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From the Desk of the Lev Rourk Group

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An Introduction to Stock Analysis

One of the clichés of Wall Street is that fundamental analysis tells you *what* to buy, while technical analysis tells you *when*. While some money managers disagree with that characterization, it points to a deeper difference between the two approaches: fundamental analysis focuses on the performance of the company behind the stock while technical analysis focuses on the behavior of the stock.

To understand these concepts, let's review the theoretical assumptions of each school of analysis.

The Fundamental Perspective

Fundamental analysts assume investors will buy the shares of companies that have good potential to make profits and, better yet, make those profits grow every year. Based on this assumption, it makes sense to look at every significant aspect of that company's business, from what its products or services are to how they stack up to the competition's, how much money the company spends and owes versus how much revenue it brings in, how good management is, whether the market is growing, and the like.

Fundamental analysts spend most of their time collecting and analyzing data on these things and much more, comparing them to the same data on competitors, including the stock prices. These analysts also try to assess the future growth of each company's markets and often factor in forecasts of the economy. They estimate what they think the future earnings of each company will be, and then use those estimates to predict the price that investors are likely to pay for that company's stock in the future.

Most investors have heard of some of the key analytical measures that fundamental analysts use. One is

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Planning Year Round

Many people confuse tax planning with tax preparation and only think about the subject when preparing their annual tax return. However, there is little you can do to actually lower your tax bill when preparing your return. If your goal is to reduce income taxes, you need to be aware of tax planning opportunities throughout the year.

Take time early in the year, perhaps as part of the tax preparation process, to assess your tax situation, looking for ways to reduce your tax bill. Consider a host of items, such as the types of debt you owe, how you're saving for retirement and college, which investments you own, and what tax-deductible expenses you incur. It often helps to discuss these items with a professional who can review strategies you might not have considered.

During the year, consider the tax consequences before making important financial decisions. This will prevent you from finding out later that there was a better way to handle the transaction for tax purposes.

Look at your tax situation again in the fall, which gives you plenty of time before year-end to implement any additional tax planning strategies. At that point, you'll also have a better idea of your expected income and expenses for the year. You may then want to use strategies you hadn't considered earlier in the year, such as selling investments at a loss to offset capital gains. ✔✔✔

Stock Analysis

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a stock's price-to-earnings ratio, or P/E ratio. To calculate it, analysts divide the current price per share of a stock by its per share net earnings, or profit. Since it's possible to calculate the P/E ratio of the entire stock market as well as each industry group, and analysts keep track of the history of those P/E ratios, analysts use P/E ratios to determine whether a stock is relatively expensive (overvalued) or relatively cheap (undervalued).

Another key metric is a company's estimated five-year earnings growth rate, which is the basis upon which they estimate the stock's future price. The estimated five-year earnings growth rate rests on projections for the company's competitive market position, its product pipeline, and its financial condition.

A third metric combines the P/E ratio and the earnings growth rate to determine whether the stock is fairly priced or not. It's called the PEG ratio, for the price-earnings multiple divided by the projected earnings growth rate. To illustrate, let's take a stock with a P/E ratio of 30 and a projected five-year growth rate of 20% per year. This stock has a PEG ratio of 1.5 (30 divided by 20). Analysts who use the PEG ratio generally avoid recommending stocks with a PEG significantly above 1.0 and generally like stocks with a PEG below that number.

The Technical Perspective

Technical analysis is based on a very widely accepted premise: that the price of a stock, just like everything else, is based on supply and demand. If, at a given price, people want to buy more of a product than the maker can produce, the price will go up, whether it's a box of cereal, a car, or a stock. Conversely, if there's more product in the market than there are people willing to buy it at its current price, all things being equal, the price will drop.

So, the theory goes, as long as you know the relative balance of supply and demand for a given stock at a given price, you don't really need to know what the product is. Technical analysts say that all the needed information about supply and demand can be found in the chart of a stock's historic price movement, particularly if the chart captures the changing levels of volume with the changes in price.

Yet one thing that makes stocks different from commercial goods is the way technical analysts define supply. Companies can increase the production of manufactured goods or delivery of services at will. Not so with stocks — unless a company issues more shares, the number in the market is fairly stable. The supply of shares of stock, from a technical analyst's point of view, is the number of shares already owned by the public that are being brought to the market for sale by brokers.

To illustrate, technical analysts interpret an upward move in a stock price, combined with higher volume the previous day, as an indication that there is a larger number of buyers (demand) than sellers at the current price, and that potential sellers are holding out for a higher price. Conversely, a downward move on higher volume means there are more sellers eager to sell shares of a stock than there are buyers willing to pay the current price.

Unlike fundamental analysts, technical analysts generally don't make predictions of future stock prices. Instead, they try to identify prices that serve either as resistance against any higher movement or support against a further loss in price. The reason these price points exist is because most investors remember what they paid for a stock and base their decision to sell by comparing the current price with what they paid for it.

For example, it's human nature to avoid a loss. So, if a stock that has risen in price comes back down to the price an investor paid, he may be reluctant to sell, but once it falls below that price, he may be eager to sell right away. By the same token, many investors — particularly professionals — know the price at which a stock peaked. As the stock approaches that price again, investors may begin to sell in order to lock in their profits. This shift toward more sellers than buyers may make that price another resistance point from which the stock declines again.

Technical analysts find many different ways to identify points of resistance and support. They can be found in peaks and valleys in the line that connects a stock's closing price over time. They can also be found in prices against which the stock has repeatedly bounced in either direction, or in lines that connect a series of price bottoms or tops, called trend lines.

