Streetsmart Guide to Valuing a Stock

The Savvy Investor's Key to Beating the Market

Second Edition

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Preface

Streetsmart Guide to Valuing a Stock is a how-to book that provides you with the tools to make money in the stock market. The book's focus is on *stock valuation*—an area of great interest to many investors, but understood by very few.

When you've finished this hands-on, easy-to-use guide, you will have learned how to:

- Value stocks of general market and high-tech companies, such as Microsoft and Cisco Systems;
- Value stocks of financial companies and real estate investment trusts, such as Citigroup, Merrill Lynch, Berkshire Hathaway, and Washington REIT;
- Spot undervalued or overvalued stocks for buying and selling opportunities;
- Estimate important valuation inputs such as growth, operating margin, and cost of capital;
- Find valuation inputs on free Internet Web sites;

- Develop a spreadsheet to value a stock;
- Combine stocks in an efficiently structured investment portfolio;
- Manage your risk; and
- Use the 10 principles of finance to your advantage.

This book is a complete revision of *Streetsmart Guide to Valuing a Stock* (1999). In the four years since the publication of *Streetsmart,* the stock market has crashed, managers of many corporations such as Enron, WorldCom, and Adelphia have been indicted for fraud, and certain Wall Street stock analysts have been discredited and have attained a business stature below that of used car salesmen. We feel that it is time to place stock valuation within the context of some general rules and concepts that are at the core of finance theory. This book explains in simple terms the 10 principles of finance and describes how you can use them to make better investment decisions and to estimate a stock's value.

This book is for all of you who *mistakenly* think you have to be a stock market guru to value stocks like a pro. All the tools you need to value stocks are outlined in the chapters that follow. All that is required is a bit of patience, practice, and persistence.

You don't need an MBA to understand the book's concepts or the 10 principles. The goal of the book is to give all stock market participants—*individual investors, investment club members, stockbrokers, SEC staffers, corporate managers, directors of corporate boards, and ordinary people who want to learn about stock valuation*—a simple quantitative approach for estimating stock values. Our model is a recipe for correctly and conservatively valuing common stock and increasing investment profits.

In this book we describe how you can use Excel to write a spreadsheet to value stocks with a minimum number of inputs. If you don't want to write a spreadsheet program, we show you how and where you can purchase the computer software, which we have developed and use in the book. Finally, we provide a free online stock valuation service on our Web site, *www.valuepro.net/.*

If you're technologically challenged, not to worry. You don't need a computer or an Internet connection to use the discounted free cash flow method to value a stock. In Chapters 5 and 6 we describe how to calculate and estimate, *long-hand,* a company's free cash flow and cost of capital—these are the essential ingredients of stock valuation. In Chapter 7 we show you how and where to get the information that you need for serious valuations. In Chapter 8 we value Citigroup, Merrill Lynch, Berkshire Hathaway, and Washington REIT. This book will help you to learn a lot about valuing stock even if spreadsheets and computers are too intimidating for your personal tastes.

Our goal is to teach you about stock valuation by using a simple and powerful valuation model. This book will make you a better informed, more intelligent, more profitable investor and will help you to understand why stocks such as Cisco trade at $14.45 and Berkshire Hathaway trades at $72,000 per share. Our valuation approach revolves around some very simple calculations that use only addition, subtraction, multiplication and division—no calculus, differential equations, or advanced math. So let's begin by taking our initial plunge into stock valuation.

Good luck, tight lines, and happy valuations!

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J. Randall Woolridge

Acknowledgments

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