7 STEPS TO UNDERSTANDING THE STOCK MARKET

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The Investing for Beginners 101 Guide

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Andrew Sather's About Page

The stock market is intimidating and confusing, yet it is the KEY to attaining financial freedom.

What is financial freedom?

It's the coveted financial situation where you receive a **perpetual** income stream from your investments – to unlock the life you've always dreamed of.

If you have a 401k, you have money in the stock market. But if you don't know how it works and aren't familiar with basic investing principles, you could be leaving hundreds of thousands of dollars (or millions!) of hard-earned savings on the table.

The thing is, you don't need a background in finance to become a self-sufficient investor.

The free resources in this book can empower you to reach your goals if you put in the effort. Learn it once and it benefits you for the rest of your life.

My name is Andrew Sather and I'm driven to help you **decode** the **jargon** of the market, investing and finance. You can get started on your path to financial freedom TODAY, by reading through this eBook, reading through the blog, listening to my podcast, or subscribing to my free email newsletter (which you just did) for daily tips.

Stop working for money, put money to work for you. Let's get started.

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Investing for Beginners 101: 7 Steps to Understanding the Stock Market

Welcome to this easy 7 step guide to understanding the stock market, *Investing for Beginners 101*. I've created the easy to follow Investing for Beginners guide to simplify the learning process for entering the stock market. By leaving out all the confusing **Wall Street jargon** and explaining things in simple terms, Investing for Beginners 101 is the perfect solution for those willing to learn.

Before we get started, here is a breakdown of the 7 categories for the first official eInvesting for Beginners guide.

Why is investing so important?

Let's imagine a life without investing first. You work 9-5 for a boss **all your life**, maybe get a couple of raises, a promotion, have a nice house, car, and kids. You go on vacation once a year, eat out regularly, and attempt to enjoy the finer things in life as best you can.

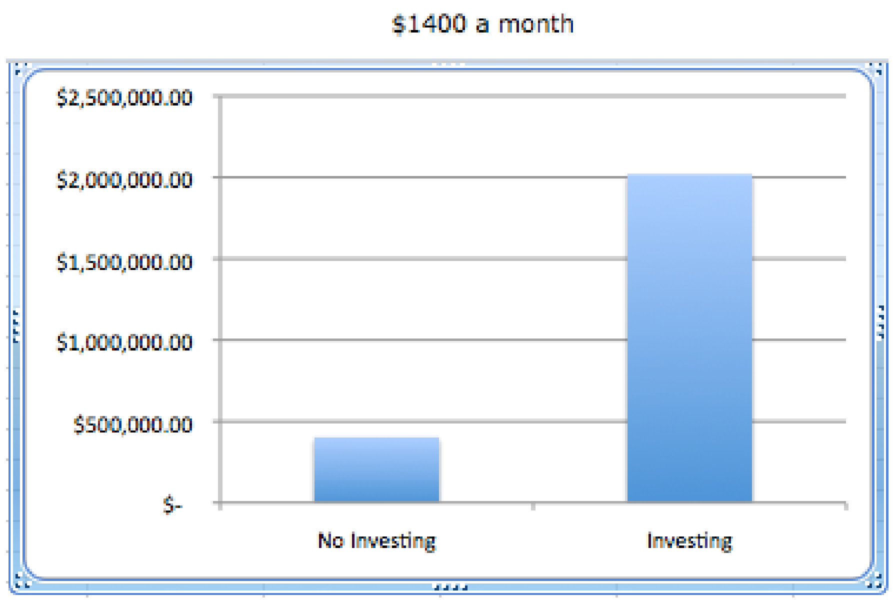
Now since you haven't invested, you get old, become unattractive for hiring, and live with a measly social security allowance for the rest of your life. You might've made good money when you were young, but now you have **nothing to show** for your lifetime of work.

Now let's say you did save some money for retirement, but again this money wasn't invested and won't be invested. Let's even stay optimistic and assume you saved **$1,400** a month for 26 years. This would leave you with **$403,200** to live on, which on a $60,000 a year lifestyle, would only last you 6.72 years. You're retiring at 65 only to go broke at 71 and you've been a good saver all your life. Well then what's the point of saving, you may ask? Now let me show you the same numbers but add investing into the equation.

Again, let's say you saved $1,400 a month for 26 years. BUT, this money was invested continuously as part of a long-term investment plan, solid in the fundamentals you learned from *Investing for Beginners 101*. Now, including dividends in long-term stock market investments, I can confidently and conservatively say that you can average a 10% annual return on these investments.

The same **$1,400** a month compounded annually at 10% turns your net worth into **$2,017,670.19** in 26 years! But the story gets even better. With this large sum of money at your retirement, again conservatively assuming a 3% yield on your dividends, you can collect $60,530 a year to live on WITHOUT reducing your saved amount.

See the graph to the right to get a visual picture of the staggering difference.



Answer: Compounding Interest

By letting the power of compounding interest assist you in saving, you leverage the resources available in the market and slowly build wealth over time. It's not some mystified secret or get-rich-quick shortcut; this is a **time-tested** method to become wealthy and be financially independent, and it's how billionaires, like Warren Buffett, have done it all their lives. He teaches this exact thing.

For those who don't want to think about tomorrow, I can't help you. But tomorrow will come, it always does. Would you rather spend the rest of your life with no plan, dependent on others and unsure of your future? Or would you rather be making progress towards a goal, living with purpose and anticipating the fruits of your labor you know you will be reaping for years after you sow?

The choice is yours, and only **YOU** will feel the consequences of that choice.

The Rule of 72 Exercise

The Rule of 72 is a simple way to quickly calculate how long it will take for an investment to double, based on compounding interest.

As I referred to in the previous section, compounding interest works its wonders by earning interest on capital, then earning interest on the interest of that capital, thus multiplying the amount of money able to be saved each and every year thereafter.

We want the ability to calculate how much interest we could earn on an average investment in order to plan sufficiently and create goals for that investment plan.

The equation for calculating how long it takes an investment to double is as follows:

[72 / (interest %)] = # of years to double

So, for our previous example of 10% compounded annually, it takes our money 7.2 years to double.

