**Article I: Understanding A True Growth Company**

Buffett is known as a value investor. It is difficult to understand why Buffett has been termed a value 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 learn about Buffett, you will soon determine he is actually a growth investor buying growth stocks at a very good value. This point will be well proven through the use of quantitative numbers and methods, which will be discussed in the second article. This first article will discuss the types of businesses Buffett might consider for his portfolio.

**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 buy price. Buffett is well known for his extraordinary patience, as it has been his patience that has rewarded him so very well over the years. He knows all too well, that sooner or later, he will be able to buy at his 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.*

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.

However, commodity businesses do well when the economy is doing well. During an economic expansion, the demand outpaces supply and commodity 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.

Another shortfall of the commodity type of business is 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 their 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 the number of products it produces and thus, 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.

Still yet another shortfall is the heavy debt load of many of the commodity type of companies. Think of General Motors. General Motors has approximately 77% debt relative to total capitalization. GM could take all its profits for the next 10 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.

How do 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 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 or have had brand loyalty. When you were younger and were thirsty, you had a Coke. When you thought 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 is a good thing. If you think back to the commodity type of businesses, you will be hard pressed to find a steel company with as much goodwill built into its stock price as Gillette or Coca Cola.

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 will delve into the financials in the next article, but for now, let’s look at the attributes that identify the consumer monopoly.

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 their debt. 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.

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 then does the company use its retained earnings (profits reinvested back into the company) to grow its asset base and thus grow the company? Is the company earning the same high Return On Equity (ROE) 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 repurchase its own outstanding shares?

Buffett especially likes companies that repurchase their own shares. As the shares outstanding decrease through share buyback programs, the earnings per share increase. This in turn, increases the price of the stock. This is a good thing for the owners of the stock of the company.

**Article II: Understanding The Efficiency of A True Growth Company**

In the first article, Understanding A True Growth Company, we discussed the qualitative (quality) aspects of a company, which Buffett deems necessary before making his decision of looking further into a business. We said that Buffett looks for a company, which has some type of consumer monopoly. In business schools across the country, we call this a form of competitive advantage. Whatever we call these qualities, they must be present for Buffett to begin his quantitative analysis (bottom line numbers) when considering the stock for a long-term buy.

The next step in qualifying a stock for purchase is the analysis of the quantitative (numbers) aspects of a company. In other words, the financials of a company must be strong. Buffett has a very unique method of simplifying the basic overall strength of the firm’s accounting numbers. As a matter of fact, as indicated by Mary Buffett in her wonderful book Buffettology, Mary suggests that Warren uses a different type of accounting to determine the future assets of a company. From the present assets, Buffett will determine the future assets and thus, a future price. Discounting that future price back to the present, Buffett then determines his all important purchase price. How Buffett finds the price at which to buy is the secret to his success.

Everyone knows the key to making money in the stock market is to buy low and sell high. After all, this is how Warren Buffett became one of the richest individuals in the world. I will now show you, according to Mary, how Warren Buffett determines a ‘high’ price and a ‘low’ price. But first I must discuss some background basics. And dear reader, the basics of Buffett’s approach are so simple you will wonder why you didn’t think of this method yourself.

**College**

In business schools across the country, we teach our students various models in order to determine the present true value (price) of a company. After all, if we can determine the true value of a company, we can simply compare the true value to the present market price. If a stock is selling for $50 a share and we determine, through one of the multitude of models, that it is really worth $100 a share, we should immediately run out and buy it. Then we can go to the beach and wait to become rich. What are these models? Well, 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 determines expected returns based on a measure of risk with risk calculated by beta. 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.

Whoa, Please stop! What are you talking about?

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 the Fortune 500 companies to ask their meaning of EVA. He received 168 different definitions. The same is true of some of the academic models.

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 the business schools continue teaching the models they now teach.

So what does Buffett do? Ahh, read on.

**Return On Equity**

Not all analysts spend their lives futilely trying to determine the true value of a company. Many of them try and 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 would be able to compare the operating efficiency of one company with another. The market will eventually reward the more efficient companies.

However, there’s one very large problem using ROE. For a true comparison, the return calculation (R) and the equity calculation (E) for each company should be configured the same way. The configuration must be standardized among all companies in order to obtain a true comparison. However, the return and the equity accounting numbers are often configured differently due to the uniqueness of occurrences in individual companies, which must be accounted for. If this is true, and it is, the comparison model used by most analysts can be thrown out the window. This is why Buffett has job security.

**Return**

Let’s begin with the return. Most analysts use earnings as the return in the ROE calculation. However, most of the earnings we see reported include such items as extraordinary write-offs and future liabilities which are totally unique to an individual company. Since the earnings number is adjusted differently depending on the individual company and individual situation, it cannot be used as a number for comparison between different companies. Throw earnings out the window as a comparison number.

A truer, more comparable number would be earnings before extra-ordinary write-offs and future liabilities, which is called Net Income. Thus, we should use Net Income as the return number in our ROE calculation because it is configured THE SAME among all companies. If you agree with this scenario so far (you should), you are already one step ahead of many analysts.

**Owners’ Equity or Book Value?**

Now we are confronted with a much larger problem. Book Value is defined as assets minus liabilities. Owners’ equity is defined as the amount of money equity investors have put into the company, which equates to common stock issuance and retained earnings. Two different definitions, but yet, we use these terms synonymously on the balance sheet. This is not a good thing.

You’ve got to love Buffett. He says (accounting) Book Value is meaningless as an indicator of a firm’s intrinsic value. Let’s look at an example. At the end of 1991, General Motors had a Book Value of $42.89 per share. By the end of 1992, GM had a Book Value of just $8.47 per share. How in the world did GM experience an 80% reduction in value in one year? It really didn’t. GM was forced to account for the future medical liabilities of their workers upon the workers’ retirement. GM was given the choice, by FASB (Financial Accounting Standards Board), to take the write-off over 20 years or over one year. GM chose the latter.

The question becomes, 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. However, the balance sheet showed the Book Value or Owners’ Equity to be reduced almost 80% to just $8.47 per share with the stroke of an accountant’s pencil.

This is not the only thing wrong with book value. We all know that some assets are held on the books at historical value while others are depreciated. This is a real impediment in determining the true value of a company’s assets. Bottom line: *book value is also unique* (not comparable) to each individual company. If it is, and it is, then we’ve lost the second part of the ROE equation in that *book value is not configured the same among all companies*. This leads us to the conclusion that we ***cannot use book value nor earnings as comparable numbers in our ROE calculation.***

**Our New Return On Equity Equation**

Between 1895 and 1937, there was mention in accounting circles concerning the inability of accounting numbers to predict the operating efficiency and thus the future value of a company. The argument discussed how the accounting numbers should show what investors needed to know about a company and at the same time show the investors some sort of predictive capability. The result was a ***surplus*** accounting statement showing earnings before abnormal charges, which really equates to 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 a picture is worth 1,000 words, more or less, so let’s go to an example for simplification.

Let’s look at two separate bank accounts each starting with $100. Let’s also assume all interest (Net Income) is reinvested back into both accounts.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Bank A** | | | **Bank B** | | |
| **Year** | **Equity** | **Interest** | **ROE** | **Equity** | **Interest** | **ROE** |
| 2002 | $146 | $14 | 10% | $142 | $11.37 | 8.00% |
| 2001 | $133 | $13 | 10% | $131 | $11.00 | 8.50% |
| 2000 | $121 | $12 | 10% | $120 | $10.85 | 9.00% |
| 1999 | $110 | $11 | 10% | $110 | $10.45 | 9.50% |
| 1998 | $100 | $10 | 10% | $100 | $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 example shows how Clean Surplus Accounting works. Owners’ Equity of today equals Owners’ Equity of last period plus retained earnings (Net Income minus dividends). It’s how much money we began the year with plus how much we earned and retained gives us next year’s beginning balance. No future liabilities and no extra-ordinary write-offs. Yes, Clean Surplus Accounting is this simple.

Looking at the above examples we can see that Bank A is constantly earning 10% for us. However, Bank B is earning an ever-decreasing return for us.

The question is very simple. Which bank would you rather put your money in?

**Surplus Accounting**

Let’s now look at the ROE of both General Electric and General Motors (up to 2001) with the ROE configured using Clean Surplus Accounting. The asset base is comprised of common stock issuance and all retained earnings. However, the 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, it is calculated the same among all companies.***

Owners’ Equity is money invested. How much did the company raise through initial common stock issuance plus all retained income(profits). If Owners’ Equity is simply configured in the same manner for all companies (it certainly is), then both the Owners’ Equity and Net Income is a commonality between all companies. If this is true, *and it is*, then the Return On Equity as configured by Clean Surplus Accounting, is truly a comparable method of determining operating efficiency. A method, which is common to all companies.

|  |  |  |
| --- | --- | --- |
|  | **General Motors ROE** | **General Electric ROE** |
| **Average ROE** | **11.5%** | **20.2%** |
| 2001 | 06.5% | 22.8% |
| 2000 | 17.4% | 22.5% |
| 1999 | 20.4% | 21.1% |
| 1998 | 13.5% | 20.4% |
| 1997 | 24.1% | 20.3% |
| 1996 | 19.9% | 19.9% |
| 1995 | 32.4% | 19.6% |
| 1994 | 36.2% | 19.5% |
| 1993 | 13.5% | 19.0% |
| 1992 | (22.6)% | 17.1% |
| 1991 | (19.1)% | 19.5% |
| 1990 | (7.6)% | 20.3% |
| 1989 | 12.6% | 20.6% |
| 1988 | 14.8% | 19.9% |

When using Clean Surplus Accounting as we have above, we see that GE has a high and consistent ROE while GM has a low and 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 ***Clean Surplus ROE is a true measure of operating efficiency***, we come to an age-old question. Would you rather invest in a very inefficient company such as GM or would you rather invest in a very efficient company such as GE?

What you have discovered (Clean Surplus) is a truly *comparable method* of determining the true operating efficiency of a company. And this method is ***common to all companies***.

By the way, in the past 10 years, GE stock has risen from a split adjusted $6 per share to $36 per share for a 600% increase. GM’s stock has gone from $35 to $50 for just a 42% increase.

**Congratulations: You’ve Unlocked the Key**

Let me repeat. The key to investing is really very simple. We want to invest in companies, which have a relatively ***high Return On Equity*** (Clean Surplus), and we want companies that show a very ***consistent Return On Equity*** as determined by Clean Surplus Accounting.

**Why Hasn’t the Entire World Figured This Out Yet?**

The world of Finance and Accounting is different than the world of Investing. The problem is most people in the investing business have not figured this out yet. Why? The reason is most investment analysts come from the worlds of Finance or Accounting.

OK, why is this a problem? Because Finance and Accounting deal ***within*** each company. They account and analyze ***within*** one specific company and Accounting must account for everything ***within*** that specific company.

The world of Investing is different. It must be able to ***compare one company with another*** in order to determine which company to put in a client's portfolio. The worlds of Finance and Accounting ***were not developed in order to compare***. This is exactly why Clean Surplus was invented. Let me repeat. ***Clean Surplus was invented in order to COMPARE one company to another.***

You see, most of the portfolio managers have not been given a good ‘investing’ education. They have been given great educations in Finance and Accounting but now you know that Finance and Accounting is not Investing.

The question we will answer in the third article of this series, is the Clean Surplus ROE able to PREDICT the future return of a portfolio? The answer will make you smile.

**Article III: The Research Beyond Buffett  
Understanding the Predictive Powers of Clean Surplus Accounting**

Dr. Farwell's Doctoral Dissertation is based on a different type of accounting. It is called Clean Surplus Accounting and differs from the traditional type of accounting we are all familiar with.

The Return On Equity ratio is used to describe the operating efficiency of a company. If this is so, then we should be able to determine which companies are more efficient and which companies are less efficient. If this is also true, we should be able to fill our investment portfolios with the most efficient companies. And in turn, we should be able to outperform the market averages over the long term.

Numerous studies have shown that most money managers cannot outperform the S&P 500 index. Those who do, rarely continue to do so. It does seem to follow that since most analysts use the *traditional accounting* Return on Equity ratio, then possibly, the Return On Equity ratio used by these analysts does not give us the operating efficiency nor the ***predictability*** we are all searching for.

**Beyond Buffett - Predictability of Clean Surplus**

Dr. Farwell studied the Academic literature to study the work of other researchers on this relatively unknown method (Clean Surplus) of calculating Return on Owners’ Equity. He studied some of the work of an Academic who began work on the usefulness of the new Clean Surplus ROE. Dr. Farwell added to the body of knowledge by trying to establish a link between the Clean Surplus ROE and a security’s total return in the future. After all, if the Clean Surplus ROE was a true operating efficiency ratio, and a company had a high level of Clean Surplus ROE and a very consistent Clean Surplus ROE, the market should eventually recognize the high level of efficiency and bid up the price of the stock over the long term.

One summarized definition of market efficiency is investors putting their money into the most efficient companies. Thus, if this new Clean Surplus ROE does indeed show a better method of determining operating efficiency than the *old traditional accounting ROE,* it follows that there may be a correlation (connection) between the ROE (as determined by Clean Surplus) and the future total return of that security.

**The Study**

The study utilized the S&P 500 stocks as of 1982 through 1998. Stocks, which did not survive the entire period because of occurrences such as bankruptcy or mergers, were not included in the study. Thus, a total of 351 stocks were used throughout the test period.

An 8-year average Return On Equity (ROE) was calculated for each stock using Clean Surplus Accounting. Stocks were sorted into portfolios of 10-stock portfolios.

