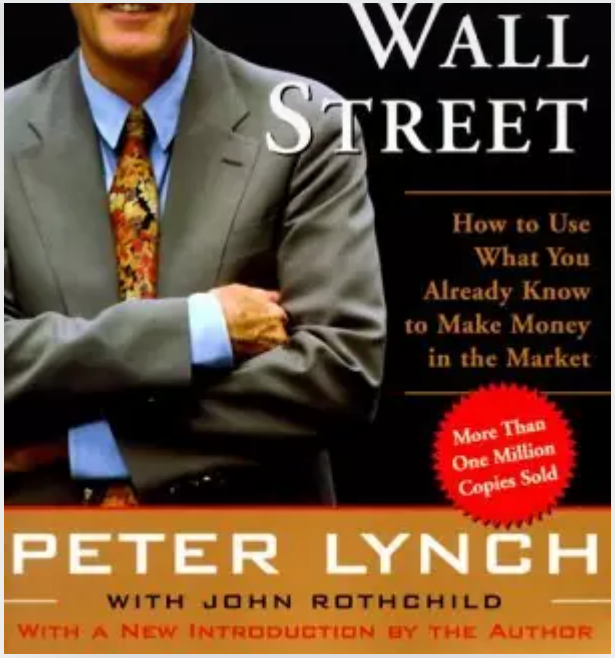
Peter Lynch's, One Up On Wall Street (Summary)



Posted on **December 14, 2020** by **Paul Paquin**

One Up On Wall Street Summary

Peter Lynch is one of the most successful investors of all time and the author of my favorite book on investing, “One Up On Wall Street.”

“Between 1977 and 1990, Lynch’s Fidelity Fund outperformed the market by a whopping 29% per year annualized. Lynch accomplished this by using fundamental principles and paying close attention to a firm’s growth prospects and “their story” (i.e., what it is that the company is going to do, or what is going to happen to bring the desired results), which the book One Up On Wall Street reveals. Lynch’s goal was to find growing companies at a reasonable price, or even better, find companies selling at a price/earnings ratio that is equal or less than its growth rate.

Investment Fundamentals

Lynch's fundamental way of investing centered around "when a company's earnings continue to rise year after year, the share price follows along."

According to Peter Lynch, when evaluating potential buying opportunities, one must consider:

- free cash flow (has the free cash flow been going down or rising over time?)
- long-term debt (has the company's long-term debt been rising over the last 5-10 years, or getting lower?)
- profit margins (have the company's profit margins been expanding?)
- price/earnings ratio (is it near the growth rate or less?)

These are a few examples of the fundamentals that Peter Lynch uses when picking stocks. Increased free cash flow, less debt, and widened profit margins are all positive signs. If a company's price/earnings ratio is less than its growth rate, this indicates a bargain.

How to Find a Company's Growth Rate?

says “Growth Estimates”. There you will find the growth estimate for the next five years and the past five years.

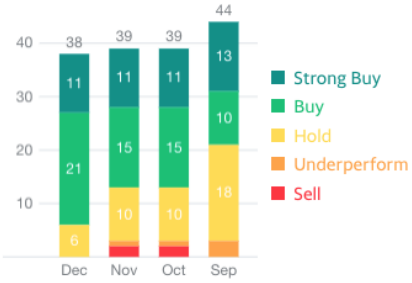
Earnings Estimate	Current Qtr. (Dec 2020)	Next Qtr. (Mar 2021)	Current Year (2021)	Next Year (2022)
No. of Analysts	29	27	38	35
Avg. Estimate	1.39	0.86	3.96	4.33
Low Estimate	1.23	0.7	3.41	3.55
High Estimate	1.58	1	4.45	5.07
Year Ago EPS	1.25	0.64	3.28	3.96

Revenue Estimate	Current Qtr. (Dec 2020)	Next Qtr. (Mar 2021)	Current Year (2021)	Next Year (2022)
No. of Analysts	26	25	35	32
Avg. Estimate	102B	72.61B	315.26B	332.07B
Low Estimate	97.74B	62.14B	284.31B	291.5B
High Estimate	110.88B	80.9B	341.13B	367.3B
Year Ago Sales	88.5B	58.31B	274.51B	315.26B
Sales Growth (year/est)	15.30%	24.50%	14.80%	5.30%