72 / 10 = 7.2 years

In a period of 26 years, our money doubles 3.6 times. When adding in the monthly additions, this is how $1,400 a month becomes $2,017,670.19.

The best way to learn is by doing. Work on this exercise and then read the answer in the next exercise section. How long until your money doubles at 12% annually?

Step 2/7: How the Stock Market Works

The saying goes that knowing is half the battle, and the same is true with investing in the stock market. By yearning to educate yourself about how to invest and build wealth, you are already halfway to your goal.

My job as your teacher is to build a foundation of educational wisdom that can be broadly used to earn money and understand any stock market strategy presented to you. I hope this guide is as entertaining and easy to follow as can be.

In order to understand investing, you must understand how the general principles behind the stock market work. Before I started researching and reading about investing, the only things I knew about the stock market were what I saw on TV or heard on the news, and it was never positive.

Stock Market is Overdramatized

I remember hearing about the disaster of the Facebook IPO (initial public offering, when the stock is first able to be bought by the public), the failures of Freddie and Fannie Mae and how stocks tumbled afterwards, and the great dot com bubble that burst in 2000.

With each stock market crash or failure, there are lots of emotional stories about everyday people losing everything they had or big, greedy corporate leaders succumbing to the fall of their empire.

Because of my limited knowledge of the stock market, I pictured it as full of Gordon Gekko businessmen types (from Wall Street: Money Never Sleeps) with money spilling out of their ears and lives full of fast action and New York speed trading. Hollywood depicts Wall Street as this extreme roller coaster ride where fortunes are won and lost every instant, when in reality, this isn't the case. Yes, the stock market has **ups and downs**, there is risk involved, and some people do get burned badly, but the majority of successful investors take very boring and safe strategies straight to success, because they understand the basic principles and are educated on how to stay out of risky investments.

Reality: The Market Fluctuates

I feel like I must give the reader some perspective to the reality of the stock market, so you can understand that the big flashy news headlines and TV specials are extremely overdramatized. The S&P 500 is a list of the top 500 stocks in the U.S. and is widely accepted as the benchmark for all stock investments; analysts consistently compare performance to that of the S&P 500. The S&P 500 is an index that you can think of that is similar to the DOW, which only has 30 companies. Now, the worst one day loss for the S&P 500 in 2008 was only **-9.03%**. In total for the year, the S&P 500 lost **-38.49%**, which was the worst year the index has ever had.

If you think about these numbers for a little bit, anyone can clearly derive that investors lost less than half their worth during that year. But as you can see from the graph below, the S&P quickly **recovered** lost ground after the '08 fall.

In fact, periods of time where the price falls are common. An important aspect of investing is knowing that stock prices do fluctuate up and down but when held over long periods of time, the chances of gains exponentially increase.

Reality: Media Covers the Extreme

As you can see, the majority of investors aren't in fact losing their shirts and the media is choosing to cover extreme cases of people losing money in the stock market, simply because they make for good stories and good TV. Those who did lose all their money weren't diversified in their investments, bought stock in companies that were over leveraged, borrowed money to purchase stocks, or a combination of all three.

For those investors who didn't sell their stocks in 2008, which would've been the worst time to bail out of your stocks, the market recovered and the "devastating losses" didn't affect their portfolio. Therein lies the importance of long-term investing and riding out the storms. Since its inception in 1957, the S&P 500 has returned on average 10.83% annually, when dividends are automatically reinvested.

For those who need a reminder on how powerful a compounding 10% return can be, recall my $2 million example. In 40 years, this amount becomes $8,179,114!

Smart Investors Don't Listen to Noise

Please don't forget that a stock is meant to be a long-term investment. It will pay you dividends that over time will compound and multiply, and if invested in a good company, the share price will appreciate substantially as well.

As financial guru Dave Ramsey put it, "The only people who get hurt riding a roller coaster are the ones that jump off." Once you gain conviction in your investments - knowing that they will recover when hit badly - you will easily be able to avoid selling your stocks at the **worst possible time**, when the market has a temporary crash and it seems like everyone around you is selling too.

Before I introduce the more in-depth topics of this guide, I feel I must explain how I derived these categories and why they are relevant to you. While the Value Trap Indicator I teach is my own original invention, the fundamental ideas and ratios are all well-known and widely used by millions of investors around the world and countless investing experts and authors. In fact, if you get around to reading enough investing and stock market books, you'll realize they are almost all the same, and many of the various ways institutional investors evaluate a stock run parallel to other strategies.

Recognizing this fact helps bring greater understanding to the process and you can feel confident in these metrics because a quick Google search will confirm their validity. I am not reinventing the wheel; instead I am utilizing my obsessive passion for investing research and presenting the most important concepts in an easy to follow guide not yet found on the web. For those who complete the guide and advance as investors, my Value Trap Indicator can be accurately implemented for a very profitable stock picking strategy.

Step 3 will uncover the **BEST** stock strategy you will ever learn and show you that buying a stock is easy. The first step to swimming is first **getting your feet wet**.

Once you climb that obstacle of learning how to transfer money into your investment account and easily buy a stock, you will find the confidence to continue educating yourself about investing to then make the right decisions with some real money.

The BEST Stock Strategy and Buying Your First Stock

For Part 3 of this guide, I will show you the absolute best strategy you should always use when investing and will help you overcome the biggest hurdle beginning investors face: buying your first stock. **Buying just 1 share** of your favorite company helps you tackle the overwhelming feelings of confusion when first starting, by keeping it simple.

I can't stress enough how important buying your first stock is, as you can read and read until your eyes turn blue, but you won't start to see progress towards your results until you **take action**. Trust me – a guy who has been there already – buying your first stock gives you a sense of **empowerment** and excitement at being part of the stock market.

Before going over buying your first stock, <u>I am going to reveal the absolute best stock strategy you can use and one that most wealthy investors use</u>. It is called:

Dollar Cost Averaging

What do investing greats have to say about dollar cost averaging? The godfather of value investing and Warren Buffett's mentor, Benjamin Graham, wrote in his book *The Intelligent Investor* that dollar cost averaging, "Enables you to put a fixed amount of money into an investment at regular intervals … You buy more – whether the markets have gone (or are about to go) up, down, or sideways." Warren Buffett called this book "By far the best book on investing ever written," and it is the resource many investors refer to for guidance.

