

Business Week

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HELP FOR INVESTORS

How to spot trouble

Scott W. Schoelzel is a very successful investor. As manager of the Janus Twenty Fund, he boasts a three-year average annual return of 28%. Even with this year's rocky market, he has managed to post an impressive 21% gain through August. One reason for his success: The \$9.3 billion fund is limited to holding about 30 stocks, so he has time to carefully monitor each one. As a result, he managed to dodge such bullets as Sunbeam Corp., selling his shares long before the collapse that lopped off 86% of its value.

So what are the tricks of the trade? While no one--not even a savvy investor such as Schoelzel--can spot the sort of accounting fraud that led to the collapse of Cendant Corp.'s stock, there are plenty of places investors can check to test how healthy a company really is. If you know where to look in the financial statements, it's not that hard to spot the kind of aggressive accounting that can lead to a financial meltdown. And if you know how to carefully read analysts' reports, they too can be packed with useful information. Here's a short guide on how to look for those elusive clues to a company's changing fortunes.

WATCH THE CASH FLOW

A company posting strong net income growth but negative cash flow could be in trouble. You'll want to look at cash flow from operations, a breakout of which appears in company quarterly and annual filings. Since this cash flow represents the revenue a company is getting from customers minus its out-of-pocket costs, it's the purest measure of how strong core operations are. If cash flow from operations is growing more slowly than net income, or not at all, management is relying on something else for earnings growth. If that something proves to be accounting gimmickry, trouble may not be far off.

COMPARE REVENUES AND RECEIVABLES

Annual reports list sales for the last three years on the consolidated statement of operations. Two years of "accounts receivable" are found in the consolidated balance sheet. Calculate each rate of growth. If receivables are piling up faster than sales, the company is not getting paid for the revenue it is booking. Any unusual spikes in receivables, up or down, can indicate some kind of revenue manipulation--and that may lead to future earnings problems.

GET OUT THE MAGNIFYING GLASS

The fine-print footnotes to financial statements can be dry reading. But forge ahead, since

they contain important information. The size of a restructuring reserve, along with the details of how much has been spent so far and on what, are broken out in a footnote. This is the place to check if money is being fed back, through the reversal of the charges, to pad income. If so, when the reserves run out, earnings may weaken.

Companies total their in-process R&D write-offs under "operating costs and expenses" on the consolidated statements of income. But there should be a detailed footnote, too. The details are often minimal, though that can change when regulators are watching. After the Securities & Exchange Commission started asking questions about such charges at Envoy Corp., management penned five pages of explanation about three deals, points out Pat McConnell of Bear, Stearns & Co. That kind of information can help you assess whether management has made a smart move or just blown a lot of cash.

CHECK BEYOND EARNINGS

Looking at a multiple of measures to size up a company will minimize the risks of making an investment based on earnings numbers that have been manipulated. In a slowing economy, professional investors suggest focusing on debt levels (they shouldn't be climbing too quickly), gross margins (if they're falling, a company may be selling goods at fire-sale rates to maintain market share), and inventory levels (growth here could signal a dearth of sales). "No one thing tells you the entire story, but taken together it gives you a good picture," says Schoelzel. Even if you're loath to search through a company's financials yourself--or just love to pore over research reports from your broker--you shouldn't take Wall Street's advice without a very large grain of salt. In going through the analysts' reports, there are a number of things to watch out for as well.

BEWARE INVESTMENT-BANKING LINKS

The first question to ask about any recommendation is if the analyst's firm is also the investment banker for the company. If so, that will appear in the fine print on a brokerage firm's report. If you hear about the recommendation by word of mouth or the media, dig deeper by calling the analyst's firm or the company's investor-relations department.

Be especially wary of early recommendations in the case of initial public offerings. The first recommendations usually come from the firm or firms that lead the underwriting. Kent L. Womack, a finance professor at Dartmouth College, says these bullish reports from the investment banker's analyst are usually issued when the stock is below the offering price. "That's why we call them booster shots," says Womack.

If an IPO starts to look like a winner, other analysts will start coverage. Womack studied stock-price behavior on the day buy recommendations were issued. Buys from analysts uninvolved in the underwriting resulted in a 3.5% price gain vs. a 1.5% gain for those from the underwriter's analyst.

DECIPHER THE RATINGS

Some firms use a simple three-part rating system--buy, hold, and sell--but most embellish

it. Robert S. Harris, a business professor at the University of Virginia, says adding gradations gives analysts "wiggle room" to avoid negative recommendations.

Some, like A.G. Edwards & Sons and Merrill Lynch & Co., use a five-rung ratings system: two levels of buy, a neutral, and two levels of sell. Many more stocks earn top grades than the bottom. Right now, 543 of 3,825 Merrill Lynch analyst recommendations are in the top rating. Only eight have an outright sell.

Some firms, like Morgan Stanley Dean Witter, use a four-part system: strong buy, outperform, neutral, and underperform. Notice that the system gives more prominence to telling investors to buy than to sell, which is couched as "underperform." It means the same thing. Who wants to hold a stock that's expected to be an underachiever?

At first blush, a hold, or "neutral" or "market performer" doesn't sound so bad. What's the harm in holding it, especially if the company is still sound? Maybe no harm if you're a long-term investor. But in the short run, the stock may get clobbered. Institutional investors may dump the stock. Their goal is to beat the market, so they can't afford to hold on to a stock that's only expected to match it. That's why many pros consider a hold to be a sell.

WATCH FOR DOWNGRADES

With Wall Street's bullish bias, any downgrading is bad news. Harris says downgrades have a far greater negative impact on stocks than upgrades have positive. Even moving from the highest to next-highest rating can trash a stock.

Big institutional investors know the analysts' pronouncements are not always what they seem. But unlike individual investors, they often meet and talk with analysts. "A wink, a nod, or some other body language tells more than the report," says Kevin Landis, portfolio manager of the Firsthand Technology Value Fund. "It's the individual investors who are most susceptible to misreading the ratings," says Bill Gurley, an ex-technology analyst, now a partner at Hummer Winblad Venture Partners. But if the individual knows how to look under the company's financial hood directly, chances are he or she will come a lot closer to getting the professionals' edge.