People Also Watch

Symbol	Last Price	Change	% Change
AMZN Amazon.com, Inc.	3,173.32	+56.91	+1.83%
FB Facebook, Inc.	274.55	+1.00	+0.36%
GOOG Alphabet Inc.	1,770.51	-11.26	-0.63%
TSLA Tesla, Inc.	640.06	+30.07	+4.93%
NFLX Netflix, Inc.	518.87	+15.65	+3.11%

Recommendation Trends ›



Growth Estimates	AAPL	Industry	Sector(s)	S&P 500
Current Qtr.	11.20%	N/A	N/A	N/A
Next Qtr.	34.40%	N/A	N/A	N/A
Current Year	20.70%	N/A	N/A	N/A
Next Year	9.30%	N/A	N/A	N/A
Next 5 Years (per annum)	12.64%	N/A	N/A	N/A
Past 5 Years (per annum)	8.42%	N/A	N/A	N/A

Look at the growth rate for the next five years, is it near the same or higher than the company's price to earnings ratio?

The PEG (price/earnings/growth) ratio of a company can quickly illustrate whether or not a company's growth rate is higher than its price/earnings. If the PEG ratio is below one, that means the growth rate is higher than the price to earnings ratio.

Here are some additional tips to consider when attempting to evaluate a company's financial situation, from the book "The Intelligent Investor":

When Picking Stocks!

ADEQUATE SIZE OF THE COMPANY

EXCLUDE SMALL COMPANIES THAT MAY BE SUBJECT TO MORE THAN THE AVERAGE VISCISSITUDESE

LONG-TERM DEBT

LONG-TERM DEBT SHOULD NOT EXCEED NET CURRENT ASSETS OR WORKING CAPITAL (DEBT/EQUITY RATIO OF < 1.0). THIS NUMBER CAN VARY PER INDUSTRY.

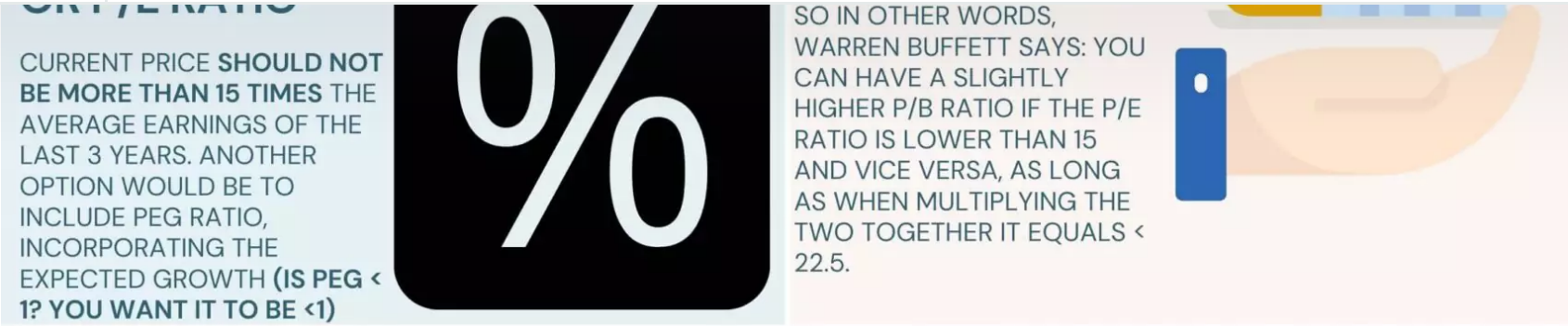
UNINTERRUPTED DIVIDENDS PAYMENTS

STRONG FINANCIAL SITUATION

CURRENT RATIO SHOULD BE ABOVE 1.5., MEANING, THE COMPANY HAS 1.5+ TIMES CURRENT ASSETS TO CURRENT LIABILITIES

EARNINGS STABILITY & GROWTH

1) ANY DEFICIT IN THE COMPANY'S EARNINGS OVER THE LAST 10 YRS? 2) HAS THE COMPANY GROWN BY AT LEAST 1/3 (USING 3 YR. AVERAGES OVER 10 YRS)?