Dollar cost averaging is simply investing the same amount of money every month, year, or week into the stock market with the effect of forcing the investor to buy more when stock prices are lower and buy less when stock prices are higher. By dollar cost averaging, the investor is always invested and will not be devastated by the losses that come with trying to time the market.

Stay Away from the "Psychics"

In your investing life, beware the analysts who claim they know the exact time to buy low or sell high. In retrospect, everyone believes they would've been able to predict the highs and lows of the market, but in reality, it is impossible. Trying to profit from timing the market will **drive you nuts** and always leave you regretting your decisions. Most investors will sell too early and miss out on bigger gains or will sell because stocks have fallen significantly, which is the absolute worst time to sell. Or, investors will often feel good about their investments when they are doing well and will, as a consequence, buy a lot more at the time when stocks are very high already and there is very little upside.

Dollar cost averaging gives you the necessary, patient **discipline** you need to stay in the market for the long term and through the ups and downs. How does this strategy help you buy more when prices are low and buy less when prices are high? Take this simple hypothetical example to explain how it works.

Say a stock's price is $10 today and you are buying $500 of stock a month in a dollar cost averaging strategy. So, the first month you buy 50 shares of this stock. Let's say next month the price has dropped to $5. Instead of getting angry that the shares have fallen so much and cursing the world, the smart investor sees this as an opportunity to **buy more** stock at a discount. So, again you invest $500 in month 2 knowing that you are in for the long term, and you end up buying 100 shares. Let's say in month 3 the price is still at $5 and you are buying 100 more shares. Finally, in month 4, the price recovers and is now at a whopping $15.

Compare where you'd be if you had or hadn't dollar cost averaged. With dollar cost averaging, you have 250 shares of stock now worth $15, and you are sitting pretty with some nice gains. Let's say you didn't use dollar cost averaging and you had invested all $1500 at once. You'd have only 150 shares, and when the price dropped to $5, you might've sold at the **worst possible time**, unable to stomach any more losses.

Remember: Don't Try to Time the Market

While this might seem like an extreme example, you'd be surprised how often this happens to investors, which is the reason why many shun the market after being burned like this. Little do they know that a simple strategy such as dollar cost averaging reduces the possible downside and keeps you disciplined and invested long term.

If the price had instead gone up initially instead of down, yes, investing all of it at the beginning might have been best in the short term for you, but over many trades and years of investing, you'd find you're getting burned more often than you are gaining. Plus, how would you know when to sell? No one is able to predict the future no matter how much convincing talk you may hear, and the true answer is no one knows.

That's why it's important to stay long term invested and take some profits along the way, without getting greedy or attempting to sell at the highs or buy at the lows. Market timing will lead you to despair, and those who claim otherwise have yet to be burned by it but eventually will.

Time for Action: Buying Your First Stock

Now that I've showed you why to invest, how the stock market works, and the best investing strategy you can use, my next recommendation is getting your feet wet and taking the first step towards obtaining control of your future by buying your first stock.

Long time fans of the podcast and blog know that I've recommended Tradeking for years for its low $4.95 commission fees. When Ally acquired Tradeking, I continued to use their service for the Roth IRA I used for the Real Money Portfolio of my eLetter, and still recommended them. However, things have changed. After several horrible customer service experiences, I've changed my tune.

I don't want to waste your time here with the details, but you can look for our "Brokers to Avoid in 2020" episode on The Investing for Beginners Podcast if you're curious about some of the ways Ally has not given the kind of customer service one should expect.

Fortunately, I have other accounts with other brokers that have been fantastic. My podcast co-host, Dave Ahern, recommends Charles Schwab, and I like Fidelity and Merrill Edge.

You really can't go wrong with either of those three — they all offer **free** commission trades!

Whichever brokerage you decide to go with, **make sure** that the company is SIPC protected (which is different from FDIC on checking accounts). That could protect your assets during the next financial crisis.

These days, the process to sign up for a brokerage account is SO easy, that there's no excuse to not get started today. Let me go through some of the basic account types.

Individual brokerage account
Taxable, not used for retirement. Deposit as much as you want, withdraw whenever.

Traditional IRA
Contributions are pre-tax. Used for retirement, early withdrawals come with fees.

Roth IRA
You can only contribute with post-tax money, but are never taxed on capital gains or dividend income. Early withdrawals also have fees but with some exceptions.

Go Buy a Stock!

I always say that the key to investing is just getting started. You could over-analyze the situation until your face gets blue, but you won't make any progress until you open an account and actually buy at least 1 share.

There's **nothing** like having skin in the game, so go buy a stock and see what it's like. You might be surprised how easy it really is.

Step 4/7: How to Calculate P/E Ratio: The Most Widely Used Valuation

For this step, I'm going to help beginning investors do their own research in stocks and show how to calculate P/E (price to earnings) ratio from a company's 10-k annual report. This guide will have pictures and links to make it very easy to follow and learn the procedure.

In order to research companies and evaluate whether they are good stock buys, you really **don't** need any special skills or education. In fact, if more people knew how to research stocks and took the time to do a little analysis on some companies, I think a lot of so-called experts and mutual fund managers would be **out of work!** Unfortunately, this hasn't been the case and for whatever reason, individual stock picking has been frowned upon and regarded as reckless and risky. In reality, picking individual stocks leaves all the responsibility of your money on yourself, as it should be.

Reality: Only You Are Responsible

In a culture where it's never your own fault and always someone else's, no wonder the average investor flocks to mutual funds every year. If more people took responsibility for their own money and were willing to see their portfolios drop in value without selling at the worst possible time, there'd be happier and increasingly profitable investors. My hope is to see more investors educating themselves and making smart, disciplined stock picks with the **long term** in mind.

Arguably the first thing you should learn about individual stock picking is how to calculate P/E ratio from a company's annual report. P/E ratio simply measures how much you are paying for a company's earnings. The higher the ratio, the more expensive the company.

A higher P/E ratio generally means a company is more popular and more people are buying this stock. P/E ratios vary based on industry and market conditions, and you can tell when the market is **overvalued** because the average P/E ratio is **high**.

