BUFFETT AND BEYOND...

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

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About the Author.

Dr. J.B. Farwell, author of a best-selling investment book, "*Buffett and Beyond*" is the World's foremost expert on the continuing research and application of a stock selection method and predictability model called Clean Surplus. Clean Surplus, developed by the accounting profession is the only statistically tested method able to truly compare the operating efficiency of one company to the operating efficiency of any other company just the way you would compare returns from one bank to another bank. Clean Surplus allows portfolio creation of the most efficient companies which research has shown consistently outperform the market averages.

Warren Buffett is known to use this method and Dr. Farwell, through his research, book, courses and seminars, takes Buffett's methods and Clean Surplus one giant step *BEYOND…*

Clean Surplus is a model developed by the accounting profession which allows investors to both compare stocks and predict future portfolio returns relative to the benchmark S&P 500 index. Comparability and predictability are not available through the use of traditional accounting methods. The research and later CPA reviewed portfolios indicate that portfolios made up of stocks with higher Clean Surplus ROEs (Return on Equity) outperform portfolios made up of stocks with lower Clean Surplus ROEs. The statistically measured comparisons (correlations) of high Clean Surplus ROEs and high future returns are statistically significant.

WE ALL USE CREDIT CARDS

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 by a substantial amount heading into the future. The question asked of us just the other day was "Is American Express still a good portfolio holding?" The answer is maybe, but there are better stocks in the financial services industry.

When we select stocks for purchase in our model portfolio, we want to see as long a track record of the Clean Surplus 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 ten years of numbers from 2004 to the forecasted 2013 Clean Surplus ROE.

Our Model Portfolio Results using the Buffett and Beyond Methodology

Compounded Model Returns as of January 31, 2013								
Period	10 yrs	7 yrs	5 yrs	3 yrs	1 yr	YTD	Comp	Avg.
PORTFOLIO	164%	32%	13%	26%	13%	4.3%	164%	16.4%
S&P 500	60%	29%	6%	34%	13%	5.0%	60%	6.0%
OUT-PERFORMANCE	104%	3%	7%	-8%	0%	-1%	104%	10%

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 a projected 2013 ROE of 14% 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 stock. 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.

On the other hand, as we look at MasterCard and Visa, we see that 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. One thing we notice about Visa is that its ROE is increasing. It does not have the required 20% ROE we require for our master portfolio, but with a rising ROE and being in the business that MasterCard is in, we look at that nice increasing ROE as a very good indicator of increasing stock price and better than average increase in stock price going forward.

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.

FINANCIAL STOCKS					
	MASTER-CARD	VISA	S&P 500	AMERICAN EXPRESS	H&R BLOCK
Symbol	MA	V	SPX	AXP	HRB
YEAR	ROE	ROE	ROE	ROE	ROE
2013	28%	17%	14%	12%	10%
2012	28%	14%	13%	11%	10%
2011	32%	14%	13%	12%	9%
2010	36%	13%	13%	11%	10%
2009	39%	11%	14%	5%	12%
2008	45%	9%	14%	8%	14%
2007	64%		15%	13%	13%
2006	37%		15%	12%	12%
2005	27%		15%	11%	18%
2004	32%		15%	14%	26%
5 Year T'tL rTN	170%	180%	15%	25%	12%
1 Yr Rtn	52%	61%	13%	26%	23%
DIV	0.2%	0.8%	1.8%	1.3%	4.0%

As we look at the time series analysis, (over multiple time periods) we are able to get a good idea of how these four stocks should perform in the future. Remember that Clean Surplus is a predictability model as well as a comparability model, thus we would predict that MasterCard and Visa should outperform the averages over the long term and also outperform both American Express and H&R Block.

All four stocks did very well over the past one year through Feb 8th which is shown as the "1 Year Return." However, when we look at the longer term graph which in this case is the past five years, we can see that both MasterCard and Visa have performed very well while H&R Block and American Express have both underperformed MasterCard and Visa by a rather large margin.

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. 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 minus dividends. Yes, folks, it's that simple.

On the other hand, we see that MasterCard with an ROE of over 30% during the past 8 of 10 years is earning profits at a much faster rate than any of our other stocks illustrated here. However Visa has something we all want to see. The ROE of Visa is increasing which is a good sign and means its earnings are increasing at an increasing rate. 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 with Visa right behind. Let's look at the graph to see how this group of stocks have performed over the past 5 years relative to price return.

The top red line is Visa showing a return of about 180% over the past 5 years. The next line down is MasterCard with about a 165% return. We can see that the market likes the projected 2013 ROE for Visa and evidently feels that Visa will eventually catch Mastercard in the ROE. The market is rewarding Visa for this increasing ROE. The third line down (blue) is American Express which surprisingly is now outperforming the S&P 500 index. The black line is the S&P 500 index showing a 15% (before dividends) return for the past 5 years. The bottom line is H&R Block which finally outperformed the general market this past January, but in previous years has underperformed the market.

We can see from this graph and also the table of ROEs that stocks with higher ROEs outperform stocks with lower ROEs. If you think about it, these results are what we would expect from the Clean Surplus ROE analysis.