Portfolio #1 consisted of the 10 stocks with the highest 8-year average ROEs. Portfolio #2 consisted of the 10 stocks with the next highest ROEs. This method of selecting portfolios continued until all stocks were selected.

**The Research Question:**

The research question was two-fold:

1) Does the average 8-year ROE (Clean Surplus Accounting) of a portfolio of stocks show predictability relative to the total returns of that portfolio over the following 4 years?

2) Does a portfolio of stocks with an above average ROE (of the 351 stocks in the study) return more than the S&P 500 over the subsequent 4 years?

**Methodology**

The first set of portfolios consisted of 10 securities each for a total of 35 portfolios. The first portfolio consisted of the 10 stocks with the 10 highest ROEs. The second portfolio consisted of the 10 stocks with the next 10 highest ROEs. This method of portfolio selection was continued until 35 portfolios of 10 securities each were formed.

The second set of portfolios consisted of 30 securities each for a total of 11 portfolios in each time period. The selection order was the same as with the 10 security portfolios. In other words, the first 30 stock portfolio consisted of the top three 10 stock portfolios

**Results**

**Research Question #1. Does the average 8-year ROE (Clean Surplus Accounting) of a portfolio of stocks show predictability relative to the total returns of that portfolio over the subsequent 4 years?**

Every portfolio with ROEs higher than the average ROE of the S&P 500 did indeed outperform the S&P over the following 4 years.

With portfolios of 10 stocks, correlations of up to 50% were achieved. With portfolios of 30 securities, correlations of 79% to 80% were achieved.

**This means that larger portfolios exhibit greater predictability.** In other words, the past ROE was a good indication of future total returns. Total returns consist of price appreciation plus dividends.

These results indicate that as portfolios of securities are constructed, the average ROE of all the stocks in the portfolio (the portfolio ROE) becomes a very good indication of the future total returns of the portfolio. The more securities in the portfolio, the greater the predictive capability of the ROE.

**Research Question #2. Does a portfolio of stocks with an above average ROE (of the 351 stocks in the study) return more than the S&P 500 over the subsequent 4 years?**

One hundred percent of the portfolios with ROEs higher than the average security ROE (of the sample) performed better than the S&P 500 during the time periods used in the test.

**Summary**

Dr. Farwell’s work shows a method of portfolio selection that during his test periods consistently outperformed the market averages. Dr. Farwell's work shows that Warren Buffett is doing something right. But of course, we all knew that. But now, we know why.

[**Article I**](http://www.buffettandbeyond.com/article1.htm) **|** [**Article**](http://www.buffettandbeyond.com/article2.htm)

Clean Surplus is a model developed by the accounting profession which allows investors to both compare and predict portfolio returns. Comparability and predictability are not available through the use of traditional accounting. The research of Dr. J.B. Farwell shows that portfolios made up of stocks with higher Clean Surplus ROEs outperform portfolios made up of stocks with lower ROEs. Dr. Farwell also statistically tested the predictability of future returns of portfolios using the Clean Surplus ROE with astounding results.

**STOCKS ON THE BUFFETT and BEYOND RADIO SHOW**

**STOCKS IN BUFFETT'S PORTFOLIO  
Walmart: With Comparisons to Ross Stores, Coach   
and Family Dollar**

**April 20, 2012**What Do We Know About Buffett? Buffett continues (except for the past several years) to outperform the S&P 500 index. However, our own portfolios not only outperform the S&P, but we also outperform the Great one himself by a wide margin. In fact, since the end of 2002, the Clean Surplus portfolios have outperformed both Buffett and the S&P by more than double on a compounded basis. Of course, your question is how did we do that if we're using the same system as Buffett?

The main reason Buffett is not performing as well today as in the past is because he is handling too much money and for this reason and this reason alone he just cannot continue to generate the type of returns he did two decades ago. Here is a quote from Buffett's 2010 report to shareholders.  
 *"Our 46-year record against the S&P, a performance quite good in the earlier years, is now only satisfactory. The bountiful years, we want to emphasize, will never return.* ***The huge sums of capital we currently manage eliminate any chance of exceptional performance.*** *We will strive, however, for better-than-average results and feel it fair for you to hold us to that standard."*

What else do we know about Buffett? We know Buffett used and I say used (past tense) a system called Clean Surplus which was not his system, but rather a system developed by the accounting profession that allows comparability among all stocks. It is also a predictive model which gives a pretty good estimation of the future returns (stock appreciation) of a company.

I've been studying and using this system since the late 1990s. I wrote and published a Doctoral dissertation on the subject as well as a book which is appropriately entitled "Buffett and Beyond." I can tell you with great certainty, Clean Surplus is a great methodology for stocks. However, Buffett is presently into currencies, oil, natural gas, derivatives, preferred stocks, real estate and who knows what else? What else? Yes, he purchased an entire railroad which we know as Burlington Railroad. All in all, stocks traded on the exchanges just don't account for a major portion of his present day portfolio.

The most positive aspect of our knowledge of Clean Surplus is that we will remain loyal to the this methodology and always will because it is this system that allows us to outperform almost all of the money managers out there in investment land including Warren E. Buffett.

Let's look at one of the present holdings in Buffet's portfolio and we will see why we are able to outperform not only the S&P 500 index, but also Warren Buffett. We will look at Walmart which he is holding at the present time.



Clean Surplus allows us to compare stocks in the same manner as we would our bank accounts. The ROE you see above is NOT the traditional accounting ROE but rather the ROE configured by Clean Surplus. All you need to know in order to compare stocks in a Clean Surplus manner is to think of your bank account. The S&P 500 **bank** is returning us 13%. The Walmart **bank** is returning 16% on the money investors have put into the Walmart bank which means we would rather invest in Walmart than an index fund representing the S&P 500 index.

Now look at Family Dollar. It is a bank returning 18%. We like that, but we like Ross Stores and Coach even better as they are banks with ROEs of more than 20%.

We try and fill our yearly portfolios with stocks from the S&P 500 index which have a Return on Equity (in a Clean Surplus Condition) of 20 % or greater. Buffett has Walmart in his portfolio which is a bank paying him 16% this year while **WE** have both Coach and Ross Stores in our portfolio both of which are banks returning more than 20%.

If Clean Surplus is a predictor of how well a stock will perform, Coach, Ross and Family Dollar should be outperforming Walmart and all of these stocks including Walmart should outperform the S&P 500 index. Let's look at a 5 year chart of these stocks along with the S&P 500 index.



This chart is a 5 year chart of the stocks we just analyzed as of April 12, 2012. If Clean Surplus is a good predictor of returns we should see Coach, Ross Stores, Family Dollar and Walmart outperforming the S&P 500 index. On the chart, the black, bottom line is the S&P 500 index which shows us that all the stocks predicted to outperform the S&P did indeed do so. The top line and best performer is Ross Stores (ROST) returning about 240% in the past 5 years ending April 12, 2012. Family Dollar is next with a 105% return followed by Coach with a 50% return and finally WalMart with a 40% five year return. Notice the market as measured by the S&P 500 index returned a negative 5%, but with dividends of 10% over five years actually returned a positive 5%.

Notice from the table above, that our two portfolio holdings, Ross Stores and Coach are up 25% and 23% YTD (Year to Date).

We've had Coach in our portfolio for a long time and just added Ross Stores at the end of 2010, but the bottom line here is that our portfolio consisting of stocks with a 20% or higher ROE should continue to outperform not only the S&P 500 index (13% ROE), but we should also continue to outperform the greatest investor of all time, Warren E. Buffett.

You can see it is relatively easy to select a portfolio which will outperform most money managers out there in investment land just by looking at their Clean Surplus generated ROEs. The difficult part is putting the numbers together in order to generate this Clean Surplus ROEs. But then again, you know us and putting together numbers is what we do for you.

See you next time.

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**The Beverage Industry: Coca Cola, Pepsi,   
Boston Beer and Molson-Coors   
Good, Bad or Ugly?  
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The stock question of the day is should Coke be in our portfolio or in someone else's portfolio? We not only researched Coke, but also other companies in the beverage industry in order to compare not only companies we all know, but possibly the new up and comers.

Boston Beer is a name you might not recognize, but their main product is Samuel Adams beer. Yes, now you recognize them. The Boston Beer Company, Inc. is a craft brewer in the U.S. Boston Beer produces malt beverages and hard cider products at the company-owned breweries and under contract arrangements at other brewery locations. The company-owned breweries are located in Boston Massachusetts (The Boston Brewery), Cincinnati, Ohio (the Cincinnati Brewery) and Breinigsville, Pennsylvania (the Pennsylvania Brewery). The Company sells over 20 beers under the Samuel Adams or the Sam Adams brand names. They have 780 employees and are headquartered in Boston, MA.

Coca Cola is a non-Alcoholic beverage company and owns, licenses and markets more than 500 (yes, 500) non-alcoholic beverage brands primarily sparkling beverages but also a variety of still beverages such as waters, enhanced waters, juices and juice drinks along with ready-to-drink teas and coffees. Coke also sells energy and sports drinks. They have 140,000 employees and are headquartered in Atlanta, Georgia.

PepsiCo is a global food, snack and beverage company. The Company's brands include Quaker Oats, Tropicana, Gatorade, Lay's, Pepsi Walkers, Gamesa and Sabritas. Pepsi as does Coke, distributes all over the world. In November 2011 it acquired Mabel, a producer of cookies, crackers and snacks in Brazil. They employ 295,000 people and are headquartered in Purchase, NY.

Molson bought out Coors approximately seven years ago. Molson Coors Brewing Company is a holding company. Its operating subsidiaries include Molson Coors Brewing Company (UK) operating in the United Kingdom; Molson Coors Canada (MCC), operating in Canada. The Company's operating segments include Canada, the United States, the United Kingdom, and Molson Coors International (MCI). Its signature brands are Coors Light, Molson Canadian and Carling. The company also brews or distributes products under license from third parties, which include Heineken, Amstel Light, Murphy's, Asahi, Asahi Select, Miller Lite, Miller Genuine Draft, Miller Chill, Milwaukee's Best, Milwaukee's Best Dry, and Foster's. During the year of 2010, the Company acquired 51% interest in Molson Coors Si'hai Brewing Co. in China. In June 2010, the Company launched Coors Light in Russia. 14,660 employees Denver CO.

Now that we know something about these companies it is time to break down the numbers in the Clean Surplus Return on Equity (ROE) method which allows us to very easily determine with a great degree of accuracy which stocks should outperform the S&P 500 index in the future. The ROE also shows us which companies are making the most money on the investment dollars investors have put into the company. The question is which company should we add to our portfolio? Coke or Pepsi?

When we select stocks for purchase in our model portfolio, we want to see as long a track record of ROE as possible. Our work on many stocks goes back almost 30 years. However for ease of visual simplicity, we will adjust our table and look at the past four years of numbers from 2007 to the forecasted 2012 Clean Surplus ROE.

As we look at the table below, we see that Coke has the highest ROE of the entire group. However, Boston Beer is right behind Coke followed by Pepsi and finally Molson Coors. We would expect the largest return in the past and going into the future to be the stocks with the highest ROEs. The one exception here is Boston Beer. Look at the five year return of Boston Beer with a stock appreciation of 190% with 133% of that appreciation coming in just 2011. How can this be? The reason is the market looks at Boston Beer as a small company (which it is) with a lot of room to grow while Coke and Pepsi are seen as having already saturated most of the world's markets.

Molson-Coors has the lowest ROE of the group and that low ROE showed itself in last year's performance of a negative 10%. With an ROE below the average stock in the S&P 500 index, we wouldn't even consider investing in Molson.

A very important point to remember is that you want to keep any stock out of your portfolio that will drag down the overall performance of your portfolio. Thus, we want to discard any stock that has an ROE equal to or below 13%. Remember, 13% is the ROE of the average stock in the S&P 500 index and if we want to outperform this index, then we must fill our portfolios with stocks that have ROEs above the average stock in this index.



Looking at just the past years of ROE from 2007 to 2012 we can get a good idea of how these four stocks should perform in the future. Remember that Clean Surplus is a predictability model thus we would predict that Coca Cola, Boston Beer and Pepsi should outperform the averages over the long term while Molson will have a difficult time outperforming the S&P 500 index going forward.

A word of caution. Boston Beer is a small company. If a small company makes a mistake, its stock could be hit and hit hard, but I'm sure you are all aware that investing in a small company not only is risky, but can also bring on big rewards.

PRICE TO PURCHASE

When we look at an ROE such as Coke's and see a 19% ROE, we would expect that stock to give us a total return (stock appreciation plus dividend) of 19%. However, purchasing Coke at the present price of $69 would only generate a total return of approximately 13% per year under normal market conditions. Looking at the table, "Pr to Pur" stands for the price to purchase in order to receive the total expected return of 19% per year.

Looking at Boston Beer with a present price of $96, we feel that this is a good price as long as it can keep up the present rate of growth (ROE) of 18%. With a small company, this can be a big IF.

Out of this group above, we see Coke as the most consistent stock of the group relative to its past ROE. This would be the stock of choice and we would begin a system of periodic purchasing. The problem with good companies is unless we have a market meltdown, we never get a good chance to purchase a good company such as Coke which is why we like to begin purchasing as we go along.

The outlier is of course Boston Beer. It may not be a bad idea to nibble at this company, but folks, Boston Beer is a very long way from a Coke or a Pepsi.

