

Buying and Selling: let the MR data do the talking

There are many ways to use the Merriam Report data, but ultimately it boils down to whether or not a security's current price reflects the improving or deteriorating signals and indicators presented in our analysis.

Beauty may well be *"in the eye of the beholder"* but objective analysis is the key to determining how attractive an investment is. We start by comparing the current stock price to its price six or seven months prior.

Undervalued Stocks: As a general rule, we consider a stock to be potentially undervalued if a stock's current price is less than or near its price 6-7 months ago **and**:

- DCF trends are bullish (confirmed and recent)
- Accrual ratio trending bullish in recent quarters
- Moderation or decline in Goodwill as a % of assets and stockholder equity

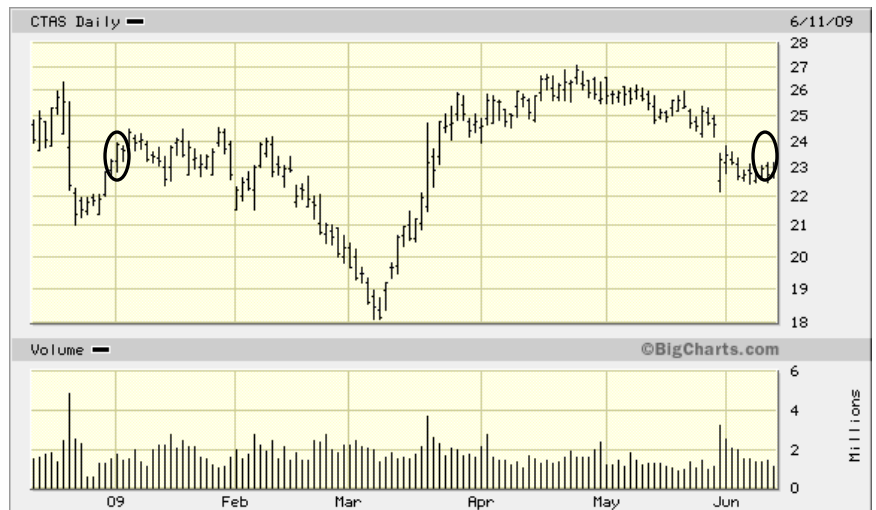
Again, these are general considerations, but the chart of Cintas Corp. (CTAS) helps to illustrate our point. For the five quarters ending March 31, 2009, the Merriam Report analysis indicated that earnings quality had been steadily improving.

In mid-June 2009, CTAS shares were trading at the same price as in January (both circled).

On June 12, we issued a **BUY** recommendation on Cintas. As of Sept. 25, 2009, CTAS is up 33% compared to a 16% in the S&P 500.

Cintas is in a highly cyclical industry and suffering along with everybody else.

Falling sales is a given, but the MR analysis provided good clues that management was doing a good job in minding the store.



Overvalued Stocks: As a general rule, we consider a stock to be potentially overvalued if its current price is more than or near its price 6-7 months ago **and**:

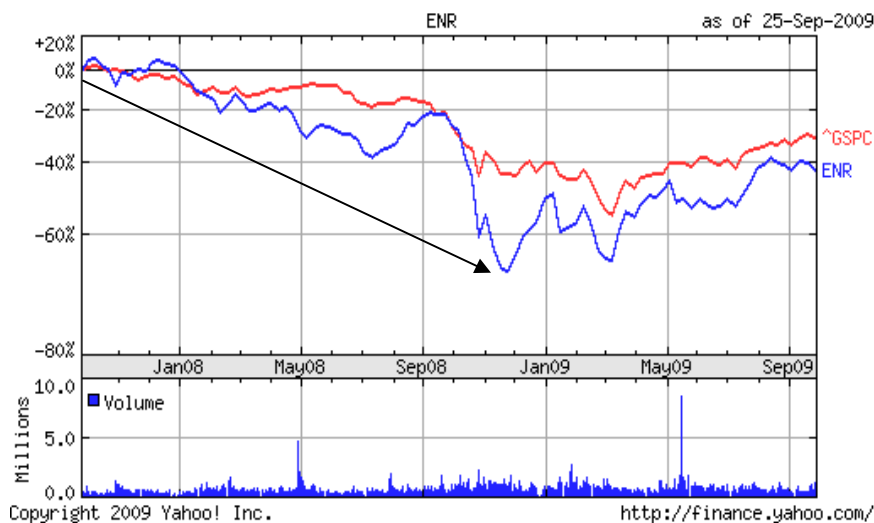
- DCF trends are bearish (confirmed and recent)
- Accrual ratio trending bearish in recent quarters
- Rising levels of Goodwill as a % of assets and stockholder equity

In contrast to the general characteristics of an undervalued security, a company with deteriorating earnings quality can often be propped-up by momentum traders, analysts using conventional fundamental methods, etc. Unfortunately, the red-flags get disguised by shifts in perfectly legal accounting techniques employed by management to push reckoning day further out.

A perfect example of this is Energizer Holdings (ENR). In a Merriam Report for the five quarters ending June 2008, our analysis showed a significant decline in earnings quality appearing in the quarter ending Dec. 2007.

The **big** problem we saw was a huge spike in Property, Plant & Equip. along with a bigger hike in liabilities on the balance sheet. Although December 2007 earnings increased 46% on a 36% rise in revenues, the accrual ratio skyrocketed and remained elevated through June 2008.

In ENR's case, the accrual ratios were lofty enough to give even the most seasoned mountain Sherpa altitude-sickness.



On August 26, 2008, we issued an **AVOID** opinion on ENR due almost entirely on the bearish accrual trends.

When the June 2008 qtr. earnings were released, inventory as a % of sales leapt from 54% the prior qtr. to 75% at end of June '08.

Needless to say, inventory is two-steps away from cash, but the company simply wasn't getting any return on the spike in added capacity.

Investors caught wind of this

and by late November 2008, ENR shares had lost some 65% of their value (arrow above) as compared to a 30% decline in the S&P 500 over a similar period.

Hypothetical Scenarios: The Merriam Report is not a market timing tool, but its uniquely predictive analysis has shown to be effective at determining potential value of a security. Note: The following information is intended solely for illustrative purposes only

If **MR** data is indicating an improvement in earnings quality, but a stock price appears to be fully-valued, consider the bonds, preferred shares and/or options associated with the equity.

Like bonds, preferred shares have a "par", (the price at IPO and expected redemption price). It's not uncommon for the debt and or preferred classes of a security to be mispriced (and under par) even though the stock price is showing accumulation.

Similarly, if the data indicates deterioration in earnings quality and the stock price remains elevated, you could:

- Short the stock (which involves borrowing shares from a broker)
- Or, buy "put" options

The rules regarding short sales have tightened considerably, but if you are on the wrong side of the bet (and the stock price rises), you will be forced to cover the position at a much higher price than you borrowed the security at.

Options on the other hand are not suitable for all investors, but they allow one to participate in upside moves (using "call" options) or downside moves (using "put" options) with a much smaller capital investment risk.

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