An average P/E ratio is about **17**, and I tend to consider a P/E below 15 to be a pretty big discount, depending on the industry. Most fundamentalists that are value-oriented agree that any P/E over 25 is generally too high, regardless of the industry or market condition.

Stocks with high P/E ratios tend to have great stories and the most optimistic of futures, but as the stock becomes more and more overvalued, the bubble eventually pops and everyone who bought in when the company had a high P/E ratio loses money. The thing with buying these stocks with high P/E ratios is that there is no way to tell when the price of the stock will catch up with its valuations, meaning when the stock prices crash to normal levels. While you can make some nice short-term gains from buying stocks like this, using this strategy regularly is essentially gambling and it is not an investment strategy I promote.

I buy companies with relatively low P/E ratios for two very simple reasons:

1. **Low P/E = company is potentially undervalued, trading at a low price**

2. **Low P/E = company most likely has high earnings**

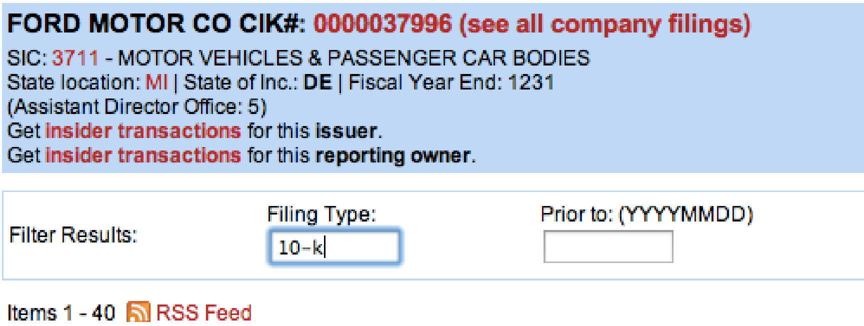
If you look at various studies, there has been a proven correlation between low P/E ratio and above average returns. *What Works on Wall Street* by James O' Shaughnessy showed multiple back tests proving this with 1 year returns from buying low ranked P/E stocks and then rebalancing your portfolio.

How To Calculate P/E Ratio

To calculate P/E, you take a company's market cap and divide by their earnings.

P/E = Price / Earnings

To look up a company's earnings from their annual report, go to sec.gov. Click "COMPANY FILINGS" and then type in the company's ticker in the search bar. I'll show how to calculate the P/E ratio for Ford ($F). Once the company is found, type 10-k in the filing type box.


FORD MOTOR CO CIK#: 0000037996 (see all company filings)

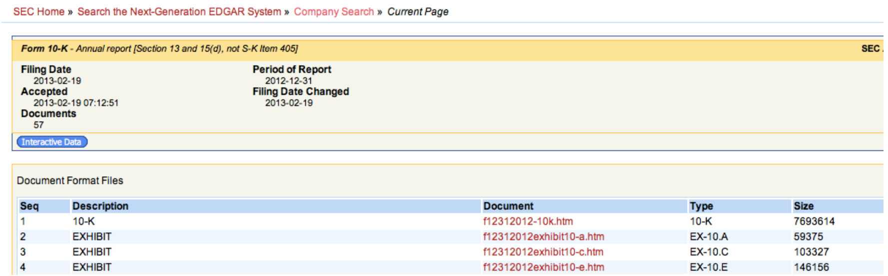
SIC: 3711 - MOTOR VEHICLES & PASSENGER CAR BODIES
State location: MI | State of Inc.: DE | Fiscal Year End: 1231
(Assistant Director Office: 5)
Get insider transactions for this issuer.
Get insider transactions for this reporting owner.

Filter Results: Filing Type: 10-k Prior to: (YYYYMMDD)

Items 1 - 40 RSS Feed

Find the latest filing date and click on documents for the 10-k. From there, click on the .htm link for the 10-k, in this case the first line, as can be seen on the right.

Note: Sometimes the company doesn't put their income statements on the "10-k" and instead will file it under "exhibit 13". You will be able to quickly tell if a company did this after clicking on the 10-k .htm file.


SEC Home » Search the Next-Generation EDGAR System » Company Search » *Current Page*

Form 10-K - *Annual report [Section 13 and 15(d), not S-K Item 405]*

Filing Date 2013-02-19
Accepted 2013-02-19 07:12:51
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Filing Date Changed 2013-02-19

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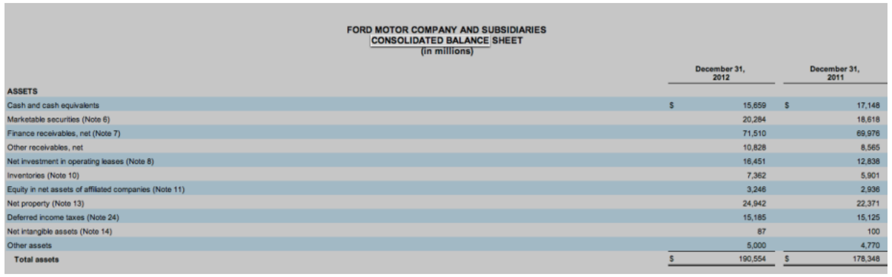
Document Format Files

Seq	Description	Document	Type	Size
1	10-K	f12312012-10k.htm	10-K	7693614
2	EXHIBIT	f12312012exhibit10-a.htm	EX-10.A	59375
3	EXHIBIT	f12312012exhibit10-c.htm	EX-10.C	103327
4	EXHIBIT	f12312012exhibit10-e.htm	EX-10.E	146156

Once you are in the 10-k, do a "Ctrl-F" to search, and search for "consolidated balance". Click through until you are looking at the company's consolidated balance sheet; it looks something like this:


FORD MOTOR COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
(in millions)

	December 31, 2012	December 31, 2011
ASSETS		
Cash and cash equivalents	$ 15,659	$ 17,148
Marketable securities (Note 6)	20,284	18,618
Finance receivables, net (Note 7)	71,510	69,976
Other receivables, net	10,828	8,565
Net investment in operating leases (Note 8)	16,451	12,838
Inventories (Note 10)	7,362	5,901
Equity in net assets of affiliated companies (Note 11)	3,246	2,936
Net property (Note 13)	24,942	22,371
Deferred income taxes (Note 24)	15,185	15,125
Net intangible assets (Note 14)	87	100
Other assets	5,000	4,770
Total assets	$ 190,554	$ 178,348

Now, we want to find the Consolidated Statement of Earnings. (Sometimes called Consolidated Statement of Income, sometimes called something completely different).

Most of the time the Statement of Earnings is right above the Balance Sheet, occasionally it's below. Scroll up until you see the income sheet and look for "Net Income attributable to Ford Motor Company". In this case for 2012, you can see it's **$5,665 million**. Now that we have the earnings, we want to calculate market cap.

FORD MOTOR COMPANY AND SUBSIDIARIES
CONSOLIDATED INCOME STATEMENT
(in millions, except per share amounts)

		Fo
		2012
Revenues		
Automotive	$	126,567
Financial Services		7,685
Total revenues		134,252
Costs and expenses		
Automotive cost of sales		112,578
Selling, administrative, and other expenses		12,182
Financial Services interest expense		3,115
Financial Services provision for credit and insurance losses		86
Total costs and expenses		127,961
Automotive interest expense		713
Automotive interest income and other income/(loss), net (Note 21)		1,185
Financial Services other income/(loss), net (Note 21)		369
Equity in net income/(loss) of affiliated companies		588
Income before income taxes		7,720
Provision for/(Benefit from) income taxes (Note 24)		2,056
Net income		5,664
Less: Income/(Loss) attributable to noncontrolling interests		(1)
Net income attributable to Ford Motor Company	$	5,665

You can Google a company's market cap, which is updated regularly on most financial websites. If you want to be detail-oriented like me, or be able to look up a company's market cap for previous years, search the 10-k document for "shares outstanding". Once you have the number of shares outstanding for 2012, simply multiply this by the share price to get the company's market capitalization.

Note: You always want the Diluted number for shares outstanding, as it considers employee stock options and is, therefore, more accurate.

NOTE 26. CAPITAL STOCK AND AMOUNTS PER SHARE *(Continued)*

Amounts Per Share Attributable to Ford Motor Company Common and Class B Stock

Basic and diluted income per share were calculated using the following (in millions):

		2012
Basic and Diluted Income Attributable to Ford Motor Company		
Basic income from continuing operations	$	5,665
Effect of dilutive 2016 Convertible Notes (a)		46
Effect of dilutive 2036 Convertible Notes (a)		2
Effect of dilutive Trust Preferred Securities (a) (b)		—
Diluted income from continuing operations	$	5,713
Basic and Diluted Shares (c)		
Basic shares (average shares outstanding)		3,815
Net dilutive options and warrants		101
Dilutive 2016 Convertible Notes		96
Dilutive 2036 Convertible Notes		3
Dilutive Trust Preferred Securities (b)		—
Diluted shares		4,015

So, once you have these values, simply take market cap/ earnings to calculate P/E ratio. For Ford, using today's stock price of $13.36, we get a market capitalization of **$53.6 Billion**. Divide this by the earnings, $5.6 Billion, and the P/E is **9.46**. Auto makers tend to have a low P/E due to the industry, so compare to its competitors to see if the ratio is favorable.

Keep in mind that most P/E ratios you see on financial websites calculate using future earnings, based on projected numbers. Thus, these numbers can **fluctuate** greatly, which is one reason I like to use past earnings to calculate P/E ratio. I like averaging earnings for the past 3 years to make my calculations less dependent on any one year. Another great idea is to calculate the P/E ratio over an average of 7 years of earnings, as Ben Graham did in his book *The Intelligent Investor.*

The answer to the Rule of 72 exercise: 6.

P/E Ratio Disclaimer

Please keep in mind that the P/E ratio, and any of the ratios presented here, are <u>not</u> a panacea.

Just because a ratio looks good doesn't mean the stock will be a great investment. These ratios are tools to help you, as an investor, get perspective on how cheap a stock is based on numerous factors, but you have to look at the whole picture to get the best results.

Step 5/7: The Single Two Factors Most Correlated To Success - P/B and P/S

From the 1951-1994 time period, there have been two single ratios that have performed very well in 1 year time periods. Ranking the lowest Price to Book and Price to Sale ratios have done **far better** than any single one parameter when ranked, bought, and then rebalanced annually.

As James O'Shaughnessy showed in his book *What Works on Wall Street*, when these single ratios are implemented with various other strategies, downside risk can be greatly reduced, while also leading to great annual returns. Combine these ratios with the others in this eBook to really see some results.

These ratios are great for teaching because they are very easy to understand and can tell a more complete picture of a company's financials than just a P/E ratio can.

Low P/B and P/S Correlate to Success Because They Indicate a Potentially Undervalued Stock

A big reason why these ratios are so successful is because they both indicate if a stock becomes overvalued from the price part.

As the P/B and P/S ratios become **higher** and higher, there are more people buying the stock and driving the price up, making it **less** valuable to a smart investor.

Also, they can be more reliable indicators than P/E ratio because revenue and book value fluctuate much less than earnings do. Earnings and earnings per share can be easily manipulated by companies depending on accounting practices.

There have been instances where companies were caught manipulating their earnings after the fact – and it is more common than people realize. However, sales (revenue) and book value are harder to manipulate – another reason these two ratios are so useful.

Also, think about revenue. Revenue is not easily increased or decreased from year to year like earnings are. To increase earnings, a company can quickly cut costs by firing workers. Revenue can only be increased through more sales. Or, a company with a successful product may have bad earnings one year because it is using its profits to pay down debt. The P/S would tell the picture that the company is in better shape than the P/E might be telling at that time.

In general, a lower P/S is better, and the historical average across the stock market has been around 1.55.

P/S = market capitalization / revenue

The P/B ratio, compared to the P/E ratio that is only correlated to earnings, has historically been a fantastic way to determine the cheapness of a stock – and worked as a pillar of many conservative value investing strategies. Benjamin Graham popularized the use of P/B ratio and successfully amassed a fortune while teaching countless investors how to do the same.