What Works for You?

Traditionally, more professional investors and advisers have relied on fundamental stock analysis than technical, particularly when the investor is in the market for the long term. But a large and growing number of them have found that both fundamental and technical analysis provide insights that are useful in determining which stocks to buy and when.

Please call if you'd like to discuss this in more detail. ✔✔✔

Before Purchasing Stocks

If you've been investing for years without a defined strategy, it may be time to make a change and align your portfolio accordingly. Or perhaps you have a strategy that needs some dusting off. Maybe it's simply time to sit down and realign your portfolio with your investment strategy. After all, the markets aren't static; your portfolio shouldn't be either.

Whether you're investing for the first time or buying new stocks to augment your current portfolio, there are five important questions to ask yourself:

What's your objective? Is your ideal stock one that pays a high dividend, or one that has a high growth rate with no dividends? Is it a stock with relatively little price volatility but lower potential gains, or one with a lot of potential risk and higher potential rewards?

How you answer those questions — and the stocks you choose — depends on your objectives. If capital preservation is your goal, for example, a lower-risk stock is probably preferred. On the other hand, if you're young and growth is your target, a higher potential return stock may make more sense. Whatever your objective, defining your goal is the first step to selecting stocks for your portfolio.

Is your portfolio diversified? When considering which stock to purchase, determine whether you need to target your investment in certain areas to balance out your diversification. Make sure your portfolio isn't concentrated in just one industry, but spread out over at least four or five. And there are other dimensions to consider as well, such as cap weighting (large, mid, and small), style (growth or value), and geography (U.S.-based, developed foreign markets, and emerging markets).

The benefit of diversification is that the up and down movements of different asset subclasses are not completely correlated, so over time, losses in one industry or subclass may be offset by gains or lesser losses in another.

What's your expected holding period? If you're looking to trade for quick gains, your expected holding period is short. In that case, you need to be sure you are timing your purchase so you're getting in near the beginning of an upswing, not the end of one.

If you are buying for the long term, on the other hand, the price you pay is less critical, as long as you don't purchase a stock in the early stages of a steep decline in value.

What's the prevailing market trend? In the 1990s, the market was so strong that almost any stock you bought was likely to go up in value. But in a trendless or declining market, it's a lot harder to find a winner, at least in the short and intermediate terms. That's because the majority of stocks move in the same direction as the market, no matter how fundamentally strong a stock may be.

At the current price, would you be paying too much? To answer this question, you'll have to consider some basic fundamentals.

First, look at the stock's price to earnings (P/E) ratio, which is its price per share divided by earnings per share. How does it compare to the stock's normal range, and how does it compare to its competitors? If the P/E ratio is high, maybe the stock is overpriced. On the other hand, if it's low, it could either be a bargain or an indication of a fundamental weakness.

In addition to the P/E ratio, you should examine the stock's past and future earnings growth rate. Then look at its price/earnings growth ratio (PEG ratio). The PEG ratio compares the stock's P/E ratio to its five-year projected earnings growth rate. A PEG ratio of 1 to 1.5 is typically considered normal. A PEG of 2.0 or higher is often a sign that a stock is overpriced, while a PEG ratio below 1 may be an indication the stock is a bargain.

Please call if you'd like help reviewing your stock investments. ✔✔✔

Calculating an Investment's Basis

Your capital gain or loss on the sale of an investment equals the proceeds from the sale less your basis (the cost of acquiring the investment). When you purchase an investment, your basis equals the price you paid plus any fees or commissions. While the calculation is fairly straightforward, other factors can affect your basis calculations:

✔ Reinvested dividends are added to your basis at full market value plus any fees or commissions.

✔ The basis of any investment received as a gift is the donor's original basis plus any gift tax paid by the donor. However, if you then sell the investment at a loss, your basis is equal to the lesser of the donor's basis or the investment's fair market value on the date of the gift.

✔ For inherited investments, the basis is the market value on the date you inherited the investment, typically the date of the donor's death.

✔ Your basis in stock that has been split is the same as your basis before the stock split. Your per share basis, however, will now equal your total basis divided by the number of shares you own after the split.

✔ When you exercise a stock option, your basis equals the price you paid for the shares plus any fees or commissions, which may be lower than market value. Shares must be retained for at least one year after purchase and for two years after receipt of the option, or any gains will be taxed as ordinary income. ✔✔✔

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Market Data

	Month End			% Change	
Stocks:	May 25	Apr 25	Mar 25	YTD	12-Mon.
Dow Jones Ind.	42270.07	40669.36	42001.76	-0.6%	9.3%
S&P 500	5911.69	5569.06	5611.85	0.5	12.0
Nasdaq Comp.	19113.77	17446.34	17299.29	-1.0	14.2
Total Stock Market	58393.30	54949.64	55374.92	0.0	11.6
Precious Metals:					
Gold	3288.90	3302.05	3115.10	25.7	39.9
Silver	32.89	32.72	33.83	11.7	2.7
Interest Rates:	May 25	Apr 25	Mar 25	Dec 24	May 24
Prime rate	7.50	7.50	7.50	7.50	8.50
Money market rate	0.45	0.45	0.45	0.42	0.51
3-month T-bill rate	4.26	4.20	4.21	4.23	5.26
20-year T-bond rate	4.93	4.68	4.62	4.86	4.73
Dow Jones Corp.	5.38	5.38	5.37	5.45	5.65
Bond Buyer Muni	4.93	4.93	4.62	4.46	4.54

Sources: Barron's, Wall Street Journal. An investor may not invest directly in an index.

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