

Investing in athletic shoes with Mac, Aisha, and Reggie
Part 1: How to find information about stocks

Mac, Aisha, and Reggie are the “guides” in Guides to Independence 203: How to Invest in Stocks and Bonds.

Mac plays on a soccer team and Aisha is a runner. Their favorite shoes are Nikes. Mac asks Reggie about investing in Nike stock, since he and Aisha both like Nike shoes so much. Reggie, who reads stock reports before breakfast, says it's often a good idea to invest in a company that makes a product you use or know about. He tells them to learn more about Nike.

Invest in what you know

“Almost all companies now have their own Web sites with information about their products and stock,” Reggie explains. Mac explores Nike's Web site and discovers the “Investor Relations” section.

There, he sees a great deal of information about the company's recent financial results such as earnings and debt, its management, copies of recent Securities and Exchange Commission (SEC) filings, and company news and press releases.

Aisha visits Web sites such as the *Motley Fool* and *MoneyCentral*. She is excited to find so much information on each one.

Projections of future financial results are mixtures of fact and fiction.

Reggie agrees that some Web sites like the ones she mentioned contain valuable and useful information, but cautions Aisha and Mac to be careful.

Question everything

“Just because a Web site says something about an investment doesn't mean it's true. Investment reports and recommendations,



whether posted on Web sites or not, are a mix of facts and opinions. And opinions are just that—opinions, not fact,” says Reggie

“Although many recommendations are well thought-out,” Reggie cautions, “Take what you see online, in magazines, and in brokerage firm reports with a grain of salt, and don't believe everything you read.”

Aisha, Mac, and Reggie look back at sources of investment information they've discovered. They realize that the real challenge is not finding information about investments, but finding good information—and understanding it.

What's the company's financial "track record?"

When researching a company and its stock, start with the company's financial results. The Securities Exchange Commission (SEC) requires companies to report their financial results every quarter, and then report those results again at the end of the year on a full-year basis.

"Investors like to look at annual results because they 'smooth out' factors that may impact a single quarter, but may not be present each quarter," notes Reggie.

Companies also post their financial results on their own Web sites, usually in the "Investor Relations" section. In addition, Web sites such as those Aisha visited, and many other sources like newspapers and magazines, contain these financial results.

Company financial reports can be complicated and detailed, but they always include the amount of money each company made by selling its products and services (also known as its "revenue" or "income").

Each company subtracts the money it spent (its "expenses") from its revenue and reports the difference—its "earnings" or profit. If a company spends more money in a quarter or a year than it makes, it will report a loss instead of a profit.

Aisha and Mac look at the Nike Web site to find its financial results. They locate Nike's most recent report and see that for Nike's third quarter in 2007 (which ended Feb. 28, because the company's fiscal year starts June 1), the company's revenues were \$3.9 billion, and its earnings were \$350.8 million.* Earning \$360.8 million in three months sounds pretty impressive!

But is it really, poses Reggie? He suggests that Mac and Aisha look at earnings as a percentage of revenue. This tells investors how much a company is spending on its expenses and says something about how much profit it's making per sale. This ratio is called the "net profit margin." In Nike's case

for the most recent quarter, Nike earned \$3,608 million on sales of \$4.04 billion for a net profit margin of 8.93%.

What's a company's financial "track record" over time?

Investors want to compare how a company does over time—to see if the company has a record of making more money from one quarter to the next, and one year to the next. Investors also want to see how net profit margins compare over time.

Aisha and Mac learn that for the quarter ending Feb. 28, 2006, Nike reported revenue of \$3.6 billion and earnings of \$325.8 million. When comparing the two quarters, they see that Nike increased its revenue by \$300 million and its earnings by \$25 million. This improved Nike's net profit margin as well.

But over the past five years, Nike's annual net profit margin averaged 8.06%. So its most recent quarter appears a bit better than average. It's the investor's challenge to understand why this might have happened and use that knowledge when deciding whether to invest.



Reggie says, "Company financial results for a quarter or a year, standing on their own, don't tell the whole story. You've got to look longer, man!"

Investors look at trends for companies, their competitors, and industries as a whole.

An investor wants to compare a company to its competitors. Adidas and Nike are close competitors. Aisha looks at Adidas' net profit margins over the past five years. She finds that over the most recent 5-year period, Nike's net profit margins look better than Adidas. For that time, Adidas' annual net profit margins averaged 5.06%.

In addition to companies that compete with the firm they're researching, investors look at net profit margins for an industry as a whole. Over the past year, net profit margins for the shoe industry averaged 9.40%. So, it looks like Nike has done better than Adidas, but both have done worse than the industry.



What makes a "good" quarter or a "good" year?

Investors like to see companies improve their revenues, earnings, and profit margins over time. They also like to see a company compare favorably with other competitors in the same industry and with the industry as a whole.

So, quarters or years in which a company posts improving financial results—and in which it compares favorably to competitors or its industry as a whole—are considered "good." Since Nike's financial results improved in the most recently reported quarter, and those results compare OK with the shoe industry, that quarter can be thought of as "good."

Net profit margins vary from industry to industry for a variety of reasons. Investors need to look at each industry closely to decide what's a "good" net profit margin for

the industry. In addition, net profit margins change over time, depending on conditions in the industry and the overall economy, so different margins may be "good" at different times.

Here are some recent average annual net profit margins for a series of industries:

Industry	Recent average annual net profit margins
Grocery store	.10%
Nasdaq companies	3.1%
Automobile	1.60%
Entertainment	7.90%
Oil and gas equipment & supplies	14.60%
S&P 500 companies	7.0%
Restaurant	8.20%
Semiconductor	15.00%

Sources: Nasdaq, Standard & Poor's.

What about the company's future?

What a company will do in the future is very important. People generally want to invest in companies that will continue to show good financial results. But no one has a crystal ball that lets him or her see the future—how can an investor know what a company's future financial results will be?

"Brokerage-firm analysts, independent commentators, Web sites, magazines articles, and many others offer projections of a company's future revenues and earnings," says Reggie.

"But," he reminds his friends, "question everything. Just like investment recommendations, projections of a company's future financial results are mixtures of fact and opinion. Investors should question projections carefully and should take them with a grain of salt."

What else should investors consider?

Investors consider companies that post steadily increasing revenues and earnings and "good" net profit margins—and are projected to keep doing so—high-quality companies. And a high-quality company is a good potential investment, but investors must consider other factors too.

After finding a high-quality company, an investor must decide whether the company's stock is trading at a reasonable price. People invest in stocks to make money. Rising stock values do that. If the stock's price is already "too" high, it might not have room to rise further.

For more information, see:

Part 2: What dividends and capital can tell you about a company

Part 3: Understanding the price-to-earnings ratio

Part 4: How debt ratio and industry structure help you pick stocks

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