The Little Book That Builds Wealth
By Pat Dorsey
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Commentary provided by Leo Schreven.

One of my favorite investing information companies is MorningStar. The book we are going to use this month is from the CEO of this great company and his associate Pat Dorsey. I have chosen this book for two reasons. First, because it is an excellent source of information how to pick the right companies to invest in, specifically in mutual funds. However as you go through the book, I want you to allow your brain to really expand with many concepts that they use to qualify the best companies. These concepts, if you think about them carefully, could also help you build amazing businesses that become very strong.

One of the first terms you're going to have to become used to is called a "moat." An economic moat is a term that Warren Buffett coined, that refers to the unique advantages that protect a company against competitors, in the same way a moat protects a castle. Warren Buffett's strategy has always been to have long-term investments with companies that have wide economic motes. To do this, he has over 100 stock analysts covering over 2,000 publicly traded companies across 100 industries. You will learn from them and how to identify companies with moats. The book is not a long one, but it has some real gems of wisdom.

The game plan is basically simple to follow:

1. Identify businesses that can generate above average profits for many years.
2. Wait until the shares of those businesses trade for less than their intrinsic value and buy them.
3. Hold those shares until the business deteriorates, the shares become overvalued, or you find a better investment. Generally this holding period will be for several years.
4. Repeat as often as you need to.

The book primarily focuses on the first step—finding businesses with long-term potential; finding a company that can take the investors money and generate a return on it; a company that can generate high returns for many years at a very fast rate. These companies are not common, and that is why they take careful research. These are the real companies that are able to withstand the relentless onslaught of competition for long period of time.

How can you identify companies like these—ones that are not only great today, but are likely to stay great for many years in the future? The answer is, ask a decisively simple question when you look for these companies.

"What prevents a smart, well-financed competitor, from moving in on this company's turf?"

You need to memorize the question because it is the foundation of choosing wisely.

The next section deals specifically with the economic moats. Long-lasting companies that have strong competitive advantages are obviously more valuable than companies that are at risk of going from great to worthless in a matter of a few months. Just imagine that we have two companies growing at about the same clip, making about the same amount of capital and generating about the same amount of cash. Imagine one of the companies has a strong economic moat. It will return a high rate to its investors for 10, 20 or 30 years. The other company without a moat will disappoint its investors as soon as competitors move in and it is no longer profitable. Therefore, the company with the moat is worth more today because it will generate economic profits for a longer stretch of time. It's kind of like paying more for car that you can drive for a decade versus a clunker that is likely to conk out in a few years.

It is not hard today to think of the thousands of once hot businesses that no longer exist. Everything from the hoop skirt, to horse drawn carriages, to fast-growing technology has seen its competitive advantage disappear overnight when another business launched a better product into the market.

A good company however can weather the storms. Take a company like Coca-Cola. Do you remember when they introduced the new Coke? Or how about Coke 2? These were both complete flops that cost the company a lot of money. But because Coca-Cola could fall back on its core brand neither mistakes killed the company. McDonald's is another example of this. McDonald's iconic brand enabled it to retool and bounce back many times. Building this kind of awareness in your mind, to see moats where others don't, and then buying them during temporary market corrections can be a huge advantage to you.

So let's review the key points here.

1. The value of the business is equal to all the cash it will generate in the future.
2. A business that can profitably generate cash for a long time is worth more today than a business that may be profitable for only a short time.
3. Return on capital is the best way to judge a company's profitability. That simply means how good a company is at taking investors' money and generating a profit on it.
4. Economic moats can protect companies from competitors, helping them earn more money for a long time, and therefore making them more valuable to an investor.

The next chapter deals with the challenge of mistaken moats. There is a common saying, "bet on the jockey not on the horse." When you translate that into business terms it means the quality of the business itself is more important than the quality of the management team. On Wall Street the focus is often on short-term results. Therefore, it is easy to confuse fleeting good news with the characteristics of long-term competitive advantage. So it is easy to get caught up in what is called, "mistaken moats." Often you will hear phrases like, "they have great products, they have a strong market share, they have great execution, or, they have great management." These kinds of phrases can trap you into thinking that a company is good when it actually is not.