Let's look at a graph and see how these companies have performed over the past five years. The bottom line in black is the S&P 500 index. The top line is Sam Adams which leads the pack by a large margin. Please be aware the graph below does not include dividends.. Thus Coke with a 2.9% would show as a total return (stock appreciation plus dividends) of approximately 65% and Pepsi and Molson would show about a 15% total return. Boston Beer with no dividend (a true growth stock) shows a wonderful appreciation. The question is can Boston Beer keep up the good work?

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**The Financial Services Industry: MasterCard, Visa,  
American Express, and H&R Block  
Good, Bad or Ugly?**

We receive more questions regarding American Express than any other stock. Since we're looking at AXP it's a good time to update some of the best known stocks in the Financial Services Industry. It sure is nice when we break down the numbers in the Clean Surplus Return on Equity (ROE) method which allows us to very easily determine with a great degree of accuracy which stocks should outperform the S&P 500 index in the future. The question asked of us just the other day was "Is American Express a good portfolio holding?"

When we select stocks for purchase in our model portfolio, we want to see as long a track record of ROE as possible. Our work on many stocks goes back 30 years. However for ease of visual simplicity, we will adjust our table and look at the past four years of numbers from 2009 to the forecasted 2012 Clean Surplus ROE.

Looking at the table below, we see that American Express has an ROE which is a bit less than the ROE of the average stock in the S&P 500 index. The average stock has an ROE of 13% and if we want to be able to outperform the averages, we must fill our portfolios with stocks that have ROEs higher than the average. In fact, we like stocks that have ROEs 20% or higher.

American Express falls in the "Below Average" category along with H&R Block as their ROEs are below the ROE of the average stock in the S&P 500 index. This lower than average ROE indicates that over the long term both American Express and H&R Block should underperform the market averages going forward.

Looking at MasterCard and Visa, both stocks have ROEs higher than the average stock in the S&P 500 index. The past is not necessarily a predictor of the future, but as Warren Buffett says there is a greater **probability** of above average earnings growth in the future if a company has had above average earnings growth in the past. He's been correct to the tune of about $59 Billion dollars.

Clean Surplus was developed as a predictability model and all the research and all the actual portfolios show that Buffett is correct. Over time, portfolios made up of stocks with above average ROEs outperform portfolios constructed of stocks with lower ROEs.

.Looking at just the past four years of ROE from 2009 to 2012 we can get a good idea of how these four stocks should perform in the future. Remember that Clean Surplus is a predictability model thus we would predict that MasterCard and Visa should outperform the averages over the long term while H&R Block and American Express should underperform the averages over the long term.

All four stocks did very well for 2011 which is shown as the "1 Year Return." However, when we look at the longer term which in this case is the past five years, we can see that both MasterCard and Visa have performed very well while both H&R Block and American Express both underperformed the S&P 500 index.

I want to bring out one very important point in your understanding of the Clean Surplus Return on Equity. A stock **cannot** grow faster than its ROE for a long period of time unless that ROE is growing. Just think of your bank account. If your bank account is paying you 10% per year and you continue to reinvest that 10%, your bank account can only grow 10% per year. It's the same way with stocks over the long term.

However, the stock market is different over the short term because of human emotions, political rhetoric and congressional maneuvering through the allocation or misallocation of resources, but over the long term, a stock (or bank account) cannot grow faster than its Return On Equity. Yes, folks, it's that simple.

On the other hand, we see that MasterCard with an ROE of over 30% during the past 7 of 8 years is earning profits at a much faster rate than any of our other stocks illustrated here. The only other stock outperforming the S&P 500 index in this group is Visa. Notice that the ROE of Visa is increasing which is a good sign. Neither MasterCard nor Visa have any debt, but MasterCard is retaining more of its earnings (95%) than the other companies. Thus, we expect MasterCard to grow faster and appreciate more than the other stocks. Let's look at a graph to see how this group of stocks have performed over the past 5 years relative to price return.

The top red line is MasterCard showing a return of about 225% over the past 5 years. The next line down in orange is Visa with about a 75% return. The third line down (black) is the S&P 500 index showing a negative return for 5 years. The next 2 stocks underperforming the S&P in the following order are American Express (blue) and H&R Block represented by the yellow line. The lines on this graph represent stock appreciation (or depreciation) without dividends, thus H&R Block and American Express had total returns (stock appreciation plus dividends) of a negative 10% over the past five years.

We can see from this graph and also the table on page 2 that the two stocks predicted by the ROE to outperform the S&P 500 did so and the two stocks predicted by the ROE to underperform did so.

MasterCard is in our Buffett and Beyond Model Portfolio and as you can see, is doing quite nicely. Very nicely indeed.

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**Smoke, Smoke, Smoke them Cigarettes**

Don't so as that old song says, but I do receive many, many questions from our radio listeners regarding the tobacco industry and individual tobacco stocks. I personally never smoked, but some folks tell me smoking gives them a buzz and makes them a bit high. Well, that may or may not be, but when you see what these stocks are doing, you will certainly reach Cloud Nine by the end of this article.

Let's look at a short synopsis of each of the most famous tobacco stocks in order to be able to see the difference between the corporate strategy and most important, the geographical areas in which they market their products.

**Tobacco Industry**

**Lorillard, Inc. Stock Symbol LO:** Third largest manufacturer in US. Brands are Newport, Kent, True Maverick, Old Gold. Newport is 90% of sales, 14% of US market share; Market share up 1% this past year. Introduced Newport Non Methanol and is great success. 2,700 employees Greensboro, NC

**Altria, Stock Symbol MO:** Parent company of Philip Morris USA, John Middleton and Philip Morris Capital Group. Marlboro, Benson & Hedges, Merit, Virginia Slims and smokeless products. Sold Miller in 2002 49% share of US market. Spun off Philip Morris International in 2008, 10,000 employees Richmond VA. **John Middleton**, an Altria **company**, is a leading manufacturer of machine-made cigars and pipe tobacco, operating two facilities in Pennsylvania. **Philip Morris Capital Group** was formed in 1982. Over the years, the company has built a diversified portfolio of assets by providing the equity portion of lease financing of domestic and international assets such as aircraft, manufacturing facilities, power generation assets and real estate.

**British American Tobacco, Stock Symbol BTI:** BTI is traded as an ADR. An ADR is a foreign company traded on a US Exchange in US dollars. One of the world's largest tobacco companies; Europe, Asia-Pacific, Latin America, and Africa. Owns 42% stake in Reynolds-American. Brands include Kool, Benson and Hedges, Lucky Strike and Kent.

**Philip Morris International, Stock Symbol PM: S**ells and distributes a wide range of tobacco products **outside** of the US. 78,000 employees New York, NY

**Reynolds American, Stock Symbol RAI:** Second largest producer of cigarettes in the US. Winston, Camel, Salem, Pall Mall, Kool, Dural, Winston and Camel are their largest selling brands in the US. BTI owns 42% of common stock of this company. 5,700 employees Winston-Salem NC.

Let's look to see if these companies are making money and the key statistic in our investing world is the Clean Surplus ROE. If we are to outperform the S&P 500 index we must fill our portfolios with stocks that generate ROEs greater than the S&P 500 index which as you can see is about 13.5%.



Remember that Philip Morris International (PM) and Altria (MO) are now two companies formed from the original Philip Morris. Thus, their ROEs are suspect in that the Equity part of the ROE (Return on Equity) may not have been divided evenly. You can see the ROE of PM is projected to be 61% for 2012. This very high ROE is of course unsustainable. The ROE of MO is just 8% which is very low for a great performing company. This is why I believe the splitting of Philip Morris into two companies distorted the Equity of the two spinoffs as only time and performance will tell.

But that story is not why we're here. If the ROE of a company is above the average S&P 500 stock, we would expect that stock to perform above the average stock. That's what the hypothesis of Clean Surplus tells us.

We can see from above that most of these tobacco stocks have ROEs higher than the S&P 500 index of 13.5%. Think of these ROEs as returns that banks will give you on your deposited money. Would you rather put your money in Bank S&P 500 index paying you 13.5% or would you rather put your money in Bank Lorillard paying 37%? The answer is clear, but let's see if the hypothesis of Clean Surplus works. In other words, do stocks with higher ROEs outperform the averages?



This chart covers five years through December 31, 2011. The bottom black line is the S&P 500 index. There is no doubt that the Tobacco Industry is outperforming the averages and this chart shows the tobacco stocks are not just blowing smoke, but are making a lot of money. Altria (MO) is paying a 6% dividend which does not show up in this chart.

Bottom line: One of the things I continue to tell people is you cannot make money by listening to the news on individual companies, but rather you must go directly to the bottom line and look at the numbers and the only number you need to look at is the Clean Surplus ROE. All our research along with actual portfolios continue to support the Clean Surplus Hypothesis in that portfolios comprised of stocks with ROEs higher than the average stock will outperform the averages. And if you can outperform the averages, you are outperforming 96% of mutual funds over any 10 year period.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Tuesday, December 6 and Sunday December 11, 2011**

**Really, How is the Economy Doing?**

**Flying High? American Airlines Going Down  
Are the Airline Stocks Good, Bad or Ugly?**

**The Economy:** We are hearing so much about the economy through the mouthpieces representing our two political parties that we all feel we are standing at the bottom of a gigantic hill in the rain with the ensuing mudslide ready to consume us.

Let's look at some numbers and this will make you all feel a whole lot better coming into the holiday season. As my good friend, David Jennett says, there is an entire cottage industry out there lead by our old TV friend Professor Nouriel Roubini who says we are "ensured" of falling back into recession this coming year. Their spiel sounds pretty solid in that orders from Europe will slow down and cut our GDP by 1 1/2% and since he sees a future growth of 2% aside from Europe, a 1 1/2% decline in orders would make us wince. If we had a simultaneous increase in the price of oil it would take us into recession. However, an increase in the price of oil AND a European slowdown won't happen at the same time.

These folks have not been paying attention to the increase in GDP as we have finally surpassed the former high GDP from late 2007. Yes folks, our Gross Domestic Product is now higher than it has ever been. We have bounced back without so much as a single quarter of lower growth since the recession ended back in early 2009.

Unemployment is still very high? Yes it is, but think of it this way. We have surpassed our past production peak with seven million fewer people in the workforce than in 2007. The U.S. has turned into a lean, mean production machine. In 2007, the lion's share of profits came from the financial sector. Today, these profits are being generated through good old-fashioned hard work.

Private, nonresidential investment continues to climb at a very steep rate which should get us to new highs toward the end of 2012. However, investment in software and equipment which is a good gauge of how much faith business has in the continued growth of the economy, has already surpassed its old high and continues to also climb at a very steep rate.

Of course, the last thing that improves during an economic recovery is the job's picture. However, jobs have been steadily improving since the recession ended. And the job's picture during this recovery looks very much like every job's recovery from every recession we have experienced going back at least as far as the 1970s. The only real difference is that this last recession was bigger than the previous one, making this climb back a bit longer. The trend towards recovery however, is unmistakable.

So folks, the bottom line here is that we are in recovery mode and as I said last year at this time, it is slow, but sure. Lots of bumps and potholes, but the economy is coming back. And also as I said last year, one of these days somebody out there will buy just one house and then everyone else will say it is time to buy. When will that happen? The first sign will be when we see an uptick in long term (mortgage) rates. At that one instant, everyone who has been waiting to buy will jump in fearing that the bottom in the interest rate cycle has been reached.

**Flying High? American Airlines Going Down**

Just last week, AMR, the parent company of American Airlines filed for bankruptcy protection after failing to win a deal with pilots earlier this month to pare its labor costs. AMR had been the only major U.S. Carrier to avoid bankruptcy proceedings in the past decade. Bankruptcy is the tool AMR's rivals have used in the past to restructure their labor agreements and cut costs.

Warren Buffett does not invest in companies in which a group of people who have no equity stake in the company, can have such a hold on a company as to strike for a bigger piece of the pie. He wants to invest in companies in which the markets decide how a company is to operate. And when you have a heavily unionized company competing with a non unionized company, the non unionized company will win out every time.

U.S. Airlines and U.S. car companies are heavily unionized and have a lot of trouble competing on the world stage. AMR has been in labor talks with its pilots for five years with nothing accomplished. This takes a lot of management time away from managing the company.

But here at Buffett and Beyond Research we don't get into politics, instead we go straight to the bottom line and look at the numbers. Why? Because the numbers tell us everything we need to know about a company and numbers also tell us whether we should invest in any particular company or not.

**AIR TRANSPORT INDUSTRY**

Let's take a look at the Air Transport Industry in general and then look at four airline companies that we're all familiar with. The following segment is from the Value Line Investment Survey.

*The Air Transport Industry's profits will likely continue to reflect increased jet fuel prices, without a corresponding revenue jump sufficient to offset the cost impact. In fact, with overall air traffic remaining near prior-year levels, top-line gains are stemming primarily from an improved mix of premium ticketing and overall airfare hikes. In all, we (Value Line) continue to believe the major airlines will mostly post profits, albeit lower year over year, again in 2012.*

*Meantime, Carriers are aiming to better match capacity to demand and alleviate the fuel match capacity to demand and alleviate the fuel cost effect. Numerous airlines are cutting back service on unprofitable routes, while reallocating aircraft elsewhere. Recent consolidation among airlines, most notably last year's formation of United Continental is also apt to enhance efficiency. Finally, industry participants are replacing aircraft with more efficient models.*

AMR CORP: (AMR) AMR owns American Airlines, AMR Eagle and the American Connection Airlines. Major American hubs at Dallas/Fort Worth, Chicago, Miami, NY and Los Angeles. 78,000 employees; Home is Fort Worth TX

SOUTHWEST AIRLINES: (LUV) One of the largest carriers in the US by revenues and the largest by passengers flown. Specializes in low fares and short hauls. Uses point to point rather than common spoke and hub model. 35,000 employees; Dallas TX.

