



WEB EXCLUSIVE: Tips for the Armchair Investor

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By Brian Coughlin

As a portfolio manager, people are always asking me, "How do you find good companies to invest in and how do you analyze them?" The easy answer is: read research reports, company financial statements and interview management to get a feel for a company's future prospects.

But for an individual investor, getting access to management can be a daunting, if not impossible, task. Many do not have access to the types of institutional research that professional money managers have. So what can an individual do to analyze potential investments? Publicly traded companies have information readily accessible to the average person. Securities Exchange Commission (SEC) filings (corporate financial statements) contain a wealth of information about a company to reveal the real story behind them.

Three key sections contained in any company's quarterly (10Q) and annual (10K) statements are: management discussion and analysis (MD&A), the statement of cash flow and financial footnotes. Also, the 10K (audited) and 10Q (un-audited) are required reports by the SEC, and often contain more detailed information than the glossy annual reports.

The MD&A section, found in the quarterly and annual statements of company filings, is vital when doing fundamental analysis of any company. Written at management's discretion, it is an open letter to the company's shareholders. It should provide an overview of a company's prior year or quarter, and how the company performed during that time frame. While the discussion does not get into all of the specific financial happenings, it does provide a clearer picture of what the company is doing.

While reviewing the MD&A, some questions investors should ask are: Does the management team seem candid in its discussion of company results? Are comments clear and concise? Do they discuss any potential risks going forward? The SEC expects companies to use clear language in this section, so the average investor will understand what is going on. Those using a high degree of industry jargon or confusing language may be attempting to conceal information and should be further analyzed. Many issues—including the Enron scandal—prompted the SEC to take a closer look at off-balance-sheet financing activities. These activities must be disclosed in this section if they are expected to affect liquidity or capital resources in a material way.

The statement of cash flow essentially illustrates the sources and uses of cash for a company. It helps investors assess a company's ability to generate positive future cash flows, meet its obligations, pay dividends, and whether the company may require external financing. It is broken into three distinct areas; cash flow from operations, cash flow from investing and cash flow from financing.

Cash flow from operations is often called the lifeblood of an organization. It shows the actual receipts and payments of cash, and is a key factor in determining if a company is able to generate enough money from its core operations to sustain itself. Therefore it is desirable for a company to generate positive cash flow from operations.

Cash flow from investing describes the associated cash flows used for investing purposes, such as acquiring and selling property, equipment, and the purchase and sale of stocks and bonds, to name a few.

Cash flow from financing describes the cash flows used for financing the company—that is, all cash flows associated with the issuance or repurchase of company stocks and bonds.

In the end, the cash flow statement tells an investor if a company is actually generating money from its core operations, or if it is sustaining itself through financing (borrowing) or investing (selling assets) activities. By having a thorough understanding of the cash flow statement, investors are able to determine how money is really being generated.

The final area of analysis is the footnote section, also known as the notes to the consolidated financial statements. Besides the standard boilerplate disclosures, the footnote section contains all the little details that are left off the income statement and balance sheet.

Ever wonder how much was paid out in that "undisclosed" settlement, or as we have seen in recent scandals, the amount of loans that were forgiven to high-paid executives? Well, some interesting facts often come to light in the footnote section. It is here that companies often disclose the forgiveness of loans made to executives and disclosure of perquisites allotted to executives and directors. Investors should ask themselves how these activities have added shareholder value.

The footnote section is also the area where individuals can find the actual settlement of those lawsuits that are termed "undisclosed." Footnotes can be dry, boring and cumbersome to read, but they often contain a wealth of information that is not normally unearthed in your traditional research methods.

For the armchair investor, knowing where to look and what to look for in corporate filings is half the battle. The rest is synthesizing the information into a manner that makes sense.

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