A good example is General Motors during the 1980s when they came out with a minivan. Chrysler had a monopoly on this market for a couple of years. But it did not take long for the competition to figure it out. So it would be easy to assume that Chrysler was a strong company to invest in. And that may have been temporarily true. But quickly Chrysler lost its edge on the minivan. So what would be the smarter investment? There was a small auto parts supplier named Gentex that owned a bunch of patents for products that were used on the minivan. No matter what company built the minivans, they had to get these parts from Gentex. So as the minivan craze escalated, and every car company in the world was building a minivan, Gentex became and still is a very strong company. Therefore, Gentex would be the better company to invest in.

Remember, unless a company has an economic moat protecting its business, the competition will soon arrive on the doorstep and eat away its profits. Wall Street is littered with the dead corpses of companies that went from hero to zero in a few days.

Another trap is that people often think bigger is better. But in highly competitive markets this is often not true. Look at companies like Kodak film—the only dominant player in the film industry. One little change in technology to the digital camera basically put it out of business. There are millions of examples like this.

So the question we have to ask is not whether a firm has high market share, but rather how the company achieved that share. Always ask how they achieved it and this will give you insight into how strong their dominant position is.

Sometimes people ask the question, "Isn't running a tight ship a competitive advantage?" And the answer is no. It is not enough to be more efficient than your competitors. Being efficient is good, but it is not a sustainable competitive advantage unless it's based on a process that cannot be easily copied, or that a new technology will make irrelevant.

What about a very talented CEO? It is true a strong management team may help a company perform better. But again it does not necessarily mean a strong company. How do you know that the brilliant manager that you're hanging your hopes on will still be with the company a few years down the road?

So we are left with the question, if great products, high market share, efficient operations, and smart executives, are all unreliable findings of a strong company, what should we look for? Basically four things:

1. A company that has specific brands, patents, or licenses, that allow it to sell products or services that can't be matched by competitors.
2. A company that has products or services that are hard for loyal customers to give up or it would cost the customer too much to switch.
3. A company that works with a network that locks out other competitors for a long time.
4. A company that has a distinct cost advantage because of the way it can process things, its location, or its access to a unique asset that allows them to

offer goods and services at a lower cost than their competitors.

With these four points you can locate companies regardless of their size, age, or industry. It is important to separate companies that have these competitive advantages from companies without them.

The next chapter deals with intangible assets. These are the kind of things that you can't put on the shelf and visibly see and handle, but they have great value—things like brands, patents, regulatory licenses, or ideas that cause companies to establish unique positions in the marketplace. A company with any one of these advantages has a mini-monopoly which can make it a very strong company.

However, one of the most common mistakes investors make concerning brands is assuming that a well-known brand gives the business a competitive advantage. Nothing could be farther from the truth. You have to ask whether the company is able to charge a premium for their product compared to a competing product. Let's look at a few examples such as The Sony Company, Tiffany, and the USG Corporation. All three of these companies sell products that many other people sell. Sony sells electronics just like Panasonic, Samsung, etc. Tiffany sells diamonds like a thousand other companies. USG sells sheet rock like other companies. Yet all three of these businesses dominate their markets. Why? What makes them the market leader when other companies like them that sell very similar products are not? It is basically the brand. People believe in the Sony brand. Sony is able to charge more for a camcorder than Panasonic, because people trust the Sony brand. Sony products last longer. Sony products have a better warranty. Sony products don't break down.

In cases like Tiffany, their brand is actually absurd. They sell the same diamond as all the others. There is literally no difference. But they charge at least a third more, and they get it! How can this be? The answer is really stupid. It's the little blue box they sell the diamond in. They own the patent on this special little blue box. Somehow there is an emotional attachment that when you hand your wife the little blue box from Tiffany's, it shows that you really care and that you bought her the very best. How Tiffany was able to pull this off I have no idea, but it works. If customers will pay more for a product, or purchase it on a regular basis, simply because of the brand, then you have strong evidence of a moat.