JETBLUE AIRWAYS: (JBLU) Uses point to point rather than common spoke and hub model. Serves 63 destinations in 21 states in US, Puerto Rico, Mexico, the Caribbean and Latin American. Focuses on underserved markets and metropolitan areas with high average fares. 13,000 employees; Forest Hills, NY

DELTA AIRLINES:(DAL) Major international airlines with ten airport hubs. Provides service to every major domestic and international market. 80,000 employees; Atlanta, GA

Now we will look at the numbers and see what they tell us. Let's look at the dismal Returns on Equity (ROE) for each of these companies. The average stock in the S&P 500 index has an ROE of about 13.5% so we want to fill our portfolios with stocks that have ROEs above 14%. Actually, the average stock in our suggested portfolio has an ROE above 20%. You can see that the airline stocks definitely fall into the UGLY category in our Good, Bad and Ugly scenario.



The Bottom line on the Air Transport Industry at least with these airline stocks is there is no reason in the world to invest in one of these companies. Just look at the horrible 5-year returns on these stocks. Don't let these stocks bring down your portfolio which is our way of saying these companies should be in somebody else's portfolio and not yours.

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**Socks on the *Buffett and Beyond* Radio Show  
for Tuesday, November 8 and Saturday November 12, 2011**

**Buy or Sell Netflix and/or Amazon?**

**INTRODUCTION:** Netflix was hit with a wave of selling this past month as management made several tactical errors in new pricing relative to their distribution of the 100,000 DVD movies they have in stock. Standard & Poor's Ratings Services downgraded its ratings on Netflix Inc. (NFLX) a notch further into junk territory, on expectations that the Internet video pioneer's expansion plans, further subscriber losses and increased content commitments will hurt near-term profits.   
  
Once known for posting staggering subscriber growth and healthy profits, Netflix has seen a wave of subscriber declines in the wake of an unpopular 60% price hike and a since-abandoned plan to separate its DVD-rental and online video businesses.   
  
The company had projected that a move into the U.K. and Ireland--on the heels of a 43-country expansion in Latin America and the Caribbean in September--will trigger a few quarters of losses next year.   
  
S&P said it considers the fundamentals of the video retail market weak, with more declines expected for DVD rentals over the next several years. Though it expects the broadband home-video market to grow by more than 50% annually during that period, it expects total movie rentals will be flat to up slightly.   
  
However, if Netflix can restore its image with consumers, it may be able to take a bigger market share, S&P said.   
  
The company also faces risk from rising movie-studio compensation demands, short terms of content streaming contracts and new competitors entering the market.   
  
Netflix recently reported that its third-quarter earnings surged 65% on a big jump in revenue, but the online video and DVD-rental company predicted weak results in the current quarter.   
  
Moody's Investors Service on Wednesday removed the prospect of upgrades for Netflix any time soon, lowering the outlook on its junk-level ratings to stable from positive. It also cited the company's international expansion and subscriber exodus.

**OUR TAKE:** Please remember that we have 30 stocks in our portfolio at any one time. Also remember we want to fill our portfolios with stocks that have an ROE of 20% or better.

Our sell signal on a stock occurs when the Clean Surplus ROE drops below 20%. Let's take a look at General Electric in the year 2003. The ROE of this once all time favorite fell to 19.6%. Not a dramatic drop for our long time holding up to then. However, the projected 2004 ROE was also below 20% and less than the 19.6% of 2003. With these projections in hand we sold GE on the first trading day of 2003.



Let's now take a look at Netflix which by the way is up 200% over the past five years even with the 50% decline this year alone. We can see that the projected drop in ROE for 2012 fell from 42% in 2011 to 11% for 2012. This would normally generate a sell signal for us except for the projected ROE increase in 2013 up to 30%.

Of course, we must hope that the projections hold up and this decline in ROE is a onetime event, but if that projection is correct and we hold Netflix or buy it here, we could be richly rewarded in a few years.

By the way, this type of event is one that Buffett looks for in order to add to his portfolio.



**AMAZON:** Here is some news on Amazon which is a lot prettier than the news on Netflix. Amazon has been a holding in our portfolios for a very long time. Amazon has increased in price 475% over the past five years.   
  
***Despite Amazon’s Margin Squeeze, Kindle & eCommerce Sales Offer Upside***

***8:12 AM ET 11/1/11*** *|*

*Although not entirely surprising,* [*Amazon’s*](javascript:void(0);) *(NASDAQ:AMZN) Q3 2011 results showed a significant drop in the company’s operating margins. The reduction in operating income reflects the heavy costs Amazon has incurred on its hardware, namely the Kindle Fire tablet which saw an enthusiastic response at its launch in September. Amidst some jitters from investors, we expect Amazon to come out strongly as the Kindle Fire acts as a major platform for Amazon’s e-commerce and e-content segments in the coming years, providing stiff competition to* [*Apple*](javascript:void(0);) *(NASDAQ:AAPL) in the mobile content market.*

Let's now look at the numbers: We can see the ROE dropping to a mere 16% for this year. However, the projected numbers for 2012 and 2013 indicate that this recent drop is a one-time event. Thus, we will certainly hold on to Amazon hopefully for a very long time to come.



**BOTTOM LINE:** The bottom line here is that the ROE tells us almost everything we need to know about a stock.

Buffett tells us there are three instances he waits for in the purchase of his stocks. The first is a vicious market decline. Second is a selloff in an entire industry in which all stocks in a particular industry sell off but the future fundamentals look sound and finally, when a particular stock is hit with a shock such as Netflix and Amazon. We will now wait and see if both these stocks are in the latter category. We're very confident with Amazon and evidently so is the market in general. Netflix, well, not so much as we can see by the dramatic price drop over the past several months. However as I said earlier, with a portfolio of 30 stocks, we can take that chance on Netflix.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Tuesday, September 20, 2011**

**THE CLOUD: What is it? Where is it?**

**Akamai, Rackspace Hosting and Cramer's favorite, Salesforce.com**

**Cloud computing** is the delivery of computing as a service (from the internet) rather than a product (software) housed on the hard drives of our individual computers. The software on our computers won't be needed any longer as we will be able to access shared resources, such as software which will be provided to computers and other devices (I-Pads) as a utility over the internet. Cloud computing provides computation, software, data access and storage services and thus does not require these services to be stored on the user's computer.

We are most familiar with software such as spreadsheets and word processing that is now stored on our computers which is why we have rather large computers. The software requires a very large amount of memory. Cloud computing providers deliver applications (spreadsheets, accounting software, etc) via the internet, which are accessed from a web-browser (search) while the business software and data are stored on servers at a remote location. This remote location, wherever it is, is called "the cloud."

With the advent of the I-Pad type of transportable computer, we cannot do all we need to do on this device because the I-Pad does not have enough available memory. However, if we use the cloud we will soon be able to access the software we need via the internet from our I-Pad. We can use our I-Pad to store our personal files and then when we want to use, say an Excel type of program, we can access the Excel program via the internet, upload our file to the "cloud" and begin working. When we finish with our work, we can save the file on our I-Pad and disconnect from the Cloud. In other words, we will not need all the capacity on our I-Pads that we now have on our desk tops or our lap tops because we will soon have access to the large programs via the cloud.

Most of us have a backup service for all our files. I use Carbonite and it continually backs up my files and stores them, well, somewhere. That "somewhere" is the Cloud.

I researched three companies that are involved with the cloud. Jim Cramer talked about Salesforce.com (CRM) on his show, but I found a stock that is doing much better than Salesforce.com and that company is Rackspace Hosting (RAX). I came across this stock because one of our astute newsletter subscribers told us about it. Great job to all you readers out there in investment land! Keep those emails coming.

Following is a brief description of these companies followed by our analysis.

**Akamai:** AKAM provides services for the delivery of content and business processes over the internet. The company operates the world's largest and most widely used on-demand distributed computing platform with more than 80,000 servers; Has exposure in 70 countries with 28% of revenues coming from abroad. Their home is in Cambridge Mass.

**Salesforce.com** CRM a leading provider of on demand customer relationship management services. It also offers a technology platform for customers and developers to build and run business applications. The company's services enable customers and subscribers to record, store, analyze, share and act upon business data. They have exposure in 70 countries with 32% overseas revenues. Based in San Francisco.

**Rackspace Hosting** RAX operates in the hosting and cloud computing industry providing information technology as a service and managing web-based IT (Information Technology) systems. It offers cloud servers, cloud files, and cloud sites, as well as cloud applications, such as email, collaboration, and file back-ups; and hybrid hosting that provides a combination of dedicated hosting and cloud computing services. They are based in San Antonio, TX.

All the above sounded very nice, but let's take a look at the Clean Surplus numbers and see if these companies are making any money.



**Clean Surplus ROE:** Just to refresh your memory, the many years of research and actual portfolios show that portfolios made up of stocks with higher ROEs outperform portfolios made up of stocks with lower ROEs. From left to right we have Rackspace Hosting with the highest ROE and because of this we would expect Rackspace to perform the best out of these 3 stocks. Notice that it not only exceeds our personal threshold of a 20% ROE for our portfolio addition, but also has a higher ROE than the average stock in the S&P 500 index.

Salesforce and Akamai have ROEs lower than the average stock in the S&P 500 index which means we don't have to discuss these stocks any further. These stocks should be in someone else's portfolio and not ours.

**Performance:** Over the past 3 years we see that Rackspace has returned 270% while Salesforce returned a very surprising 120% over 3 years. With an ROE of just 9-10% we don't think this stock can maintain that pace. Looking at the one year return we see Rackspace up 50% while Salesforce has returned nothing and Akamai has lost 60% of its value in just one year. Rackspace with the highest ROE has the highest return over both a 3 and 1 year period just as the Clean Surplus ROE indicated.

**Dividend and Retention Rate:** None of these companies are paying a dividend which is what we want to see in a growth stock. The Retention Rate is the opposite of the Dividend Rate and indicates the percentage of the profits that are retained within the company in order to grow. If the company is not paying a dividend it means that 100% of profits are being retained for growth. How do we know that a company is using the retained profit efficiently? If the ROE is steady or growing it means that the company is deploying its retained profits in an equally profitable manner as it had deployed capital in the past. A steady or growing ROE is a very good thing.

**Years to Pay Debt:** Buffett's rule of thumb for the amount of debt for a company is the following: How many years would it take to entirely pay off its existing debt if the company took every penny of its profits and used them to pay off its debt? Buffett's threshold is 5 years. If a company has to take more than 5 years to pay off its debt, it could be in trouble when things slow down. Rackspace would take just 1.4 years to pay off its debt while Salesforce would take 8.8 years. This is good for Rackspace, but very scary for Salesforce.com. Akamai has no debt, but the low ROE tells us it is not very efficient at what it's doing.

**Bottom Line:** Rackspace has been public just a bit over 3 years, but it's high and increasing ROE tells us this company is doing everything right. Rackspace is a stock to consider for our portfolios (the Good) while Cramer can have Salesforce.com for his own portfolio (the Bad) and at this point Akamai should be in no body's portfolio (the Ugly).

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, August 25, 2011**

**U.S Stocks with International Exposure vs. U.S. Domestic Only Stocks  
  
AutoZone vs. AutoNation**

We are looking at definite shifts in the investment landscape and it is being supported by our Clean Surplus method of analysis. We already know that the increase in the generation of earnings correlates almost exactly with the increase in stock price over the long term.

Our analysis using the Buffett and Beyond Clean Surplus model shows us which stocks have a steady increase of earnings and it is these stocks which grace our portfolios. And it is this portfolio of stocks that consistently outperforms most other money managers out there in investment land.

However, if we look below the surface and try to find the reason some stocks have a consistent increase in earnings we find two major themes.

The first theme we've already spoken about and it is the shift of business and sales from the bricks and mortar companies to the internet companies. We've already compared **Barnes & Noble vs. Amazon** with Barnes and Noble hardly making any money at all, while Amazon is growing faster than authors can write new books. We also analyzed how advertising has gone from the newspapers and very large advertising companies which have long been a favorite of Buffett, to the internet giants Google and Yahoo.

Another theme has come into play and that is U.S. companies with overseas exposure are beginning to outperform those U.S. companies in the same industry that do not have overseas exposure. Please remember that some of the large emerging economies are growing four times faster than the U.S. economy. It is no wonder that good, solid U.S. companies with exposure in Japan, China and India along with all of South and Central America can generate more sales than a domestic only company in the same industry.

This week we'll look at AutoNation and AutoZone.

**AutoNation** is an automotive retailer in the United States which offers various automotive products and services including new vehicles, used vehicles, parts, automotive repair and maintenance services. It owns and operates 242 new vehicle franchises primarily in the Sunbelt region of the U.S.

**AutoZone** operates as a specialty retailer and distributor of automotive replacement parts and accessories. Its stores offer various products primarily to do-it-yourself customers and delivery of parts and other products to local, regional and national repair garages, dealers, service stations and public sector accounts. AutoZone operates 4,300 stores in the U.S. and Puerto Rico and 188 stores in Mexico.

Let us now look at the Return on Equity in a Clean Surplus condition of these companies which will show us if AutoZone's business model, which includes international exposure is proving to maximize shareholder value more than AutoNation.