The Buy Low Strategy

The basic premise behind buying stocks with low P/B ratios involves buying a company that is selling close to or below their book value, with the idea that you are buying a stock with **very little downside** because it has already been shunned by the market, hence its low P/B ratio. By coupling a low P/B ratio with the limitation of only companies with a strong balance sheet and a stable dividend, you improve the likelihood of purchasing great companies trading out of favor in the short term but with upside potential in the long term.

This strategy has also been shown to work in back tests. James O'Shaughnessy's work found that investing in the companies with the 50 lowest P/B ratios **and then rebalancing your portfolio** every year, over a period of over 40 years, would've given you the second highest portfolio compared to any other one single variable. When combined with other limitations to reduce risk, a **low P/B ratio** becomes a great ratio to use as a prudent value investor attempting to build a safe portfolio.

To calculate P/B ratio, simply divide price by book value. A company's book value is easily calculated from the consolidated balance sheet, and equals total assets minus total liabilities. Book Value can be correlated with stability because it measures how much a company's assets cover their liabilities.

To find the consolidated balance sheet, search for it in the company's 10-k, like in Step 4. An example of Apple's ($AAPL) balance sheet is shown below (in millions):

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CONSOLIDATED BALANCE SHEETS
(In millions, except number of shares which are reflected in thousands)

		September 29, 2012
ASSETS:		
Current assets:		
Cash and cash equivalents	$	10,746
Short-term marketable securities		18,383
Accounts receivable, less allowances of $98 and $53, respectively		10,930
Inventories		791
Deferred tax assets		2,583
Vendor non-trade receivables		7,762
Other current assets		6,458
Total current assets		57,653
Long-term marketable securities		92,122
Property, plant and equipment, net		15,452
Goodwill		1,135
Acquired intangible assets, net		4,224
Other assets		5,478
Total assets	$	176,064

Total Assets = **$176,064**

LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$	21,175
Accrued expenses		11,414
Deferred revenue		5,953
Total current liabilities		38,542
Deferred revenue - non-current		2,648
Other non-current liabilities		16,664
Total liabilities		57,854

Total Liabilities = **$57,854**

Book Value = $176,064 – $57,854
Book Value = **$118,210.**

The price part of the formula comes from the market capitalization, calculated the same way as shown in Step 4. So again, price to book value is calculated like this:

P/B = Market cap/ book value = Market cap/ (total assets – total liabilities)

For this example, Apple's market cap (in 2013) was (945,355 shares) * (market price of $452.08) = $427.3 billion.

So, their **P/B** ratio in this case was 427.3/ 118.2 = **3.6**.

I first published this example in 2013, and I love how it shows that a higher P/B ratio isn't always bad. As we know now, Apple went on to have fantastic stock market performance after 2013. That said, I personally continue to use the P/B ratio as it's been very helpful in finding undervalued stocks that went on to do well.

Step 6/7: Cashing In With a Dividend is a Necessity

Welcome to Step 6 of this comprehensive guide. First and foremost, I explain why a dividend is so important to investors. This section covers a lot of important ground and each of these parameters diversifies your stock picking requirements to reduce risk.

Simply put, this step confirms that the entire picture of the stock looks healthy. As with all parameters examined in the stock picking process, each category should be regarded as significantly important.

A Dividend Creates Compounding Interest

The first parameter we want to examine is the dividend yield of a company. This aspect is important because a good investment is constantly returning cash to the shareholders. Receiving a dividend and **reinvesting** that dividend is so crucial for you in utilizing the power of compounding interest.

Dividends are a guaranteed return on investment, and as I've said before, I **never** suggest buying a stock that doesn't pay a dividend.

A healthy dividend yield and dividend payout reflects a company that is using excess cash efficiently. It's really as simple as that, but it is also very important. That being said, let me show you how to calculate these parameters.

Dividend yield is quite easy to calculate and will often be explicitly stated next to a stock's price as a percentage. To calculate this Yield %, just divide dividends the company paid for the year by the current share price.

Dividend yield % = dividend / share price

The only hard part about this is finding the information. You can quickly Google this to find it out, however if you are researching years prior, it's beneficial to know how to extract this from the 10-k annual report. Here's what I do: Once you have the annual report document open, hit Ctrl+F to search for "dividends". You can also search "quarter" or "quarterly" to see the dividends paid along with share price numbers for each quarter of the year you are looking at. Sometimes the dividend paid is included in the statement of income, which helps if you are filling out spreadsheets.

Reinvested Earnings (Accumulated Deficit)
Balance at beginning of year
Net income attributable to Verizon
Dividends declared ($2.03, $1.975, $1.925) per share
Balance at end of year

Next, we want to know the dividend payout %. If a company had too high of a %, this could indicate a company being irresponsible. It also commonly warns of a company in trouble who is trying to hide its balance sheet failures by still paying high dividends.

On the surface, the company may still appear to be in good shape, but a prudent investor who has done his/her due diligence will be able to identify this by use of the payout ratio. To calculate this, take the dividend paid for the year divided by the company's EPS (earnings per share found in the statement of income).

Payout ratio % = dividend / EPS

The next parameter to consider is price to cash (or P/C) ratio. This ratio reflects the profitability of a company and their ability to generate cash. Basically, by buying a company with a low P/C ratio, you are getting access to their cash pile at a low price. A stock with a P/C of 10 means you are paying $10 for $1 of cash generated.

I like to use the P/C ratio to make sure the company has cash on hand to handle emergencies – another great way to reduce risk when looking at stocks.

To derive this ratio, simply divide a company's market capitalization by their net cash at end of year. This is also called "Cash and Cash Equivalents" in the balance sheet.

P/C = market cap / net cash

To find the net cash at end of year, scroll down to the statement of cash flows in the 10-k annual report.

Near the bottom of the page lies the net cash numbers, organized by year.