In a similar way you have to be aware of patents. Patents can be challenged, and the more profitable the patent is, the more lawyers will be trying to come up with a way to attack it. As a general rule, you need to be careful of any company that relies on a small number of patented products for its profits.

One of the best simple rules is this: If you can find a company that can charge a premium price and has a monopoly without being regulated, you've probably found a company with a strong economic moat. As always, there are thousands of variances of this. Take the slot machine industry. There are only four companies involved in this business, and there hasn't been a competitor in years simply because of the incredible regulation on this industry. If you take the same principle into academics, having accreditation is a huge competitive advantage because a degree from a non-accredited school is worth far less to students than one from an accredited school. Accredited schools can also accept federally subsidized student loans. Another example are companies we typically call, "not in my backyard" companies. This would be companies such as waste haulers or a gravel pit. Who wants that in their backyard? Things like landfills or stone quarries can become extremely valuable. So the key to assessing intangible assets is to think about how much value they can create for a company, and how long they're going to last.

The next chapter is a very significant one and it covers switching costs. Especially today in the technical world we find ourselves, this is important. Switching costs is best illustrated by something as simple as when you purchase gas. The vast majority of people have no loyalty to any particular gas station company. If you exit off the highway and see a Shell station, an Exxon, or a Texaco, you are most likely not going to look at the company name but rather, which one has the cheapest gas? On the other hand, let's say you want to switch banks. Even though another bank may have cheaper fees and more services, it is difficult for customers to switch simply because it involves tedious work such as filling out forms, changing direct deposit or bill paying arrangements you've already made, or the delay of switching from one bank to another. It is really not that much work, but psychologically it is a huge factor to the majority of people who will not switch. So just by this simple example you can see that switching costs are a valuable competitive advantage. Especially is it an advantage if the company you are with charges you money if you switch and move to a competitor.

One of the areas we are seeing this in is small businesses that use QuickBooks or TurboTax. Both these software programs come from Intuit. It is a very smart company and offers the software quite economically because they know that loyalty is very high, and no small business wants to run the risk of switching to a different software accounting system because an important bit of financial data might get lost. On a larger scale, Oracle, the giant software company sells massive database programs to large companies. These companies use Oracle to store and retrieve huge amounts of data. Once they start with Oracle, it is almost impossible for them to move the data to another system and to reattach it to all the different programs it is yoked to. So Oracle has a huge advantage here.

Switching costs are everywhere, and should be one of your greatest considerations in finding a strong company to invest in. The stronger the psychological switch in people's mind, the better the company. Most people will always take the path of least resistance and just stay where they are. The majority of these good companies are not consumer-oriented such as retailers, restaurants, clothing stores, etc. You can walk from one clothing store to another or choose a different brand of toothpaste at the grocery store just as easily as at Wal-Mart. So it is hard for retailers and restaurants to have this competitive advantage. So look for companies that make it tough for customers to use a competitor's product or service. If customers are less likely to switch to another company, that company can charge more.

The next chapter deals with the network effect. It discusses the benefits of creating large networks of contacts. The more people you know, the more they can connect for their mutual benefit. In a similar way, businesses that benefit from the network effect are much more successful. Believe it or not, there are very few businesses that have this benefit.

For example, think about how many large credit card networks there are in the United States. The top four, Visa, MasterCard, American Express, and Discover, account for 85% of all spending on credit cards nationwide. That is a huge competitive advantage. It just makes a lot of sense—if the value of goods or service increases with the number of people using it, then the most valuable company will be the one that attracts the most users and soon will become a dominant network. And as a dominant network gets bigger, it also gets stronger.

Let me give another example. Most of you listening to this use Microsoft

Office. It costs quite a bit to purchase. But did you know there is a competitor called "Open Office"? It costs almost nothing and it works just as well as Microsoft Office. So why do so many of us use Microsoft Office and pay more? Simply because some of the Open Office files may not be compatible with Microsoft Office files. Microsoft has a huge network advantage.

Think of it this way. Most goods can only be used by one person at a time. For example, when I buy an earth mover from Caterpillar no one else can use it while I'm using it. But when I use a Visa card, millions of other cardholders can use the same kind of card at the same time. That's tremendous leverage! The network effect is an extremely powerful type of competitive advantage. It is most often found in a business that is based on sharing information or connecting users together. You don't see it very often in businesses that deal with physical goods.

The next chapter deals with having lower cost than the competition. Cost advantages are powerful, but they can also disappear very quickly. So as an investor, you need to be able to determine whether a company's cost advantage can be replicated by a competitor. Especially with today's global economy, a low-cost region of the world such as China, India, or the Philippines is something you have to really watch.

Cost advantages can come from 4 sources—a cheaper process, a better location, a unique asset, and/or a greater scale. A good example is Southwest Airlines which most of you have probably flown on. Southwest flies only one kind of jet, they minimize ground time with fast turnovers, and they cultivate an employee culture that rewards quick work. Southwest changed all the rules. Their pilots help clean the planes. They don't have to worry about international passengers. There is no first class, no assigned seats. All that adds up to a huge cost advantage. The one caution here is that these kinds of cost advantages can be duplicated by others quite quickly, so you have to watch this carefully.

Location can also be another type of cost advantage. A simple example is Ultra petroleum. This is a midsize energy firm that produces and sells natural gas at a very low cost because it owns property in a special part of Wyoming. This company purchased the land at a very cheap price and therefore is twice as profitable as most other gas companies. Most of their wells cost around $7 million to drill because of the location and the short depth. For other gas companies it costs $17-$25 million to drill. So cheaper processes, their locations, and unique resources can all create cost advantages.

The next chapter deals with the size advantage. Bigger can be better. This brings us to an area we need to discuss called, "scale advantages". You must know the difference between fixed cost and variable cost. For example, a grocery store has fixed costs like rent, utilities, and salaries. It also has variable costs such as the wholesale cost of products the store needs to stock the shelves. On the other hand, a real estate agent has very few fixed costs, but a large percentage of variable costs. As a general rule, the higher the level of fixed costs compared to variable costs, the more consolidated an industry tends to be. That's why there are very few automobile manufacturers, or microchip producers. But on the other hand, there are thousands of small real estate agencies, law offices, and accounting agencies.

Let's break it down a little bit further into three categories. Distribution. Manufacturing. Niche markets.

Distribution can be a huge advantage if it is big. For example, in the medical waste disposal industry there is a company called Stericycle. It is 15 times larger than its nearest competitor. So, let's say that the driver of the waste disposal vehicle drives 200 miles a day and stops at 50 facilities. The competition drives the same 200 miles but only stops at 15 facilities. Having more stops per route is obviously far more profitable. So Stericycle can under-price its competitors and still generate a higher profit.

Manufacturing also can be an advantage. The closer a factory is to 100% capacity, the more profitable it is. And the larger the factory, the easier it is to spread fixed costs like rent and utilities over a larger volume of production.

A niche market is one of the greatest advantages. Even if a company is not big, but it is larger than its competition in a specific market segment, it gives the company a huge advantage, often helping it build near monopolies.

Those three things together can help you identify companies that are good to invest in. Now let's look at some of the dangers. For example, what if companies lose their competitive advantage? Investing would be easy if all we had to do was look for companies with strong moats, buy them at a cheap price, and lock them away for years and eventually cash out with huge profits. But it doesn't work that way, especially today. Thirty years ago, Kodak was revolutionizing the way people took pictures. But the company died a slow death and the digital camera put the final nail in their coffin. Long-distance telephone was once a very profitable business, but today it is nearly obsolete.

All of these businesses possessed strong competitive advantages at one point in time. But the world changed. This kind of change can easily kill what was once a profitable investment. This is why it is critical to continuously monitor the competitive position of the companies in which you invest, and watch for signs that they might be eroding. This is especially true in areas of technology where a competitive advantage can disappear overnight if a better product hits the market.

