
1994	5.03%	1.32%	5.16%	3.84%
1993	16.87%	10.06%	5.50%	-4.56%
1992	7.39%	7.62%	11.91%	4.29%
1991	24.19%	30.48%	43.93%	13.45%
1990	-0.73%	-3.12%	5.29%	8.41%
1989	32.09%	31.69%	42.53%	10.84%
1988	16.03%	16.40%	16.74%	0.34%
1987	5.66%	3.55%	18.15%	14.60%
AVG.	**13.50%**	**12.35%**	**18.74%**	

Remember that the market, just as you, loves an efficient company and in turn, the market rewards those efficient companies. Why does the market love efficient companies? Because efficient companies continually generate enough of a return to reinvest some or all of their profits back into the company and thus continue to build their asset base.

The larger a company's asset base, the more products it can generate for sale. The more sales, the more profits. The greater the profits, the higher the price of the stock in the future. And remember, that's what investing is all about — forgoing gratification today in hopes of even greater gratification in the future.

One of the reasons these companies are so efficient is they have a sort of monopoly or goodwill which they've built up over the

years. We know about companies such as Coca Cola, Wal-Mart and General Electric. General Electric will only compete in an industry in which they can hold the number one or number two position worldwide. Home Depot began with a great business model, which in turn, propelled it to the number one position in its industry.

We also know about very good companies which are not part of the Dow 30 which also dominate their industries. How about Clorox, Gillette and Colgate? Yes, unless you've been living in a faraway place with a strange sounding name, you certainly have heard of these companies and you've very probably used their products.

Buffett likes companies that have some type of consumer monopoly. He likes companies that also have a high and consistent ROE. Really, if you think about it, who wouldn't?

There are an awful lot of people out there who insist on buying stock in companies that are average or less than average performing companies. Why? The main reason is these investors have no clue how to calculate the operating efficiency of the companies they select for their portfolios.

Many, many investors will try and buy companies they believe will eventually become the next Coke or Gillette or Home Depot while still in the embryonic stage. This allows capital formation for the huge number of companies that are starting up in the hopes these small companies will eventually become one of the very efficient companies.

PUTTING THE ODDS OF SUCCESS ON MY SIDE

However, most of the readers of this book are very much like me. I want to put the odds of success on my side. Remember the definition of luck? When opportunity meets preparation. I feel you now have been sufficiently prepared to effectively take advantage of the opportunity that greets you through the understanding of this book. You are now one step ahead of most market analysts.

It wouldn't be luck if your portfolio continually outperforms the market averages in the future, because by reading this book, you are putting the odds of success on your side. The academic world will

call you lucky, but you know better. You are now prepared to garner the rewards of doing your homework.

The next chapter will aid you in continuing your education. Through my website and a little help from your new friend (me), your portfolio will probably outperform almost everyone else over time. And since I know this to be true, I'm sure I'll soon see you at the beach. Move over, Jimmy and Warren B.

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SUMMARY OF CHAPTER 17

It is our goal, through the understanding of our newly learned investment strategy, to invest successfully like Warren Buffett and then live just as we imagine life is enjoyed by Jimmy Buffett.

CHAPTER 18

We Won't Leave You Out There Alone

BuffettandBeyond.com

Supplementary Materials – The Web Site, Self-Study Courses, the Video, the Computer Program and Educational Seminars

The great thing about this book is it doesn't leave you off at the bus stop in the middle of nowhere. Most of you don't want to worry about getting the information needed to fill in the spreadsheets year after year. I don't blame you. My website has information relative to investment courses and the computer program which was used to generate the spreadsheets in this book.

A PROFESSIONAL MONEY MANAGER AND SERIOUS INVESTOR COURSE INCLUDING A VIDEO (DVD) AND COMPUTER PROGRAM

We presently have a great course for both professional money managers and serious investors which is augmented by a video (DVD) and a very easy-to-use computer program. The course goes into great detail on how to use the computer program in many, many ways not shown in this book.

The video (DVD) gives step by step instructions not only on the use of the program, but wonderful insights into the "whats" and

"whys" of the program. The course gives you all the detail in writing and the video augments the course in a wonderful fashion.

The computer program has information on over 500 stocks at the present time. It shows you the anticipated prices ten years into the future based on a 10-year, 5-year and 3-year average of the ROEs, Retention Rates and P/E multiples. It then discounts back to the present based on ***your*** required return to give you ***your*** purchase price.

No professional money manager or serious investor should be without the ability to effectively analyze stocks relative to a comparable operating efficiency. Clean Surplus should be the professional's first filter in his or her arsenal of analytical tools.

This course is available in both a self-study and live/group format. Please see the website, **BuffettandBeyond.com** for details and dates.

CONTINUING PROFESSIONAL EDUCATION COURSE FOR CPAs

How about you CPAs needing Continuing Professional Education credits to maintain your professional standing in your organization?

We've developed a 10-credit course which is in the final stages of approval in almost all states by the National Association of State Boards of Accountancy. The course falls under the heading of Accounting and Auditing for Continuing Professional Education Credits. Please check our website for a description of this course and the states for which it has been approved.

This course is also available in both a self-study and live/group format.

FOR INDIVIDUAL INVESTORS

You may be an individual investor who can care less about research. After all, it's work and you are more efficient working at your job than trying to select stocks. You can call us to supply you with the names of some of the several very good money managers who follow the strategy in this book.

As time goes on and more professionals hear about us, many will want to learn our strategy and become affiliated with our method of investing. As an individual investor, just contact us and we'll supply you with a list of those money managers who have taken the money manager self-study course, have viewed the video and use the computer program. Of course, we'll have the track records of the best of these money managers available for you.

OTHER MATERIALS ON OUR WEBSITE

BuffettandBeyond.com
Lectures, Newsletters and More

We have **free** (love that word) newsletters giving analyses of stocks that we feel fit the discipline described in this book. As we go on and hear your suggestions, we will add areas you feel are important to you. Just check into our site every now and then for updates and new materials.

Also keep in touch as we will post schedules for lectures. If we're near you, just call and let us know you'll be around. If you want us to lecture to your group, we'll try to accommodate you.

We will soon have several videos (DVDs) of our accredited lecture series. If you want to see the lecture, which is a short version of this book along with information from the self-study courses, we can send it out to you and you can view it in living color. If the video has been accepted by your organization for continuing education

credits, we will also mail you a certificate of completion along with the video.

IN SUMMARY, I'M STILL A TEACHER

So yes, this book is just part of the whole educational organization of seminars, continuing professional education courses, a professional money manager course, professional money managers following our discipline, a wonderful computer program and several videos.

Please remember that I'm also a university instructor. One of my goals in life is to pass on knowledge that can be used by other people to help better their lives. I want you all to make as much money as possible by investing in the best companies. If you invest in the most efficient companies, you will be reducing your risk of disappointment. The markets go up and the markets go down. We want to see your stocks go up more than the markets over the long term without taking on more risk than is generally inherent in the overall market. If you can use the information contained here and on the website to make more money than most of those around you without taking on undue risk, then I'll see you at the beach sooner than you think.

As a university Instructor, I want to thank you for taking time to better your lives. After all, that's what education is all about.

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