We can see that AutoZone is generating a 21% ROE while AutoNation generates an 11% ROE or an ROE almost half that of AutoZone. Would you rather have your money in Bank AutoZone paying interest of 21% or in Bank AutoNation earning interest at 11%? Now that you see the ROEs of these two companies in a Clean Surplus Condition, there is no question as to which stock you would rather own, but only if stocks with higher ROEs outperform stocks with lower ROEs. Let's take a look at the stock appreciation of both companies over the past five years compared to the S&P 500 index.



We can see without any doubt that AutoZone (Blue Line) has outperformed AutoNation (Tan Line) by more than 2:1 **just as the ROE predicted**. Both stocks have outperformed the S&P 500 (Black Line) index over this 5 year period. As long as AutoZone continues to generate an increase in earnings at the rate of 21%, it will outperform both the S&P 500 index as well as AutoNation for a very long time to come.

We are beginning to see both intuitively and quantitatively that stocks with higher ROEs outperform stocks with lower ROEs and in this case and most cases, stocks in the same industry with international exposure are outperforming stocks with just domestic exposure.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, July 28, 2011**

**Bricks and Mortar vs. The Internet  
Barnes & Noble vs. Amazon**

There is a definite shift in almost all segments of our economy and it is one of how we shop. My wife likes to go to the mall. I like to sit at my computer and order anything online that I don't physically have to shop for. Sometimes, my wife will shop online. However, I will never go to a mall unless absolutely necessary which is almost never.

This introduction paragraph brings me to the question asked of me from a radio listener. The question is what should he do with his Barnes and Noble stock now that Borders is going bankrupt? Barnes and Noble and Borders are in the same industry as is Walden Books. And the new kid on the block? Yes, you all know it as Amazon.com.

I can remember the first time I ordered books for Christmas presents online from Amazon. I finished almost all my holiday shopping in about an hour which made me the happiest person in the world. The only reason I ever physically went to Barnes and Noble was to see if my book, "Buffett and Beyond" was on the shelf. My trip to the mall was a very exciting day when I saw my name in print. But did I buy anything at the store? No, I did not.

Just to reinforce the theme of this exercise, I was talking about the internet in one of the finance classes I teach a few times during the year. I said that I receive ten times the orders for the electronic version of my book than the hard or soft cover which is a total reverse of just seven years ago.

I teach mostly adults who are in the process of earning their degrees through evening classes. I love teaching adults as the discussions are full of real life experiences. It is from that experience that one student asked the question that puts internet shopping in perspective. "Do you (meaning me) make more money selling the physical book or do you make more selling the electronic version?" The answer was my epiphany. My electronic version sells for $9.99 which is all profit. The purchaser pays online with PayPal using a credit card and the electronic version of an entire book is sent out automatically while I'm napping in my hammock. Within minutes someone is reading my book on their computer or even more probable, on their IPad or one of the other pads which are on the market. The planet saves a tree, and no gas is used by the post office delivering a book and I actually make more money than selling the actual book. The hardcover which sells for about $28 earns me $2.80.

Now the question is are other folks out there thinking the same as I do and can we as investors take advantage of this shift in the market place? I know a very easy way to tell and that is to compare who is making the most profit between the bricks and mortar companies and the internet companies in the same industries with our focus today on books.

Let's take a look at the Return on Equity (in a Clean Surplus condition) over the past dozen or so years (time series analysis) and see which stock under discussion has the highest and most consistent ROE. Stocks with high and consistent ROEs should be in our portfolios and stocks with lower ROEs should be in someone else's portfolio. Stocks with high and consistent ROEs have the fastest earnings growth and the most consistent earnings growth. Consistency over the years in the growth of earnings allows us to sleep better at night.

We want to fill our portfolios with stocks that have higher ROEs than the average stock in the S&P 500 index so that we have a good chance of outperforming that index. Remember, over 10 year periods just 4% of mutual fund managers can outperform the S&P 500 index.



We can see above, that Barnes and Noble, the nation's largest seller of books is earning nothing while the average stock in the S&P 500 index is earning a 14% Return on Equity.

Amazon on the other hand sports a 33% ROE for 2012. Also, you can see that over the years Amazon's ROE has been generally increasing.

Amazon's online income is derived from two areas. The first area of books, music and videos account for 43% of income while electronics account for 54% of income. I know, like really, who knew? Here is one more very important point that I look for in a company and that is overseas exposure because overseas is where the growth is coming from. A full 46% of the revenues that Amazon brings in comes from overseas.

There is one more very important point I would like you to think about. When it comes to employing new technology it is usually a new, startup company that enters the field rather than an established company coming up with a new and better way. Barnes and Noble is also an online seller of books, but it wasn't until Amazon came along and firmly established itself as the largest online retailer of books that Barnes and Noble decided to enter the online business. With this thought in mind think Intuit (Turbotax) and H&R Block and the traditional advertising companies (including newspapers) and Google. Do you all see a trend here?

Stock Returns: Let's look at a chart of stock returns of Amazon and Barnes and Noble over the past five years.

Amazon (blue line) has appreciated 725% while the S&P 500 index has gone nowhere (black line) and Barnes and Noble has declined 50% over this time period.

**Bottom Line:** Amazon has been in our portfolios as long as I can remember. It also has revenue from other countries that are experiencing growth greater than the growth in the U.S. The rising ROE means Amazon's earnings are rising at an **increasing** rate. Folks, you can't ask for a better stock. Yes, Amazon should be in your portfolio and Barnes and Noble should be in someone else's portfolio.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, June 30, 2011**

**The Tobacco Industry**

**Philip Morris International, Lorillard, British-American Tobacco, Reynolds American and Altria**

We received an email full of questions regarding Philip Morris and Altria. Let's clear up the confusion of one of our radio listeners right now.

Philip Morris (NYSE; MO) **was** the USA tobacco giant who developed such brands as Marlboro, Merit, Benson & Hedges, Virginia Slims, Parliament, L&M and Chesterfield. It also owned Miller Brewery and a good chunk of Kraft foods. Philip Morris USA sold off Miller Brewery in 2002, and then in January of 2003 with the approval of its shareholders, changed its name to Altria. The stock symbol remained the same which pleased almost everyone. Those of us in the "biz" used to call Philip Morris the "Mighty Mo." After all, prior to 2002, the company made cigarettes, owned Miller Brewery and also owned part of Kraft foods. There is no way you can beat the combination of cigarettes, plus a little cholesterol in the thirst causing Kraft Cheese and a cold bottle of Miller Lite to wash it all down. Now, that's a company we all wanted to own as it was a cash cow selling the two most popular legal drugs, nicotine and alcohol. And to cap it all off, Philip Morris was a recession proof stock if we ever saw one.

Along came unrelenting amounts of litigation in the U.S. which spurred lots of future planning by the company. There was a reason Philip Morris changed its name. March 28, 2008, Altria divided itself into two companies. Altria (NYSE: MO) became the U.S. cigarette company while Philip Morris (NYSE: PM) became the international tobacco company with its new name being Philip Morris International.

What was the reason for the split in the original company? The U.S. became a hot spot for tobacco and the company found itself spending more on litigation than it did on, well, almost anything else. The U.S. cigarette market was shrinking and because of the litigation, the stock price was held down due to continuing uncertainty.

In 2009 Altria bought UST which is known for its smokeless cigarettes. The smoking habit of the adult population in the U.S. is declining 3-4% per year. 21% of adults in the U.S. smoke while 35% of adults in developed countries smoke and 50% of adults smoke in the developing nations. Just in China alone, 300 million adults smoke. 300 million people is more than the entire population of the U.S.

The bottom line is the long term growth rate for tobacco in the U.S. is declining while the international tobacco consumption is growing.

Where do we go from here? Altria pays a nice 6% dividend, but Philip Morris International is the fastest growing tobacco company paying a 3.9% dividend.



Looking at the Clean Surplus ROEs we see Philip Morris has the highest ROEs, but we only have 3 1/2 years of data because of the spinoff. Nonetheless, we expect stocks with the highest ROEs to outperform stocks with lower ROEs. However, looking at the 5-year and 1-year returns all of these stocks are on a roll while using their afterburners to totally blow smoke at the paltry returns of the S&P 500 index over the one and five year time periods.

Lorillard, Reynolds and Altria all are domestic companies and are subject to the harsh U.S. litigious society. Both Philip Morris International and British American Tobacco are the international companies. FYI, British American sports such brands as Kool, Benson & Hedges (Altria also sells Benson & Hedges in the U.S.), Lucky Strike and Kent.

None of the companies have excessive debt and all sport very nice dividends. We have Altria in our income portfolios where we add to that dividend by selling either put options or sometimes covered call options. Our goal is to gain a 10% return per year in these portfolios and with a 6% dividend, we're almost there.

We also like Philip Morris International for its growth and almost 4% dividend and of course, British American with its 6.1% dividend and no exposure to the U.S. litigation problems.

Reynolds American is very much over priced at the present levels. The others are fairly priced at this juncture in the market.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, June 23, 2011  
The Retail Store Industry:  
Dollartree, Coach, Family Dollar, Big Lots and Saks**

One of our listeners called and said Jim Cramer talked about some stocks in the retail industry recently. Cramer mentioned Dollartree along with Family Dollar and Saks. He said Family Dollar was his favorite stock in this industry and he also liked Saks.

Well folks, we've got to disagree with Jimmy as Family Dollar is not the best stock in this industry and Saks is just not a good stock at all except possibly short term. Please remember we're long term investors and we stay away from flash in the pan type of trades.

We covered both Family Dollar and Coach in the past and we mentioned Coach has been in our portfolios for a very long time. We looked at Dollartree for the first time for this report and wow, we should have looked at it sooner.

Remember, Clean Surplus analysis develops a Return On Equity (ROE) that allows us to compare one stock to another just as we would compare one bank to another relative to the interest they pay us on savings accounts. Also, we know from both research and actual portfolios that stocks with higher ROEs outperform stocks with lower ROEs over the long term.

Also remember we would like to fill our portfolios with stocks that have a 20% ROE or higher and the following chart lists stocks with the highest ROEs on the left. As you read to the right you will see the ROEs decline. Since the ROEs have a very, very strong correlation with stock appreciation we would expect the stocks with the highest returns to be the stocks with the highest ROEs.

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As you can see, Dollartree has the highest ROE and also the highest five year and highest one year returns. Coach, a long time portfolio holding, is next in line followed by Cramer's favorite Family Dollar. Now look at Saks. It's dead last and I wouldn't touch this stock with someone else's money let alone my money. It has had a nice one year return, but it is still down 30% for the past 5 years.  
  
Bottom line: We are going to add Dollartree to our portfolio and keep Coach. Let Jimmy Cramer buy Saks.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, June 16, 2011  
The Industrial Services Industry:  
C.H. Robinson, Healthcare Services, Iron Mountain, SAIS and Cintas**

The Industrial Services Industry is comprised of companies that have very little in common with each other. Industrial Services is a diverse group with individual performances tied to many disparate influences. In other words, they are very different companies as you can see from their descriptions below.

**Cintas** designs, manufactures and distributes uniforms through its rental division.

**Iron Mountain** is the leading provider of records, documents and information-management services.

**C.H. Robinson** (a portfolio holding) is one of the largest third-party logistics companies which provides multimodal and logistic solutions. Multimodal describes all forms of transportation and answers the question, "How do we get these goods from here to there?" Goods are packed into containers and by containers, we're speaking of those 40 foot containers you see on trucks, trains, ships and also in planes.

**Healthcare Services** provides housekeeping, laundry, linen, facility maintenance and food services to the healthcare industry primarily in the US.

**SAIC**, Inc provides scientific, engineering systems integration and technical services and solutions to various branches of the military, agencies of the U.S. Department of Defense and the intelligence community as well as other U.S. Government civil agencies.

Well how in the world does anyone make sense as to which of these companies should grace our portfolios since they are such different companies? The answer is by comparing the Clean Surplus Return on Equity (ROE) of each company. We do know we must compare these ROEs to that of the S&P 500 index which sports an ROE of 14%. Thus we want to search for stocks that have ROEs higher than 14%. And while we are at it why not select stocks with ROEs of 20% or higher in order to select companies which have the capability of producing superior returns? Let's look at the ROEs of these companies.



We can see that the stocks with the highest ROEs had the best five year returns which is what the Clean Surplus ROE predicts for us. Stocks with higher ROEs outperform stocks with lower ROEs over the long term. The no brainer here is C.H. Robinson and also Healthcare Services. Both have ROEs higher than the rest of the stocks listed and both their ROEs are above 20%. These two stocks have each returned 90% over the past 5 years relative to the S&P index returns of 5%.

Looking at the "Years to pay Debt" we see that both C.H. Robinson and Healthcare Services have do debt at all. This makes them pretty safe companies. Looking at Iron Mountain we see it had a respectable 40% return over the past five years, but their debt is very high. Remember the "years to pay debt" means how many years would a company need to pay off its debt if it took all of its earnings each year just to pay debt. Buffett doesn't like any company that takes more than five years to pay off debt so with this in mind, we wouldn't get near Iron Mountain. It also has a 15% ROE which makes it an average stock. The huge amount of debt makes it a dangerous stock.

**Bottom Line:** C.H. Robinson has been in our portfolio for a very long time. We're beginning to like Healthcare Services but it still is considered a small company. It has a very nice dividend, but we would rather see a small company such as this put all or most of its earnings back into the company for growth. However, with no debt it is a cash generator and it has a very nice rising ROE which you can't see by this chart, but is evident in our research work.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, June 9, 2011  
Jim Cramer says what about Heinz?**

We received a call from one of our listeners alerting us to the fact that Jim Cramer highlighted Heinz Foods on a recent show. The story was that Goldman Sacks issued a sell order while UBS said to buy it. And both of these announcements came on the same day this past week. Jim Cramer really stuck his neck out (Ahem!) and said to buy it if you think the economy is getting better, but sell it if you think the economy is going to get worse. Well, the problem is Cramer didn't shed one bit of light on the economic front. Here's our take on Heinz while we compare it to some other stocks in the Food Processing industry.