Source The Intelligent Investor and Golden Financial Services, www.GoldenFS.org, June, 28th, 2020

Lynch especially favors companies that have a high cash to debt ratio. To figure out a company's net cash position refer to its consolidated balance sheet. Add up the "cash and cash items" plus marketable securities. Lynch will then check the long term debt. Your last step is to subtract the long-term debt from cash (assuming cash exceeds long-term debt), and that's your "net cash minus debt" total.

Using simple math here, let's take a stock selling for $10 per share with $0.50 per share of earnings and a p/e of 20. The company has total cash of $8 per share and long-term debt of $5 per share. Lynch will subtract the long-term debt from total cash, figuring out in this case, the company's net cash position is $3 per share. So what Lynch does next is will then subtract that $3 from the share price of $10, re-evaluating the enterprise value to be $7 per share. Enterprise value is what you would pay in a real transaction when buying another business, where cash and debt are normally included. With the new share price of $7 per share, the updated p/e ratio is 14.

You may be asking, but what about current liabilities (i.e., short-term debt)? Does Peter Lynch ignore it? Lynch does not pay any attention to short-term debt; as long as the total cash exceeds long term debt, he's comfortable with ignoring short-term debt.

During Lynch's introduction chapter, he discusses the following points;

Don't buy directly into "hope" (e.g., "it's the next Amazon or Apple").

Lynch explains:

What's one of today's hottest stocks that appear to be too expensive to invest in at this point?

Tesla (TSLA).

The company has a market cap of over $578 Billion and is selling for 1,000+times earnings. Many investors consider this overvalued. So, in Lynch's day, how would he go about getting in on Tesla without directly investing in it? Here's one possible way. Consider Tesla's most significant suppliers and manufacturers.

- AGC Automotive: windshields
- Brembo: brakes
- Fisher Dynamics: power seats
- Inteva Products: instrument panel
- Modine Manufacturing Co.: battery chiller
- Sika: acoustic dampers
- Stabilus: liftgate gas spring

In general, the Electric Vehicle (EV) industry is booming. Any time a new IPO comes out, and the phrase "EV" is included in the name, watch the stock price soar like a rocket ship, and in many cases these companies don't even have earnings yet! But how about considering the manufacturing companies that sell the parts to the EV industry, like perhaps a battery company?

Think outside the box. Amazon's price may be high too high at this point for some investors, but not the retail store that just partnered with Amazon to sell more clothes. A retail company that sells clothes could see a significant boost in sales after partnering with Amazon, one of the tops sites on the internet, considering that near 70% of all retail sales are done online. This is a move that HanesBrands just made!

How to get ideas:

Ideas are right in front of you.

Consider:

-Your favorite stores

-Items around your house

I looked around my house.

Apple TV on the wall.

Apple phone on the table.

Mastercard in my wallet.

Amazon Alexa next to the table.

Apple Watch on my wrist.

Boxes on the doorstep for my wife (in Amazon boxes).

A new LG smart refrigerator.

OK, so Amazon and Apple were clearly my starting points.

- Rising Free Cash Flow
- The company was buying back shares ($32 Billion worth in 2017, and more than double that in 2018)
- PEG Ratio close to 1 (remember, under 1 means growth rate is above price/earnings ratio, so between 1-2 is also favorable)
- A Debt/Equity ratio of under 1.0 (as of 2018)
- Current ratio above 1.0 (According to Investopedia: "A company with a **current ratio** less than one **does** not, in many cases, have the capital on hand to meet its short-term obligations if they were all due at once, while a **current ratio greater than** one indicates the company has the financial resources to remain solvent in the short-term.")
- Return on Equity near 50%, up from 36% in 2017 and 30% in 2013
- Average earnings rising over the last decade
- Cash and Cash Equivalent (including marketable securities) of $25 Billion in 2014, $41 Billion in 2015, $66 Billion in 2018, and already $90 Billion for 2020

Where do you go every day? Maybe, Starbucks or Dunkin Donuts? If you invested in either of these companies in the past, you would have made a profit by today.

The six categories to consider when investing in stocks:

1. Slower Growers, like Coca Cola KO (1-4% growth per year that pays dividends)
2. Stalwarts (10-12% growth per year)
3. Fast Growers, like Amazon (20+%)
4. Cyclicals, like Toyota (TM) and Nissan NSANY (profits rise and fall)
5. