Get to the Heart of It

Assess Securities' Fundamentals

Objective A

Practice Makes Perfect

With your basic knowledge of investing, you're well on your way to making reasonable judgments about securities' values. Now, you need to *practice*. Let's do just that, by thoroughly assessing a stock from the Panera Bread Company.

Have you eaten at Panera? It wouldn't be surprising. According to Panera's web site, the company has 825 bakery-cafés in the U.S., up from 741 at the end of 2004. Panera is on the move, but is it a good investment choice for you? Let's take a look at Panera's fundamentals—how it makes money, how it competes, and how it has performed.

Panera Bread Company

You can find a basic company profile at Hoover's, Yahoo! Finance, ValueLine, Standard & Poor's, or BetterInvesting. After reading some profiles, see if you agree with this description of the Panera Bread Company:

> Based in Missouri, Panera (NASDAQ:PNRA) was originally organized in 1981 as Au Bon Pain Co., Inc., changing its name to Panera Bread Company in 1999. Panera targets suburban areas, offering fresh food products in a "fast casual" environment. Its stores, both company-owned and franchised, provide food for breakfast, lunch, dinner, snacks, and coffee breaks in a café atmosphere. In October of 2005, Panera operated 265 company-owned bakery-cafés and 560 franchises.

Objectives:

A Demonstrate procedures for assessing a stock's fundamentals.

B Demonstrate procedures for assessing a mutual fund's fundamentals.

So, Panera makes money by producing and selling fresh bakery products through a large network of retail locations. Does this mean Panera is part of the restaurant industry? Some sources say yes, identifying it as a restaurant in the consumer discretionary sector. Others say that Panera is part of the specialty eateries industry in the services sector. How you classify a company is not important in and of itself, but it does clarify a company's competition. Do you see Panera competing with restaurants in general or with other specialty eateries? Your opinion affects how well you think the company is going to perform. For this exercise, let's consider Panera to be part of the specialty eateries industry.

Other Qualitative Factors

What exactly is Panera's product? The menu (available at www.panerabread.com) includes iced green tea, sandwiches made with fresh-baked bread, and hand-tossed salads. The company is definitely on top of the trend toward offering more healthful food. It's on top of some other trends, too—offering coffee beverages, providing indulgent desserts, and focusing on the customer's "experience," as evidenced by made-to-order menu choices and free wireless Internet access.

What can we say about management? Co-founder Ronald Shaich is chairman and chief executive officer. According to the 2005 **proxy statement**, Shaich's 2004 salary and bonus totaled just under $1 million—a very reasonable sum for a company of Panera's size. In the proxy statement, you can also read about a number of Panera's managers—representing a wide variety of skills, experience, and education.

The Competition

On February 23, 2006, Panera had 31.14 million shares outstanding. With shares trading at about $71, **market capitalization** comes to $2.21 billion (31.14 x $71). Does that make Panera a leader in the specialty eateries industry? Not quite. Compared to Starbucks, Panera comes in a distant second. But, Panera is still very much ahead of the rest of the pack.

Specialty Eateries Industry

Company	Market Cap
Starbucks (SBUX)	27.82 billion
Panera (PNRA)	2.21 billion
Caribou Coffee Co., Inc. (CBOU)	161.28 million
Diedrich Coffee, Inc. (DDRX)	21.73 million
Flanigan's Enterprises, Inc. (BDL)	18.21 million

Source: Yahoo! Finance

In the 2004 annual report, CEO Shaich outlines plans for continued expansion, market research, and product development. Panera's team has managed to provide what consumers like, and it looks as if it intends to continue.

The Numbers

In fundamental analysis, investment experts often disagree about the ratios to consider. We'll stick with those we've grown to know and love: sales growth, EPS, profit margin, ROE, PE, and PEG.

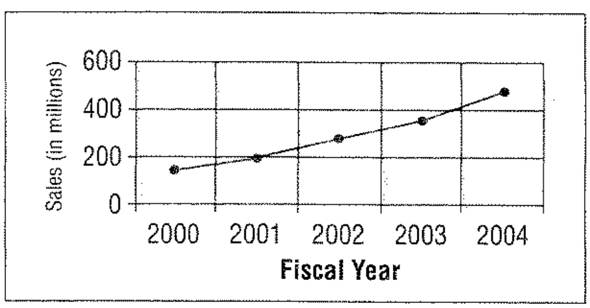
Sales growth. Two approaches to examining sales growth are helpful here. First, you can graph sales over time in order to *see* the growth visually. Second, you can calculate the exact change in sales from year to year—and then figure a long-term average. Over the last five years, sales at Panera have grown at a high, steady rate.

Panera Sales History

2000	2001	2002	2003	2004
151.1	201.1	277.8	355.9	479.1

Source: Standard & Poor's data from BetterInvesting.org

Panera Sales Growth



The steady growth in sales indicates a high-quality company. A company with the same rate of growth, but with sales that zigzag up and down from year to year, is less predictable and of lower quality.

Panera Change in Sales
(Year Two Revenue – Year One Revenue) / Year One Revenue

2000–2001	(201.1 – 151.1) / 151.1	33.1%
2001–2002	(277.8 – 201.1) / 201.1	38.1%
2002–2003	(355.9 – 277.8) / 277.8	28.1%
2003–2004	(479.1 – 355.9) / 355.9	34.6%
Average rate of annual sales growth 2000 through 2004		33.5%

An average growth rate of 33.5% is remarkable. Panera is not likely to sustain such a high rate, but the company has demonstrated that more than just good luck is behind its current success.

Earnings per share. These are EPS figures as reported by Standard & Poor's at the BetterInvesting web site:

Panera EPS History

Fiscal Year	2000	2001	2002	2003	2004
EPS	.28	.46	.73	1.01	1.25

Source: Standard & Poor's data from BetterInvesting.org

As you can see, earnings per share also increased steadily in the last five years, making Panera a true **growth company**. A growth company's sales and EPS grow at a rate greater than that of the market. Over the long term, Panera's sales and earnings growth should produce comparable growth in stock-price appreciation.

Profit margin. Pre-tax profit margin is considered a good measure of management's performance because managers have control of all of the expenses incurred—cost of goods sold, operating expenses, and interest—up to the point of taxes. Pre-tax profit margin can be interpreted as the amount of each sales dollar left before taxes are paid.

Panera Pre-Tax Profit Margin
Pre-Tax Profit / Sales

Fiscal Year	2000	2001	2002	2003	2004	5-yr avg
Sales	151.1	201.1	277.8	355.9	479.1	
Pre-Tax Profit	11.5	21.4	34.5	48.6	61.1	
Margin	7.6%	10.6%	12.4%	13.7%	12.8%	11.4%

Source: Standard & Poor's data from BetterInvesting.org

For 2000 through 2004, the average pre-tax profit margin is 11.4%, with an upward trend. As confirmation of this trend, in the most recent quarter (ending December 27, 2005), Panera reports a pre-tax profit margin of 14.7%.

Are these numbers worth getting excited about? Yes. The upward trend means that management is becoming more effective at controlling costs. And, Panera is doing as well as the industry leader, Starbucks, whose average is 11.3%.

Return on equity (ROE). ROE is another great measure of management's talent. Keep in mind the basic accounting equation, Assets = Liabilities + Shareholders' Equity—or stated another way, Assets – Liabilities = Shareholders' Equity. Shareholders' equity is what's left of a company's assets once liabilities are subtracted. ROE measures how well management turns that equity into more profit.

Panera Return on Equity (ROE)

Net Income / Shareholders' Equity

Fiscal Year	2000	2001	2002	2003	2004	5-yr avg
Net Income	7.2	13.1	21.8	30.7	38.5	
Shareholders' Equity	91.6	119.9	153.7	195.9	241.4	
ROE	7.9%	10.9%	14.2%	15.7%	15.9%	12.9%

Source: Standard & Poor's data from BetterInvesting.org

Panera's average ROE for 2000 through 2004 is 12.9%. (Reaching 10% is considered good.) As management becomes more skilled at running the company efficiently, ROE is expected to increase.

Price-earnings (PE). Now, *this* is a great ratio. PE tells you at a glance how much investors are willing to pay for each dollar of earnings. A PE of 62.3 means that Panera's investors are willing to pay $62.30 for every dollar of earnings. Compared to its historical PE average of 35.2, Panera's current PE is very high, perhaps indicating an overvalued stock.

Price-earnings and growth (PEG). The PEG ratio compares PE to earnings growth to see if investor expectations are supported by actual growth rates. The EPS used to calculate PEG is an estimate of *future* earnings per share, not the "trailing-twelve-months" number that typically appears in a stock table. Yahoo! Finance uses a five-year projection of growth and includes the PEG ratio on each stock's key statistics page. Here's how Panera compares to Starbucks:

Starbucks (SBUX)	2.16
Panera (PNRA)	1.63

When expectations and earnings are perfectly matched, PEG is 1. For both stocks here, investor expectations are high given projected earnings growth, resulting in PEGs greater than 1. (A PEG less than 1 is ideal, indicating that the market does not yet reflect the company's growth potential.) Although Panera and Starbucks may be overpriced, investors must judge for themselves if expected profits justify paying a high price.

Although many investors think Panera is a wise investment, others believe the company is due for a fall. Investors must draw their *own* conclusions when assessing a stock's fundamentals.