Since Heinz sports an ROE no better than the S&P 500 index, it will be pretty much an average performing stock in the future. Better stocks in this industry are General Mills and McCormick both of which returned nearly 50% over the past 5 years while the S&P 500 index returned a mere 5%. Notice that McCormick has less debt in the "years to pay debt" row. Buffett likes to see a company able to pay off its debt in 5 years or less. None of the stocks above grace our growth portfolio as our portfolio is filled with stocks which have higher ROEs and better returns over the past 5 years.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, June 2, 2011  
The Internet Industry: Priceline, Netflix, Amazon, Google, Yahoo and Ebay**

There have been new additions to the S&P 500 index from our Internet stock list. Priceline became part of the benchmark index in November of 2009 and Netflix entered this prestigious group of 500 stocks in December of 2010. Amazon, Google, Yahoo and Ebay all have been part of the S&P 500 index for some time now.  
  
The Internet industry is very large and there are other stocks which I want to explore but that will have to wait until next time. For now, let's look at the Clean Surplus ROEs of these great stocks.  
  


Notice that the stocks (for the most part) that have the highest ROEs also had the highest returns. Priceline and Netflix have recently been added to our portfolio while Amazon and Google have been in our portfolios for a long time. All four of these stocks grace our portfolio because they have ROEs higher than 20%. However, it seems as though Google has grown so large that as with Microsoft (not shown) there doesn't seem to be much room to grow. It has grown only 40% in the past 5 years. However, Google has grown over 400% in the past 7 years with most of their growth coming in the first several years after becoming public. We are considering deleting Google from our portfolio, but I will delve into that story in a week or two.

Notice that all these stocks are pure growth stocks in that their retention rates are 100%. This means they don't pay dividends, but rather put all their profits back into their business model in order to grow faster than anyone else. We like this.

Also, none of these companies have any debt and they are all large companies. We just like everything about this group and the key to growing your portfolio is to invest in the fastest growing stocks and as long as they can continue to generate earnings which keep those ROEs nice and high, the price appreciation is sure to follow.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, May 26  
The Retail Automotive Industry  
Autozone, O'Reilly Auto and Carmax, Auto Nation, Penske Auto and Pep Boys**

Autozone has been in our portfolios since the beginning of 2004. We purchased it at an average price of $85.21. Today, it is close to $300 for a gain of 252% vs. the S&P return of 18.7% during this same time period. This is why we select stocks for our portfolios that have Clean Surplus ROEs well over the ROE of the S&P 500.

The Retail Automotive Industry is comprised of two kinds of companies: Those that sell replacement automotive parts and accessories to "do-it-yourself" customers and to commercial "do-it-for-me" clients; and those that sell a wide assortment of new and used vehicles over the Internet and networks of regional or national franchised dealerships.  
 **Economic Considerations**The dealer business tends to by cyclical, since its fortunes are tied to auto industry, production levels, gasoline prices, the financial health of the consumer, and the state of the domestic economy. Indeed, dealership groups, even the better managed ones with lean cost structures and extensive product lines (e.g., parts & service and finance & insurance), tend to struggle during tough economic times.  
  
Parts retailers are also affected by the prevailing macroeconomic environment, **but to a lesser degree**. (Autozone to a lesser degree than all the others.) These usually less-mature, faster-growing outfits are influenced by their own merchandising & remodeling initiatives and unit development strategies. And they are subject to secular long-term trends, including fluctuations in the older-vehicle population and the number of licensed drivers. Notably about 70% of all parts purchases made by consumers and commercial customers are need-based, rather than discretionary. This helps to shield aftermarket parts retailers from unwelcome economic headwinds.  
  
Looking at the spreadsheet of the ROEs of the various companies, we see that Autozone has the highest ROE of the group followed by O'Reilly and then Carmax. These three companies all have ROEs higher than the average stock in the S&P 500 index.  
  
The above description of the industry mentions cyclicality in the industry and those of you listening to the Buffett and Beyond radio program know we really stay away from cyclical companies. Cyclical companies make a lot of money when times are good and lose money or go bankrupt when times are bad. Since we are long term holders, we don't want to see our portfolios decimated during recessions.  
  
However, look at the ROE of Autozone in 2008 which was a very nasty recession. The ROE stayed steady which means the earnings were rising. (For a company to maintain a steady ROE, the earnings must be increasing at the ROE rate.) Looking across at the other companies we see the ROE declining which means the earnings were declining at a rapid rate. We don't like that so on that premise (cyclicality) we would only select Autozone out of this entire group.  
  


The "Yrs to pay Debt" is an interesting row in the above chart. A rule of thumb is if we take all of the earnings of a company to pay off only the debt, we want that company to be able to pay off the debt in less than 5 years. Autozone fills that requirement and so does O'Reilly. In fact, O'Reilly has almost no debt which is excellent. Another important point about O'Reilly along with Autozone is it is a large company and is putting 100% of earnings back into the company in order to grow. We like this very much in both companies.   
  
The number one question regarding the research on Clean Surplus is do stocks with higher ROEs outperform stocks with lower ROEs? If so, we would expect to see Autozone (AZO) outperform O'Reilly (ORLY) which in turn should outperform Carmax (KMX) and all three should outperform the S&P 500 index. In the following chart of the past 5 years of performance, we see this is certainly true. And so we see that Clean Surplus is indeed a very good predictability model which is used in our real life portfolios to greatly outperform the S&P 500 index.  
  


You see that Autozone is our stock of choice as it far exceeds the other companies and the S&P 500 index. The S&P is the bottom bold black line.  
  
Now you know how we select stocks and why we select the stocks that we do.  
  
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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, May 12  
Stocks in Buffett's Portfolio: Walmart**

WHAT DO WE KNOW ABOUT BUFFETT?

Buffett continues (except for this year) to outperform the S&P 500 index. However, our own portfolio not only outperforms the S&P, but we also outperform the Great one himself by a wide margin. In fact, since the end of 2002, we have outperformed both Buffett and the S&P by more than double on a compounded basis. Of course, your question is how did we do that if we're using the same system as Buffett?

The main reason Buffett is not performing as well today as in the past is because he is handling too much money and for this reason and this reason alone he just cannot continue to generate the type of returns he did two decades ago. Here is a quote from Buffett's 2010 report to shareholders.

*"The table on page 2 shows our 46-year record against the S&P, a performance quite good in the earlier years and now only satisfactory. The bountiful years, we want to emphasize, will never return.* ***The huge sums of capital we currently manage eliminate any chance of exceptional performance.*** *We will strive, however, for better-than-average results and feel it fair for you to hold us to that standard."*

What do we know about Buffett? We know he is handling much too much money which inhibits his ability to generate the type of returns we have gotten used to over the years from him.

What else do we know about Buffett? We know Buffett used and I say used (past tense) a system called Clean Surplus which was not his system, but rather a system developed by the accounting profession that allows comparability among all stocks. It is also a predictive model which gives a pretty good estimation of the future returns (stock appreciation) of a company.

I've been studying and using this system since the late 1990s. I wrote and published a Doctoral dissertation on the subject as well as a book which is appropriately entitled "Buffett and Beyond." I can tell you with great certainty, Clean Surplus is a great methodology for stocks. However, Buffett is presently into currencies, oil, natural gas, derivatives, preferred stocks, real estate and who knows what else and doesn't much use the Clean Surplus model for stock selection.

The most positive aspect of our knowledge of the subject is that we will remain loyal to the methodology of the Clean Surplus system and always will because it is this system that allows us to outperform almost all of the money managers out there in investment land.

Let's look at one of the present holdings in Buffet's portfolio and we will see why we are able to outperform not only the S&P 500 index, but also Buffett. We will look at Walmart which he is holding at the present time.



Clean Surplus allows us to compare stocks in the same manner as we would our bank accounts. The ROE you see above is NOT the traditional accounting ROE but rather the ROE configured by Clean Surplus. All you need to know in order to compare stocks in a Clean Surplus manner is to think of your bank account. The S&P 500 **bank** is returning us 14%. Walmart is a bank returning us 16% on the money investors have put into the Walmart bank which means we would rather invest in Walmart than an index fund which represents the S&P 500 index.

Now look at Family Dollar. It is a bank returning 18%. We like that, but we like Ross Stores and Coach even better as they are banks returning us more than 20%.

We try and fill our yearly portfolio with stocks from the S&P 500 index which have a Return on Equity of 20 % or greater. Buffett has Walmart in his portfolio which is a bank paying him 16% this year while we have both Coach and Ross Stores in our portfolio both of which are banks returning more than 20%.

If Clean Surplus is a predictor of how well a stock will perform, Coach, Ross and Family Dollar should be outperforming Walmart and all of these stocks including Walmart should outperform the S&P 500 index. Let's look at a 5 year chart of these stocks along with the S&P 500 index.

This chart is a 5 year chart of the stocks we just analyzed. If Clean Surplus is a good predictor of returns we should see Coach, Ross Stores, Family Dollar and Walmart outperforming the S&P 500 index. On the chart, the bottom line is the S&P 500 index which shows us that all the stocks predicted to outperform the S&P did indeed do so. The top line and best performer is Ross Stores (ROST) returning about 180% in the past 5 years ending May 11, 2011. The next two stocks tied at a 100% gain over this same time period are Coach (COH) and Family Dollar (FDO) with Walmart (WMT), the heavy black line, showing a 20% gain over our 5 year period.

We've had Coach in our portfolio for a long time and just added Ross Stores at the end of 2010, but the bottom line here is that our portfolio consisting of stocks with a 20% or higher ROE should continue to outperform not only the S&P 500 index (14% ROE), but we should also continue to outperform the greatest investor of all time, Warren E. Buffett.

You can see it is relatively easy to select a portfolio which will outperform most money managers out there in investment land just by looking at their Clean Surplus generated ROEs. The difficult part is putting the numbers together in order to generate the Clean Surplus ROEs. But then again, you know us and that is what we do for you.

See you next time.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, May 5  
The Advertising Industry**

Today we'll look at the Advertising industry. To tell the truth, there is nothing to look at except to say that Clean Surplus sure does keep us away from those underperforming stocks out there in investment land. If you listen to the radio program of 5/5/11, you will see that I said to keep away from these stocks. Here's why.

First of all, just two of these stocks Global Sources and Interpublic have ROEs higher than the average stock (in the S&P 500 index) which means both of these stocks should outperform the S&P.

Just one stock, Omni Com has an ROE about equal to the S&P and should perform about as well as the S&P. The chart of returns below shows this to be true. In other words, Clean Surplus is indeed a predictor of future returns.



The other stocks should be in someone else's portfolio and not yours so don't even think about owning these stocks for the long term.

Just look at the Global and Interpublic "years to pay off debt" line. It will take 7 and 5 years respectively of total earnings earned in order to pay off their debt. This is too long or putting it another way, they have too much debt especially Global.  
  
Also look at the year 2008 which is highlighted. We can see the ROE of these stocks dropped off dramatically during this past recession. This rapid decline of ROE tells us these stocks are very cyclical which means they make money in good times and perform horribly in bad times. Remember we don't like cyclical stocks at all and the reason is they can make a huge dent in our portfolio during bad economic times. We saw the S&P drop 40% in 2008 and we certainly don't want to see any stocks in our portfolio drop more than the market.

Bottom line: Just stay away from this entire industry.

**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, April 14, 2011**

**The Financial Services Industry: Mastercard, Visa, American Express, Capital One Financial and Hartford Financial**

**The Good, the Bad and the Very Ugly**

It sure is nice when we break the numbers down to the Clean Surplus Return on Equity (ROE) in that we are very easily able to determine with a great degree of accuracy which stocks should outperform the S&P 500 index. The question asked of us was on American Express as a purchase for a portfolio.

We can see that American Express has an ROE less than the ROE of the average stock in the S&P 500 index. If we do not have a good chance of outperforming the S&P 500 index then we shouldn't even consider purchasing that stock. In fact, American Express falls in the Bad category while Capital One Financial and Hartford Financial all fall in the Ugly category as all three stocks have ROEs less than the S&P 500.

On the other hand, we see that MasterCard with an ROE of over 30% over the past 7 of 8 years is earning profits at a much faster rate than any of our other stocks. The only other stock beating the S&P 500 index in this group is Visa. Notice that the ROE of Visa is increasing which is a good sign. Neither MasterCard nor Visa have any debt, but MasterCard is retaining more of its earnings (95%) than all the other companies. Thus, we expect MasterCard to grow faster and appreciate more than the other stocks. Let's see how this group of stocks have performed over the past 5 years relative to price return.

MasterCard is the top line showing a return of about 475% over the past 5 years. The next line down in yellow is Visa with about a 45% return. The third line down is the S&P 500 index showing just about a zero return for 5 years. The next 3 stocks underperforming the S&P in the following order are American Express, Capital One Financial and finally Hartford Financial with about a negative 60% return over the past 5 years.

We can see from this chart and also the spreadsheet above that the two stocks predicted by the ROE to outperform the S&P 500 did so and the three stocks predicted by the ROE to underperform did so.

From the negative returns of American Express, it is a Bad stock while the seriously negative returns of Capital One and Hartford, allows us to call these stocks just plain Ugly!