Look again at companies like Eastman Kodak. I remember when they totally dominated the market for photographic film. Today it struggles and has lost 97% of its business due to the digital camera revolution. Newspapers were at one time one of the best businesses in the world. They generated cash through local news, advertising, and classifieds. But today most newspapers are going bankrupt due to the Internet where all this information can now be found free. Look what the Internet has done to telecommunications. I can sit in New Zealand with my mobile phone and make calls over the Internet for free anywhere in the world. AT&T charges me $2.99 per minute for the same call if I use their mobile service. That's why AT&T is hurting—it can't compete with something free.

There can also be industrial earthquakes. Remember the days when you used to go down to your local hardware store? Mom-and-pop hardware stores were everywhere. But they've now been largely replaced by Lowe's or Home Depot. The same has happened in manufacturing jobs. The availability of low-cost workforces in Eastern Europe or China has done massive damage to many manufacturing businesses. So, as you pick companies, constantly review them in this light and stay on top of things.

With all this background the question remains, what is the best way to measure a company's profitability? The basic answer is, look at how much profit the company is generating, compared to the amount of money invested in the business. From a numbers perspective, this is the real key to separating a great company from an average one. The job of a good company is to make money and invest it in its projects, products, or services to generate more money. The more capital that comes out compared to the amount that goes in, the better the business.

How then do we measure return on capital? There are three ways.

1. The return on assets. (ROA)
2. The return on equity. (ROE)
3. The return on invested capital. (ROIC)

Return on assets simply measures how much income a company generates per dollar of assets. It is a good place to start, and if you go to websites like MorningStar.com you can find this for just about any company. In a general sense, if you can find a company that generates an ROA of 7% or more, you have found a good company.

The return on equity measures the efficiency of a company and how they use their shareholders equity. In other words how much profit per dollar of the shareholders equity do they make? One of the things you have to be careful with when using ROE is that companies can take on a lot of debt, which makes their ROE look higher without actually becoming more profitable. So you also have to look at how much debt the company has. Typically, companies that can demonstrate ROE of 15% or better are strong companies.

The return on invested capital actually combines the best of both worlds. It measures the return on all capital invested in the company regardless of whether it is equity or debt. So it incorporates the debt issue, but removes the illusion of a false ROE. It also uses a different definition of profits that is more accurate, so the higher the ROIC the better the company.

The next chapter deals with management. The bottom line of the authors is that management matters a lot less than you might think. Long-term competitive advantage is rooted in the characteristics we have laid out so far in this book. Managers only have a limited amount of ability to affect these fundamentals. It is rare for the manager's decisions to have a big impact on a company's long-term competitive advantage. Managers typically adjust the <u>structural</u> characteristics of the company. To say this in a critical way, there's just not much you can do with an auto company that has structurally higher costs than the competition. There's nothing you can do with a fashion retailer who has an out-of-date brand. The best engineer in the world can't build a

10-story sandcastle. This is a very important area to understand when investing because CEOs typically get a lot of attention, and yet they are pretty insignificant. It's kind of like the president of the United States. Everybody focuses on him. He basically does nothing. It's the 514 members of Congress that make all the decisions and vote everything.

In the media today the CEOs are happy to have the publicity, and the media reporters love to write these kinds of stories—it is a win-win for both parties. But for investors it is easy to fall into the illusion that the CEO's control the fate of the company. It is inherent in human nature to tell stories and see patterns that actually do not exist. We feel better when we can identify a cause for every effect that we observe. By doing this we confuse the possible with the probable. And many investors fall into this trap. Don't base your investments on a CEO or great leader. Stack the odds in your favor with the fundamentals. Yes, management matters. Great managers can add value to a business, but management by itself is not a sustainable competitive advantage.

Let's take all this information now and take you through a three-step process you can use to determine a good company to invest in. Step number one is, "show me the money." Has the company generated decent returns in the past? When you analyze this, look at the returns on capital over as long a period of time as possible, remembering that a bad year or two in 20 years does not disqualify a company. Again, use the website MorningStar.com. I love this website for resource information like this.

Step two in the process is identifying a competitive advantage. Figure out why the company has been able to fend off competitors and generate excessive economic returns. Remember, it is possible that even a good company with a solid record of good returns may not be a good company to invest in if there's no specific reason why those returns will persist or continue into the future. Ask the hard questions. Does the company have an enduring brand? Or patents? Is it tough for customers to switch to competing products? Does it have sustainable lower costs? Does it benefit from network economics? Is it subject to a technical disruption or a shift in industry dynamics?

Step three is figuring out just how durable and long-lasting that advantage is likely to be. Can you face the future with this company with confidence? Let me give an example. John Deere & Co. has cranked out some very solid gains over the years. Yes, there have been slumps here and there, but overall it has been a super-strong company. Why? It fits almost all the tests. Farmers for 170 years have been extremely loyal to the John Deere brand. John Deere also has the largest dealer network which means they can quickly source and complete repairs on John Deere equipment which minimizes downtime during critical planting and harvesting seasons. The ability to get broken equipment up and running in short order is critical because John Deere's customers are extremely time sensitive. A farmer might use a $300,000 combine for only two weeks of the year, but if there is a breakdown in those two weeks he must have it repaired immediately. So John Deere has a long historical track record of generating returns on capital, it has very specific reasons that it can maintain that competitive edge, and it would be very difficult for any other company to overtake them. Once you get used to thinking in these patterns, you will start to analyze companies like this without even thinking, it will be second nature.

Then there is one more skill you want to develop. How much are you going to pay for the stock of this company? The price you pay for a stock is really important for your future investment returns. Even professionals who get paid to do this sometimes have a hard time. In simplistic terms, you always try to buy at a lower price than what is the most likely value of the business. So the question is, what is a company worth? The answer is a stock is worth the present value of all the cash it will generate in the future. That's it.

Some of the cash that a company generates pays operating expenses. Some gets reinvested back in the business. What's left over is called the free cash flow. Free cash flow is often called earnings. It is basically the amount of money left over from a business each year that is not needed to keep the company operating. I like to think about it as if I was renting a home. I get the rent money, then I have to pay for my mortgage, the upkeep of the building which is my operating expenses, some repairs which is my capital expenditures, taxes, and then after all expenses, whatever money is left over is my profit. That's what my company is worth—whatever cash it generates for me. A higher return on capital makes my business worth more. I know this seems simplistic but it is a most important concept.

Look at a business with four quick factors.

1. What is the likelihood that future cash flows will actually happen? (Risk)
2. How large will those cash flows likely be? (Growth)
3. How much investment will be needed to keep the business running in the

future? (Return on Capital)
4.   How long can the business generate excess profits? (A strong Economic Moat.)

There are three types of tools that can help you in this process.
1. Price multiples.
2. Yields.
3. Intrinsic value.

Before we use these tools, let's detour for a minute and ask the question, what drives stock returns? There are really only two things that make a stock go up or down—the investment return which is driven by earnings growth in dividends, and the speculative return driven by the changes in the price to earnings ratios. The investment return is simply the company's financial performance. This speculative return reflects more the excitement or pessimism of investors. A stock can go from $10 to $15 per share based on either one. You need to pay attention to valuation rather than a speculative return, because the mood of investors can change very quickly, often based on media bias on a day-to-day basis.

Let me give an example of what I mean. Microsoft has increased earnings at roughly 16% per year over the last 10 years. So 16% was the company's 10-year average investment return. Not bad at all. But Microsoft shares have appreciated at a rate of only 7% over the same 10 years. What does that tell us? It tells us the speculative return is negative. The investors buying shares are less than half of the company's investment return. This is happening because Apple is taking the market in investors' emotions. Apple has come out with all the new products, all the new software, their computers don't get viruses, and people perceive Microsoft as struggling. It keeps putting out new Windows-based programs promising to be better than the last one, but each version has more trouble. The Apple is so easy to use, but Microsoft keeps popping up with windows that you don't know what to do with. Apple gives you an English-speaking representative to talk to 24 hours a day. Microsoft out-sources to somebody in India that you can't understand on the phone.

Because of all this, Microsoft's shares 10 years ago were valued at a price to earnings ratio of 50, but today it is just 20. I would not invest in a company like that. On the other hand Apple in less than two years has seen its shares go from $90 to near $400. Apple's price to earning ratios are through the ceiling right now. That's a good company.

Let's get another example going the other way. Let's take Adobe. They produce Photoshop, Acrobat, and a bunch of other image processing software products. Over the last 10 years Adobe's earnings have increased 13% per year. Again, that's the investment return. But the shares have appreciated almost twice that rate at 24% over the last 10 years. That simply means the investors have a lot of emotion and excitement about this company. Therefore the price to earning ratio has gone up from 17 to 45. That's a huge amount of speculative return! I would not invest in that. Half the price of the company is based on human emotion.

That is why valuation is so important. By paying close attention to valuation, you're maximizing the impact of the things you can forecast such as a company's financial performance as well as your future investment returns, and at the same time minimizing the impact of something you can't forecast.

OK, with that background let's go a little bit deeper into price multiples. The first one is the price to sales ratio. That simply means you take the current price of the stock and divide it by the sales per share. Low margin businesses such as retailers typically have very low price to sales ratios. Other companies such as software or pharmaceuticals have high price to sales ratios. So use this tool with an understanding that it applies differently to different businesses.

The second one is the price to book ratio. This compares the company's market price with its book value. Book value means all the physical capital invested in the company such as factories, computers, real estate, inventory, etc. In other words the basic stuff that a company physically owns has a value. The key here is what does the "book" represent? A company that has a lot of assets like railroads has a book value that represents the bulk of the assets that generate money—things like locomotives, factories, and inventory. On the other hand, a technology firm generates its money through people, ideas, and processes. None of those have a book value. Book value is most useful when you are assessing financial companies to invest in. This is where you can apply that principle the best.

As you have seen by now, every price multiple has a good and a bad side. But this is especially true when it comes to price to earning ratios. Price to earnings ratios can be very useful when used in the right way. I like to encourage people to look at a company and how it has performed in good times and bad, and then look into the future to see if this can get better or worse using the price to earning ratio. Price-to-earnings ratios are also valuable to compare with a competing business. So the best way to use this is to look for companies whose multiples are trading lower than normal, but still have strong growth prospects, strong returns on capital forecast, and a competitive position.

One of my favorite principles is cash flow from operations. Cash flow can represent a more accurate picture of a company's profit potential, simply because it shows how much cash is flowing in and out of the business. Earnings on the other hand are subject to a lot of adjustments.

Here's an example. Publishers usually have a higher cash flow than earnings because people pay for a year's worth of magazines before they actually receive them. On the other hand a business that sells things on credit like a store selling televisions will have higher earnings than cash flow, because the store will record earnings as soon as you walk out of the door with the television, even though it won't get your money until you send in your monthly payments. As you might guess, it's an advantage when your customers pay you before you do anything for them. The one caution with cash flow is to remember that it does not take into account depreciation. For some companies this is a big deal.

Okay, it's time to wrap it all up. Let's summarize everything with five basic principles.
1. Always remember the four drivers of valuation. Risk, return on capital, competitive advantage, and growth. Pay less for riskier stocks, and pay more for companies with higher returns on capital, pay more for companies with strong competitive advantages, pay more for companies with higher growth prospects.
2. Use multiple tools. If one ratio indicates that a company is cheap, use another indicator. When multiple indicators are saying the same thing, you can move forward with confidence.
3. Be patient. Good businesses do not trade in great prices very often, so you want to have a watch list of good companies that you would love to own at the right price, and then wait patiently for that price and jump. Remember that not making money beats losing money any day!
4. Be tough. The odds are good that everyone will be telling you not to invest at precisely the time you should be. Remember, prices get cheaper

when the news is bad and investors overreact. Most often you will be buying when everyone else is selling.

5. Be yourself. You will make better investment decisions based on your own hard-won knowledge than anyone else who will handle your finances for you. I always tell people no one takes better care of your money than you.

To be a truly good investor you have to go beyond what the typical person does. Read broadly. I especially encourage you to read the Wall Street Journal, Fortune magazine, Barrons, and MorningStar. Good investing basically boils down to knowing more than the person sitting beside you.

I hope you have found these tools to be helpful as you continue to be a good steward of God's money.

Leo