Mutual Benefits

Objective B

Assessing a mutual fund is different from assessing an individual stock. Instead of looking at the characteristics of specific companies, investors consider the companies' combined value. And, investors adjust the assessment process to suit the contents of the fund—whether stocks, bonds, or a mixture of stocks and bonds.

For practice, let's assess a stock fund called Hartford Growth Opportunities HLS IB (HBGOX). This fund is classified as a mid-cap growth fund. For simplicity, we'll call it "Hartford Growth."

Personality Profile

You may hear rave reviews about a particular fund, but there's no point in doing a lot of homework if the fund doesn't match your investment abilities or goals. First, check to see if the fund requires a minimum investment. Then, determine if you can spare the required amount of cash. Some funds require thousands of dollars to get started, but our example (Hartford Growth) requires no minimum initial investment.

Second, look at the fund's objective, strategy, and holdings. You can find these things in the fund's **prospectus**, usually available online. (For Hartford Growth, go to http://www.hartfordinvestor.com/common/prospectus/mutual_funds/p_mf_abc.pdf.) Or, you can find them in summaries from reputable research firms, such as Morningstar, Yahoo! Finance, and BetterInvesting. The Morningstar summary of Hartford Growth looks like this:

Investment Objective: The fund seeks short- and long-term capital appreciation.

Strategy: Under normal circumstances, the fund invests primarily in a diversified portfolio of common stocks covering a broad range of industries, companies, and market capitalizations that the fund's sub-advisor believes have superior growth potential. The fund may invest up to 20% of its total assets in foreign issuers and non-dollar securities.

Now we take a closer look at the portfolio. How well are the fund managers doing what they've set out to do? Consider these facts:

- ✔ Nearly 97% of the fund's investments are in stocks.
- ✔ Foreign companies make up about 20% of the fund's investments, the maximum stated in the fund's strategy.
- ✔ The stocks cover a broad range—103 companies across many industries.
- ✔ The fund's top 10 holdings represent 17.71% of its assets.
- ✔ Most of the stocks are from information technology (24.77%), followed by health care, consumer discretionary, and industrials.
- ✔ Holdings cover all cap-size categories:

Large	30.24%
Medium	45.72%
Small	23.94%

From this information, you can see that the managers are achieving their objectives.

What about the collective performance of the stocks within the fund? Just as with individual stocks, look for sales growth, earnings growth, and a reasonable PE ratio. According to BetterInvesting, the stocks in Hartford Growth reflect these numbers:

Sales Growth	33.9%
Trailing Earnings Growth	54.9%
PE Ratio	29.1

The fund's net asset value, or NAV, represents how much you'd have to pay per share to invest in the fund, but it is not a reliable indicator of value the same way that stock price is. To determine value of a mutual fund, an investor must consider the manager's performance and the cost of owning the fund, which are discussed below. Early in March 2006, Hartford Growth's NAV was $31.79.

Who's in Charge?

Assessing management of a mutual fund is the next step. You are, after all, paying for the fund manager's expertise. Specifically, the rate of return should compare favorably with the performance of the market as a whole.

Michael Carmen has managed the Hartford Growth fund since it was established in 2002. Over the last three years, Hartford Growth's total return percentage averaged 28.02, 10.92 better than the S&P 500. Not bad, but this is a relatively short track record. Some investors prefer managers with at least a five-year history.

A manager's performance is also measured by how often stocks are bought and sold, known as turnover. A turnover rate over 20% does ***not*** support a long-term, buy-and-hold strategy. Instead, it leads to higher brokerage costs and perhaps higher taxes. Hartford Growth has a turnover rate of 0%.

Remember **SPDR®?**

Minimize your mutual-fund expenses by purchasing index funds and/or exchange-traded funds—which require minimal or no fund management.

What's the Charge?

Costs, though sometimes hidden, are significant to accurate mutual-fund assessment because they can dramatically affect return. These costs include fees and taxes. There are two kinds of fees, each reported as a percentage of assets:

- Transaction or commission fees are called "loads." Loads can be paid at the "front end" when you buy into the fund or at the "back end" when you sell. Good news: Hartford Growth has no loads (known as a "no-load" mutual fund).
- Managerial fees are reflected in an **expense ratio**. The expense ratio includes the management fee (what the manager gets) and the 12b-1 fee, an ongoing charge for promotion. Hartford Growth has a reasonable expense ratio of 0.88%; similar funds have about 1.6%.

In addition to fees, there are capital gains taxes. Every time a fund manager sells a security, investors pay a tax on the difference between the purchase price and the selling price.

Whether you're looking for a fund that complements your current holdings, or one that is well-rounded in itself, you can use this basic knowledge of fund assessment to determine if an investment is right for *you*.