By the way, MasterCard is in our Buffett and Beyond portfolio and as you can see, is doing very nicely. Very nicely indeed.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, April 7, 2011**

**Buffett's purchases of Lubrizol 2011 and Burlington Northern 2009**

This past week has been an active one relative to Buffett's Berkshire Hathaway. His supposed successor and number 2 man at Berkshire, David Sokol bought several thousand shares of the specialty chemical company Lubrizol before he spoke to Buffett about buying the company in total for the Berkshire portfolio. To be fair, Sokol spoke to Buffett twice before so this latest request was reportedly the third time Sokol spoke to Buffett about this very company. Sokol supposedly made $3 million dollars once Buffett announced his all out purchase of the company. Sokol's maneuvering was not illegal (??), but since Buffett hates negativity relative to both himself and Berkshire, this frontrunning was not a very ethical move on Sokol's part. Sokol tendered his resignation and Buffett accepted it immediately.

This ongoing saga is not the topic of this writing, but what does fall within our area of curiosity is in the form of a question from one of our radio listeners, Ed from Deerfield Beach in Florida. Ed asked about Buffett's purchase of Lubrizol. His actual question is: "Was this a good purchase for Buffett?

Let's look at the Return on Equity (ROE) in a Clean Surplus condition. Clean Surplus is a comparable model and we use the Clean Surplus ROE in order to determine if Lubrizol is better than the average stock in the S&P 500 index. If you recall from my many writings and radio programs, the average stock in the S&P 500 index sports a 13.5% ROE. Thus, a stock which has a higher Clean Surplus ROE than 13.5% is considered a faster growing stock than the average. However, in order to be considered for our portfolio, we would like to see a stock with an ROE higher than 20%. Yes, any stock with an ROE above 20% is very worthy of our consideration.

We can see from the numbers above that over the years between 2000 and 2007, Lubrizol was a bit better than the average stock in the S&P 500 index. However, in 2008 the ROE increased dramatically because Lubrizol's earnings almost doubled in one year. Not only that, but today the earnings are growing consistently higher as evidenced by the continued high ROE right up to the present. Lubrizol has debt which can be easily managed. It is retaining 85% of its earnings and paying out a dividend just over 1%. We like to see the retention rate high which means the company is in growth mode through the reinvestment of the profits (earnings) it is making. Let's check out the return chart below and see how the increase in earnings affected the stock price.

The above is a 5 year chart of Lubrizol's stock price (black line) compared to the S&P 500 index which is the bottom line. For 3 years, Lubrizol was slightly ahead of the S&P then in 2009 the stock took off and went to the sky. Notice toward the very right side of the chart, the price took off once again from about $105 per share to $135 per share. This was due to Buffett's announcement that he was going to pay existing shareholders $135 per share. Once this tender offer was announced, the stock immediately shot up to almost $135.

Bottom line here is Buffett did a good job in purchasing this stock even at $135 per share. If this company can keep growing its earnings as it has the past 4 years or so, then it could turn into a great buy for Buffett.

**Burlington Northern**

Buffett purchased Burlington Northern back in 2009. Let's look at the ROE of this stock.

As you can see, the ROE of this stock is far below the ROE of the average stock in the S&P 500 index. For the life of me I couldn't figure out why Buffett would have purchased this company which was his largest purchase up to that time. We certainly would not have purchased it and in fact, would not have touched it with a 10 foot pole. But now in 2011, there has been some light shed upon this purchase.

I came across a recent article just the other day and spoke about it on the radio show of April 7th. And the article is all about coal. Here are some highlights.

\* Bramwell, West Virginia, the heart and soul of Appalachian coal country.

\* In 1910, Bramwell was the wealthiest town in America. Tucked away back in the hills, 19 different millionaires lived in this little village.

\* Today, Appalachian Coal Boom II

**\* Coal Fact #1:** Without exception, Appalachian coal is the single highest grade of coal found anywhere in the world.

**\* Coal Fact #2:** Coal demand from emerging markets, especially the metallurgical Appalachian coal needed to make steel, is absolutely exploding.

**\* Coal Fact #3:** The world currently derives over 50% of its power generation from burning coal and that dependence isn't changing any time soon.

**\* Coal Fact #4:** Republicans and Democrats in Congress, and President Obama are all committed to coal. A quote from our President which is a real turnabout from 2 years ago: "Clean coal technology is something that can make America energy independent. This is America. We figured out how to put a man on the moon in 10 years. You can't tell me we can't figure out how to burn coal that we mine right here in the United States of America and make it work."

**\* Coal Fact #5:** Billionaires are buying anything that burns.

AND HERE IS WHERE WE SEE WHY BUFFETT BOUGHT BURLINGTON NORTHERN.

About a month ago, two of the world's richest men visited the coal mines near Bramwell, West Virginia. You guessed it, they were Warren Buffett and Bill Gates who tried to be very discreet. But secrets are getting harder and harder to keep in the age of Facebook and Twitter. Mining employees recognized Buffett and Gates. News of billionaires touring coalfields hit the social media universe within hours.

**Now the biggie:** 75% of Burlington Northern's quarterly earnings are from transporting coal to ports on the West Coast of the U.S. for shipment to Japan and the rest of Asia.

Yes folks, now you know the rest of the story.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, March 24, 2011**

**Express Scripts, Walgreen, CVS and Medco Health**

**Pharmacy Services Industry**

**INTRODUCTION:** We will enter the world of Pharmacy Services which includes most stocks you've already heard of and the one stock you have not heard of which just happens to be the one that should be in your portfolio.  
  
The reason we look at 3 or 4 stocks in an industry is so that we may compare these stocks equally (Clean Surplus analysis) in order that we may find the one stock that should be in our portfolio.

The stocks for analysis for this week are Walgreen, CVS Caremark, Medco Health and Express Scripts. We will not look at Rite Aid (symbol RAD) as Rite Aid has lost money the past 6 years in a row and lost money for the past 10 of 13 years.   
  


**ROE:** In order to build a portfolio that is able to outperform the S&P 500 index, we want to select stocks that have ROEs greater than the average S&P 500 stock of 13.5% (right column). For the Buffett and Beyond portfolio, we want our stocks to have ROEs above 20%.

Our stocks for this week are sorted left to right from the highest ROE to the lowest ROE. We can see all the stocks above have ROEs higher than the average stock in the S&P 500 index of 13.5%. Express Scripts leads this group with a wonderful ROE of 29%. Since it has the highest ROE of this group and an ROE greater than 20%, we will consider it for our portfolio. The others with ROEs consistently above the market average of 13.5% are all good stocks, but it is our policy to go with the highest ROE stock.

Think of your bank account. You will go to the bank that pays you the highest interest rate. It's the same with stocks as long as we develop the ROE in the Clean Surplus method.  
 **DEBT:** An easy way to think about debt is to ask the question that if all earnings are used to pay off debt, how many years would it take to pay off the total long term debt? Buffett's rule of thumb is he wants companies to be able to pay off their debt in less than 5 years.

All the stocks above meet our low debt benchmark of being able to pay off debt in less than 5 years.

**RETENTION RATE:** Retention rate is the percentage of earnings (profits) put back into the company rather than paying dividends. Companies will reinvest their earnings in order to grow. If they reinvest their earnings efficiently, they will grow faster than the average company.

As you can see above both Express Scripts and Medco Health are trying to grow as fast as possible by reinvesting all of their profits, but Express Scripts is reinvesting its earnings at a more efficient rate as evidenced by the higher ROE.

What do we mean by reinvesting more efficiently? Efficiency means earning a higher return (ROE) on the newly reinvested money. Yes, it all comes down to the ROE.

**CHART OF PAST STOCK RETURNS:** Predictability of the Clean Surplus method shows that stocks with higher ROEs and more consistent ROEs will outperform stocks with lower and less consistent ROEs over the long term.

In the 5 year chart above, we see the S&P 500 index in black and is the second from the bottom sporting about a 0% return for 5 years. From the top down, we see, just as the ROE predicted that Express Scripts (ESRX) leads the group with almost a 140% return. They are followed surprisingly by Medco Health (MHS) then CVS with a 15% return and last is Walgreen (WAG).  
 **BOTTOM LINE:** Our pick for our portfolio relative to the Clean Surplus method is Express Scripts. Medco is coming on fast due to the rising ROE. Even though the ROE indicates that it should be an average stock, the increasing ROE is indicating a very nice increase of earnings growth and this earnings growth is shown by the increasing ROE and in turn is being rewarded by the market.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, March 17, 2011**

**Boston Scientific and Factset Research**

**INTRODUCTION:** A frequent question we receive is does the Clean Surplus method work all the time? The answer is eventually, yes. A case in point is Boston Scientific (BSX). We had BSX in our portfolio until the year 2000. Looking at the chart below we can see that in 2000 the ROE fell below our "threshold" of 20%. A fall to 19.7% is not earth shattering, but look at 1997 and 1998. In 1997, the ROE of BSX fell to 18.4%. We did not sell at that time. 1999 saw a rise to 24.5% and then a fall to 19.7% in 2000. This stock was a very volatile stock in regards to its earnings. Remember that the ROE is a reflection of earnings and the earnings were up and down and up and down. We decided to sell BSX and replace it with Factset Research with an ROE of 35.7% in 2000.

We were correct in that the ROE of BSX continued to fall, but in 2004, the ROE shot up because the earnings increased dramatically. Boston Scientific which we sold at $10 a share shot up to $43 a share and we had egg on our faces because during this same time period (2004), FDS was up to just $30 a share which was an increase of just 15% since we bought it.

BSX continued to see its earnings decline which was reflected in the ROE which was declining significantly. Meanwhile Factset Research continued to post nice earnings even though its ROE began to decline but the ROE continued to stay above our threshold of 20%.   
  
Fast forward to the end of 2010 and we can see we were correct after all as BSX fell to $7 a share while FDS went on to achieve a price of $102 per share.

**Bottomline Results are as follows:** Over this 10 year time period, BSX declined 30%. The S&P 500 index was down 14% and our portfolios were up 48% and FDS was up 400%.

**Bottom, Bottom line:** We want to put stocks into our portfolios with high and CONSISTENT ROEs. We see what happened to BSX with a very inconsistent ROE which could have hurt us had we held on to this stock and not replaced it with a real winner.

Folks, this is how we structure portfolios. Stocks with higher ROEs and more consistent ROEs outperform stocks with lower ROEs. This is how you can outperform the market averages and in so doing, outperform 96% of professional money managers out there in investment land.

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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, March 10, 2011**

**GE, Yum Brands, Chipoltle, McDonald's, Darden Restaurants, Cheesecake Factory**

**INTRODUCTION:** We have two segments this week due to the many questions of specific stocks emailed to us. The first question was, when should we have sold General Electric which was such a great stock for almost 20 years? The second stock for analysis was KFC which is owned by Yum Brands. Yum Brands is of course in the restaurant business so we'll also look at Chipoltle Mexican restaurants, McDonald's, Darden Restaurant (Red Lobster) and finally, the Cheesecake Factory. But first, GE.

Our strategy is to construct a portfolio with Stocks that have ROEs higher than 20%. Remember, the average stock in the S&P 500 index, and think of your bank account, returns us a 13.5% ROE. We want to fill our portfolios with stocks that have higher than 13.5% ROEs. My own personal criteria is when a stock's ROE falls below 20% and can be replaced with a stock with an ROE higher than 20%, we will replace it.

GE was a hot stock for almost 20 years. Then in 2003, the ROE fell to 19.6% as you can see below. Now 19.6% is not very far below 20% so we waited until the end of 2003 when the projected 2004 ROE was expected to be 18.5%. You can see, the ROE was falling while the ROE of other stocks was rising. Rather than fall in love with GE which had been so good to us, we replaced it with another stock with an ROE higher than 20%.

**Here's the good part.** GE was priced at $30.98 on 12/31/2003 and the S&P 500 was at 1111. As of 12/31/2010, GE was priced at $18.20 and the S&P was at 1257. GE lost 41% while the S&P 500 index gained 13%. During this time, our actual Clean Surplus portfolio was up 48%.  
  
This move worked out to be a very good call. Are there stocks that have ROEs below 20% that keep going up? The answer is yes, but sooner or later, the stock appreciation plus dividends, or total return, will fall in line with the ROE. In other words, the ROE is a predictor of future returns.



Let's now look at our restaurant stocks. I've listed the stocks from left to right in order of their level of ROE.

**ROE:** In order to build a portfolio that is able to outperform the S&P 500 index, we want to select stocks that have ROEs greater than the average S&P 500 stock of 13.5%. For the Buffett and Beyond portfolio, we want our stocks to have ROEs above 20%.

Our stocks for this week are sorted left to right from the highest ROE to the lowest ROE. We can see all the stocks above have ROEs higher than the average stock in the S&P 500 index of 13.5%. Chipoltle leads this group with an ROE in the high 20s. Mickee Dees is next and following right behind it is Yum Brands, Darden Restaurants and finally Cheesecake Factory.

Notice the ROE of Cheesecake is very erratic. We don't like erratic. Also, sometimes the ROE falls below the 13.5% ROE of the average stock. And finally, look at 2008 which was a nasty year all around. Cheesecake's ROE fell to 9.57% while the other stocks above maintained their ROEs even in a recession. We can eliminate Cheesecake Factory right now.

**DEBT:** An easy way to think about debt is to ask the question that if all earnings are used to pay off debt, how many years would it take to pay off the total long term debt? Buffett's rule of thumb is he wants companies to be able to pay off their debt in less than 5 years. All the stocks above meet our low debt benchmark of being able to pay off debt in less than 5 years.