Provision for uncollectible accounts	**972**	1,026	1,246
Equity in earnings of unconsolidated businesses, net of dividends received	**77**	36	2
Changes in current assets and liabilities, net of effects from acquisition/disposition of businesses			
Accounts receivable	**(1,717)**	(966)	(859)
Inventories	**(136)**	208	299
Other assets	**306**	86	(313)
Accounts payable and accrued liabilities	**1,144**	(1,607)	1,075
Other, net	**(3,423)**	(2,900)	(1,930)
Net cash provided by operating activities	**31,486**	29,780	33,363
Cash Flows from Investing Activities			
Capital expenditures (including capitalized software)	**(16,175)**	(16,244)	(16,458)
Acquisitions of investments and businesses, net of cash acquired	**(913)**	(1,797)	(652)
Acquisitions of wireless licenses, net	**(3,935)**	(221)	(786)
Proceeds from dispositions	–	–	2,594
Net change in short-term investments	**27**	35	(3)
Other, net	**494**	977	251
Net cash used in investing activities	**(20,502)**	(17,250)	(15,054)
Cash Flows from Financing Activities			
Proceeds from long-term borrowings	**4,489**	11,060	–
Repayments of long-term borrowings and capital lease obligations	**(6,403)**	(11,805)	(8,136)
Increase (decrease) in short-term obligations, excluding current maturities	**(1,437)**	1,928	(1,097)
Dividends paid	**(5,230)**	(5,555)	(5,412)
Proceeds from sale of common stock	**315**	241	–
Proceeds from access line spin-off	–	–	3,083
Special distribution to noncontrolling interest	**(8,325)**	–	–
Other, net	**(4,662)**	(1,705)	(2,088)
Net cash used in financing activities	**(21,253)**	(5,836)	(13,650)
Increase (decrease) in cash and cash equivalents	**(10,269)**	6,694	4,659
Cash and cash equivalents, beginning of period	**13,362**	6,668	2,009
Cash and cash equivalents, end of period	**$ 3,093**	$ 13,362	$ 6,668

See Notes to Consolidated Financial Statements

In picture: Net cash numbers for 2010-2012. Click the picture to zoom in.

Earnings Growth

Last but not least is the parameter of earnings growth. Earnings are the name of the game for most investors, and therefore can't be ignored.

This is how a business grows.

Popularized by mutual fund phenomenon Peter Lynch in his book *Beating the Street*, so-called growth investors' primary focus is earnings growth. And because it is so widely **popular**, the type of stocks with good earnings growth can be **volatile**, as minor changes in growth can cause major upswings or downswings because of all the attention on its growth.

For example, a highflying stock with stellar growth may see its growth slow down, and in turn, many growth investors might see this as unfavorable and their selling could drive the stock down very quickly. Because of this volatility, earnings growth becomes only one part of my investing strategy instead of the whole focus. A good long-term plan won't be adversely affected by such short-term swings.

Earnings growth percentage is calculated by subtracting the previous year's earnings from current year earnings and dividing by previous year's earnings; then multiplying this quotient by 100 to get the percentage.

Earnings growth =

100* (Current earnings – last year's earnings) / last year's earnings

To increase accuracy and get a better feel for how much a company is growing over a longer time period, average the earnings growth percentage over the 3 most recent years. For example, if earnings growth for a company was:

2012: 2.4%
2011: 4.6%
2010: 3%

Then the average earnings growth for the company is (2.4+4.6+3)/3 = 3.33%. A good earnings growth is around 6-7%, and indicates a stock with possibly a very bright future.

Make sure to catch the last and final step to *7 Steps to Understanding the Stock Market*. The topic covered is the **BEST** way to avoid risk, how this ratio prevents catastrophic losses and then the final step to putting it all together to make precise buy and sell decisions.

Real Example: Dividend Yield and Payout

For this next example, we are going to look at 2 stocks that have increased their dividend for more than 50 years in a row. While these companies are long established and have outstanding long-term track records, this factor alone doesn't constitute a good buy. Just because a company has a history of increasing stock prices and dividends **does not** mean a blind buy and hold strategy will be profitable.

In 2012, 3M ($MMM) had a cash dividend of $2.36 per share, average share price of $88.72, and EPS of $6.32.

In 2012, Diebold ($DBD) had a cash dividend of $1.14 per share, average share price of $35.29, and EPS of $1.23.

How can we use this information effectively? Let's first calculate dividend yield %, then look at payout ratio to determine sustainability.
Div. yield $MMM = ($2.36) / ($88.72)
Div. yield $MMM = 2.6%

Div. yield $DBD = ($1.14) / ($35.29)
Div. yield $DBD = 3.2%

From this $DBD initially looks more attractive. However, we can't look only at yield to decide which stock to purchase.

Payout Ratio $MMM = ($2.36) / ($6.32)
Payout Ratio $MMM = 37.3%

Payout Ratio $DBD = ($1.14) / ($1.23)
Payout Ratio $DBD = 92.6%

As we can see from the calculations, Diebold's dividend is unsustainable at these levels. 3M's dividend is much healthier, as it is below 40%. As a result, 3M's stock price has seen a gain of 19% since 2012. Meanwhile, DBD has lost -17% as of today (4/21/13).

Real Example: Average Earnings Growth

With plenty of companies showing earnings growth most of the time, there is no reason to gamble with negative growth. Instead, wait for a company to prove it has made a comeback; only the numbers can truly identify such a time.

The average stock price for RadioShack ($RSH) in 2010 was $20.85. Earnings numbers for the years 2007-2010 for $RSH looked like this:

2010 RSH $206.1
2009 RSH $205
2008 RSH $189.4
2007 RSH $236.8

At the same time, competitor Walmart ($WMT) had an average stock price of $50.72. Earnings numbers for 2007-2010:

2010 WMT $14,355
2009 WMT $13,400
2008 WMT $12,731
2007 WMT $11,284

The growth numbers for $RSH were 0.5%, 8.2%, and -20%. Average growth = **-3.7%**

The growth numbers for $WMT were 7%, 5.2%, and 12.8%. Average growth = **8.3%**

Since 2010, $WMT has gained 54.3% while $RSH has lost -85%. Growth numbers matter.

The Best Way to Avoid Risk and Putting it all Together!

Congratulations on making it to the final step of this eBook! I've done my best to save the best for last, but each part of this guide is equally important, and I encourage those who have skipped sections to go back and read what was missed.

In this final step, you will learn what I've found to be the best way to discover and avoid risk to save yourself from catastrophic losses. Through many back tests for my Value Trap Indicator dating back to 1994, I've found a common characteristic in companies about to experience substantial stock price drops or bankruptcy. These companies would consistently score above 1,000 on my Value Trap Indicator, triggering a strong sell in my system **before** the company went bankrupt.