**RETENTION RATE:** Retention rate is the percentage of earnings a company puts back into the company rather than paying dividends. Growth companies will plow back as much of their earnings in order to grow.

As you can see above, Chipoltle and Cheesecake are putting all earnings back into the company (100% retention) in order to grow. The problem with Cheesecake is this company is just not getting a high return on their reinvested profits while Chipoltle is doing just fine with its reinvested money. McDonald's, Yum and Darden are all paying out dividends which means to us their growth is beginning to slow.

**SHARE REPURCHASE:** McDonald's, Yum and Darden are all buying back their shares which is something Buffett loves. Chipoltle is issuing more shares and evidently they are growing so fast, they need to raise money and the way they are doing it is to issue more shares. This is not a bad thing as long as that ROE is high which in turn means they are making money.  
  
**CHART OF PAST STOCK RETURNS:** Predictability of the Clean Surplus method shows that stocks with higher ROEs and more consistent ROEs will outperform stocks with lower and less consistent ROEs over the long term.

In the 5 year chart above, we see the S&P 500 index in black and is the second line from the bottom with about a 5% return for the past 5 years to date. All the stocks analyzed today with the exception of Cheesecake outperformed the S&P over the past 5 years which was perfectly predicted by Chipoltle's, McDonald's, Yum's and Darden's ROEs higher than the average stock in the S&P 500 index.

Just looking at the ROEs and their performances, each of these stocks have ROEs higher than the S&P 500 average of 13.5%. Looking at the 5 year chart once again, Chipoltle, McDonald's, Yum and Darden's are all good stocks. Only Chipoltle has an ROE above 20%, but it is not in the S&P 500 index. Our criteria is we "usually" only have S&P stocks in our portfolio. Another drawback of Chipoltle is the stock is up almost 500% in the past 3 years alone which is a bit scary.

**BOTTOM LINE:** Our pick for our portfolio relative to the Clean Surplus method would only be Chipoltle if we were to venture outside the S&P stocks. However, we would like to see a large pullback to even think about buying this stock. And of course, we do have enough larger stocks in the S&P with ROEs above 20% so why bother? McDonald's, Yum and Darden's are all very nice stocks and all would look nice in most portfolios.  
  
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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, March 3, 2011**

**Johnson & Johnson, Intuitive Surgical, Life Technologies and Stryker**

**INTRODUCTION:** The stock selection for analysis for this week is Johnson and Johnson (JNJ). This stock has and still is a core holding for most investment portfolios both large and small, but not ours.  
  
As is our policy, we will not only research Johnson and Johnson, but other stocks in the Medical Supply Industry in order that we may find the best stock or stocks in that particular industry. We will now also examine Intuitive Surgical (ISRG), Life Technologies (LIFE), and Stryker (SYK) in addition to JNJ. Please remember we are analyzing these stocks using a Return on Equity (ROE) in a Clean Surplus condition. This allows us to compare these stocks so we can see how much money these companies  
are making on investors' money as well as the profits that are being reinvested back into the company.  
  
**ROE:** In order to build a portfolio that is able to outperform the S&P 500 index, we want to select stocks that have ROEs greater than the average S&P 500 stock of 13.5%. For the Buffett and Beyond portfolio, we want our stocks to have ROEs above 20%.  
  
Our stocks for this week are sorted left to right from the highest ROE to  
the lowest ROE. We can see all the stocks above have ROEs higher than the average stock in the S&P 500 index of 13.5%. Intuitive Surgical leads this group with a wonderful ROE over 30%. Life Technologies is next with an ROE into the mid 20s followed by Stryker with an ROE that has recently fallen below our 20% threshold.  
  
Intuitive Surgical (ISRG) and Life Technologies (LIFE) are presently in our Buffett and Beyond portfolio for 2011. ISRG has been in our portfolio for many years, LIFE is new this year and Stryker (SYK) was dropped from our portfolio last year. JNJ has was replaced by ISRG many years ago.

**DEBT:** An easy way to think about debt is to ask the question that if all earnings are used to pay off debt, how many years would it take to pay off the total long term debt? Buffett's rule of thumb is he wants companies to be able to pay off their debt in less than 5 years.

All the stocks above meet our low debt benchmark of being able to pay off debt in less than 5 years.  
  
**RETENTION RATE:** Retention rate is the percentage of earnings a company puts back into the company rather than paying dividends. Companies will plow back as much of their earnings in order to grow.  
  
As you can see above, ISRG and LIFE are putting all earnings back into the company (100% retention) in order to grow. The high ROEs of both these companies show us they are making good use of the retained earnings by earning a high ROE on the newly reinvested earnings. Stryker is paying a small dividend of 1.3% and JNJ has a great dividend of 3.6%. However, by paying dividends, these two companies are beginning to see growth slow and in turn must pay out some of their unused earnings in the form of dividends as growth opportunities begin to slow.  
  
**SHARE REPURCHASE:** We like to see a company buy back its shares in the open market. This shows that your invested dollar into a company is not being diluted by a company issuing more shares rather than buying back shares. When Buffett bought a stake in Coca Cola a long time ago, he suggested (strongly) to the board of directors that they buy back as many shares as possible. Yes, Buffett likes share repurchase programs.  
  
Only JNJ has a share repurchase program. We would like to see share repurchase for both ISRG and LIFE, but this drawback is well overshadowed by the high ROEs and 100% of reinvested earnings going back into the company which supports continued growth.  
  
**CHART OF PAST STOCK RETURNS:** Predictability of the Clean Surplus method shows that stocks with higher ROEs and more consistent ROEs will outperform stocks with lower and less consistent ROEs over the long term.

In the 5 year chart above, we see the S&P 500 index in black and is the bottom line with about a 0% return for 5 years. All the stocks analyzed today outperformed the S&P over the past 5 years which was perfectly predicted by each of these stocks having ROEs higher than the S&P 500 average of 13.5%. Looking at the 5 year chart once again, the stock performance from top line to bottom line is ISRG with a 250% return over the past 5 years, LIFE with a return of 48%, Stryker with a return of 45% and finally JNJ with a stock return of 0%, but JNJ dividends (not accounted for in the chart) of 3.6% per year translates into an 18% total return (dividends plus stock appreciation).  
  
**BOTTOM LINE:** Our picks for our portfolio relative to the Clean Surplus method are Integrative Surgical (ISRG) and Life Technologies (LIFE). Stryker and JNJ are both above average stocks and should continue to outperform the S&P 500 index. However, faster growth will be seen by ISRG and LIFE.  
  
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**Stocks on the *Buffett and Beyond* Radio Show  
for Thursday, Feb 24, 2011**

**Direct TV, Comcast, Dish Network and Knology**

**INTRODUCTION:** Warren Buffett sold some of his holdings toward the end of 2010. One of the stocks he sold was Comcast which is in the Cable TV Industry. As is our policy, we will not only look at Comcast, but other stocks in the same industry in order that we may find the best stock or stocks in that particular industry. We now will also examine Direct TV, Dish Network and Knology. Please remember we are analyzing these stocks using a Return on Equity (ROE) in a Clean Surplus condition. This allows us to compare these stocks so we can see how much money these companies are making on investors' money as well as the profits that are reinvested back into the company.  
  
 **ROE:** Looking at the extreme right of the chart we see the ROE of the S&P 500 has been about 13.5% over the past 5 years or so. In order to outperform the S&P 500 index, we must fill our portfolios with stocks that have higher ROEs than the S&P of 13.5%. Out of all the stocks listed here, we see that DTV has the greatest ROE and in the past two years, the ROE has been increasing.   
 **DEBT:** An easy way to think about debt is to ask the question that if all earnings are used to pay off debt, how many years would it take to pay off this debt? Buffett's rule of thumb is we want to see companies be able to pay off their debt in less than 5 years. Out of all the stocks above, we see that just DTV is able to pay off its debt in less than 5 years. Since this industry is capital intensive, 4 years to pay off debt is a good sign.  
 **RETENTION RATE:** Retention rate is the percentage of earnings a company puts back into the company rather than paying dividends. Companies will plow back as much of their earnings in order to grow. We see all the companies above except Comcast are putting back 100% of earnings into the company for growth. One must also look to see that the ROE continues to be high as a high ROE means that the company is earning as much on the newly reinvested money as it did on previously invested money. In other words, the new growth is as profitable or more profitable than past growth. We see that DTV is doing just that.

**SHARE REPURCHASE:** We like to see a company buy back its shares in the open market. This shows that your invested dollar into a company is not being diluted by a company issuing more shares rather than buying back shares. When Buffett bought a stake in Coca Cola a long time ago, he suggested (strongly) to the board of directors that they buy back as many shares as possible. Yes, Buffett likes share repurchase programs.  
 **PAST STOCK RETURNS:** Predictability of the Clean Surplus method shows that stocks with higher ROEs and more consistent ROEs will outperform stocks with lower and less consistent ROEs over the long term. In the chart below, we see that DTV has outperformed the S&P 500 index, Comcast and Dish Networks as was expected when we examine the ROEs of all the above stocks. However, Knology has gone against the predictive model as it has outperformed all the other stocks including DTV even though it has a very erratic ROE. This erratic ROE translates into stock volatility and we can certainly see this stock has a lot of volatility. Not shown is Knology has gone from losing a lot of money to positive earnings in the past two years. Evidently, this is what the market is looking at and evidently feels Knology will continue to post even greater returns in the future.

**BOTTOM LINE:** Our pick relative to the Clean Surplus method is DTV. Knology is one of those gambles, but a pretty good gamble since it now has positive earnings and increasing positive earnings at that. Comcast? We really don't know why Buffett bought Comcast in the first place, but we're sure he expected better earnings which evidently did not materialize.

**January 20, 2011  
  
H&R Block and Intuit**

One of Buffett's fairly large holdings was H&R Block. I say was because I don't think he continues to hold any shares and we will show you why.

In the past, Block had a nice, high and consistent ROE (Return on Equity configured by Clean Surplus). Buffett talks about companies that have built a moat around their business as stocks he likes. Block began undercutting accountants in one area by being the first company to enter the tax return business in a big way. Block had small offices seemingly in all the towns across America.

Block had built a moat because anyone wanting to compete with Block would have to do so by undercutting the cost of tax preparation which would be almost impossible on a large scale. In other words, Block came out with a better mouse trap at the best price.

The only problem with Block's business model is somebody invented computers and along with computers came a company named Intuit. Intuit began cutting into the accounting world and bookkeeping world in a technological way. It was a computer program that performed a lot of the duties of a secretary, bookkeeper and/or accountant which of course we know as QuickBooks.   
  
Then one day, Intuit came out with TurboTax as a simple, low cost program for tax preparation. And now H&R Block had a lot of competition. An awful lot of competition. TurboTax could spit out individual, partnership, small business and corporate tax forms in minutes after you put the information into the correct places. The program very nicely guides you along as you go. Fast and simple and saves you a lot of money.  
  
Let's look at the Clean Surplus ROE of both companies and see which company should be in your portfolio and which one should be in someone else's portfolio.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **H&R Block** |  |  | **Intuit** |  |
| **YEAR** | **ROE** |  | **YEAR** | **ROE** |
| 2011 | **12.56%** |  | 2011 | **17.78%** |
| 2010 | **11.94%** |  | 2010 | **18.53%** |
| 2009 | **12.05%** |  | 2009 | **19.02%** |
| 2008 | **13.69%** |  | 2008 | **20.08%** |
| 2007 | **13.43%** |  | 2007 | **21.87%** |
| 2006 | **11.81%** |  | 2006 | **23.16%** |
| 2005 | **18.27%** |  | 2005 | **23.20%** |
| 2004 | **26.11%** |  | 2004 | **24.21%** |
| 2003 | **34.57%** |  | 2003 | **25.27%** |
| 2002 | **39.30%** |  | 2002 | **24.22%** |
| 2001 | **33.53%** |  | 2001 | **21.86%** |
| 2000 | **25.00%** |  | 2000 | **21.19%** |
| 1999 | **24.43%** |  |  |  |
| 1998 | **25.99%** |  |  |  |

We can see that as time went on Block had decreasing ROEs. We liked the stock until 2005 when it began to show ROE dropping from 26.11% in 2004 down to 18.27% in 2005 and then to a paultry11.81% in 2006. The earnings (not shown) went from $1.58 down to $1.15 per share between 2005 and 2006.  
  
Let's look at Intuit. Intuit had a nice consistent ROE and in 2006 when Block saw earnings drop which caused the Clean Surplus ROE drop to 11.81%, Intuit sported a 23.16% ROE. Intuit's ROE has stayed nice and high with just a slight drop recently into the high teens.  
  
By our analysis, we should be seeing Intuit greatly outperforming H&R Block and since the S&P 500's average stock ROE is just 13.5%, Intuit should be outperforming both Block and the S&P 500 index. Let's take a look.

This is a 5 year chart with H&R Block in black, the S&P 500 in rust and Intuit in blue. With a recent 5 year average ROE of about 12%, H&R Block is lagging the S&P 500 index and both H&R Block and the S&P 500 lag Intuit by a huge amount. In fact, over the past 5 years Block has declined 50%, the S&P 500 has done nothing and Intuit has returned almost 80%.  
  
You see folks, the ROE tells all. Now you decide, would you rather have stocks with high ROEs in your portfolio or stocks with low ROEs. You now know that stocks with high ROEs should be in your portfolio and stocks with low ROEs should be in someone else's portfolio.