A common characteristic I discovered was too much debt when compared to shareholder's equity, and higher debt was worse.

Avoid Risk by Avoiding Debt

Debt to equity is a common measure of risk in investing. If you think about it, it makes sense too. A person more likely to become bankrupt is one with too much debt, and the same is true for companies.

If the company considered doesn't have enough assets to cover their liabilities, or shareholder equity, then they have debt to equity ratios that skyrocket. Financial companies like banks have extremely high debt to equity ratios compared to other industries because of the nature of their business, so I tend to avoid them. As Warren Buffett explains, stay out of businesses that are outside of your circle of competence.

For a normal company, you like to see a debt to equity ratio that is **below 1**.

Even among financials, a Debt to Equity much higher than 10 is a sign that a company is seriously leveraged. Lehman Brothers had a D/E of **60** right before their bankruptcy.

Many investors overlook the debt to equity ratio and in turn become shocked at seeing staggering portfolio losses, which is why I've saved this ratio as the last and most important one. Now that I've uncovered its importance, let's calculate the debt to equity ratio.

There are two ways to calculate debt to equity ratio, using total liabilities or looking at only long-term debt.

In my opinion, it's important to consider total liabilities instead of only long-term debt because a company should be able to cover all their total liabilities with their total assets in case of a financial struggle.

Also, a company with less total liabilities is obviously in a favorable financial condition and this must be accounted for. Debt to equity ratio can be found from balance sheet numbers. It's total liabilities divided by shareholder's equity, which is total assets minus total liabilities.

The lower the ratio, the less risky the business in times of severe earnings distress.

Debt to equity
= total liabilities / shareholder's equity
= total liabilities / (total assets minus total liabilities)

Example: Debt to Equity

For this final example, we will examine two more financial companies and determine which stock is the safer choice. In 2011, MF Global Holdings ($MFGLQ) had total liabilities of $39,037,258 and shareholder's equity of $1,373,731. The average share price for $MFGLQ was $7.56.

In 2011, Citigroup ($C) had total liabilities of $1,694,305 and shareholders' equity of $179,573. The average share price for Citigroup for 2011 was $37.20.

Just as a reminder to you, we want a debt to equity ratio below 10 for financial companies and banks and below 1 for all other companies.

Debt to eq. $C = ($1,694,305) / ($179,573)
Debt to eq. $C = 9.4

D/eq. $MFGLQ= ($39,037,258) / ($1,373,731)
D/eq. $MFGLQ = 28.4

As we can see from the results, MF Global Holdings was extremely overleveraged in 2011. Consequently, the company went out of business the next year. At the same time, a company like Citigroup, with a healthy debt to equity ratio, remained intact and saw stock price appreciation.

As of today (4/22/13), Citigroup has gained 21%, while shareholders in $MFGLQ have lost everything (-100%).

With this final lesson, I've equipped you with many tools for getting started investing in the stock market. You know how to avoid risk, calculate important ratios, and dollar cost average. I hope you've enjoyed this eBook, as I've enjoyed sharing what I know and have learned through various sources.

I strongly recommend to you to **take the next step** and apply what you have learned to make specific stock picks. To quantify this stock picking format into an easy to follow method, I've formulated the Value Trap Indicator to quickly calculate the combination of various valuations of a company. Using the 7 steps of this guide you are reading now, the Value Trap Indicator assigns any stock a number, with a Strong Buy being 0-250, and a Strong Sell being larger than 800. I use the Value Trap Indicator spreadsheet on every stock I analyze.

The Value Trap Indicator showed an 800+ score for both Lehman Brothers and Circuit City the year right before their **bankruptcies**.

7 Rules to Invest By

1. Don't buy any stock with negative earnings for the year
2. Don't buy a stock not paying a dividend
3. Remember you are a long-term investor
4. Think twice before selling a stock that you haven't owned for more than a year
5. Don't sell a stock just because it has gone down in price
6. Sell a stock that no longer has good ratios
7. Remember, mistakes are part of learning

Resources

Additional Suggested Readings

Value Trap Indicator; Andrew Sather
The Intelligent Investor; Benjamin Graham
The Richest Man in Babylon; George Clason
What Works on Wall Street; J. O'Shaughnessy
The Millionaire Next Door; Thomas J. Stanley

Additional Suggested Websites

For financial data: FINVIZ
For annual reports: SEC.gov
My podcast: The Investing for Beginners Podcast
Co-host Dave's website: Intrinsic Value Formula

Photo Attributions

Wall Street: http://flic.kr/p/9Zisvi

Recommended Stockbrokers

Fidelity, Charles Schwab, Merrill Edge

I'd Like to Say Thank You

First and foremost, thank you, God, for giving me a second chance at life when I didn't deserve it and didn't expect it.

I'd like to say thank you to everyone who has supported me along the way during my journey – whether I realized it or not.

Creating these resources has not been an easy task; every email of thanks and gratitude, every word of encouragement, and every one of my friends and family who've sat through my wild and crazy thoughts have helped shape who I am and what this whole journey has become.

Thank you is in order to my mentor, Mike, who introduced me to investing and has shared so much wisdom that I try to apply every day.

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I'd like to thank my growing team at Sather Research LLC, which started with Dave Ahern and our podcast in 2017 and in 2019 expanded to Andy Shuler and Cameron Smith, who've been instrumental with their blog posts on the site. Working with you guys has made this process so much more fun and given me so much inspiration, not to mention is 100% responsible for the crazy growth and popularity we've seen lately.

Finally, **thank you** again to everyone who has read this book and emailed me with your kind words through the years. I'm grateful to have made such an impact to so many of you.

For those who have shared my website or podcast with their friends on social media or have purchased one of my products, I owe you all of my gratitude; you've made my mission to teach and educate beginners possible.

I hope to have at least planted the seed to your eventual wealth. While this is just the beginning for many in their investing journey, there is so much power in educating yourself by reading this book.

Alright, that's enough out of me. Enjoy your path to financial freedom, and invest with a margin of safety, emphasis on the safety.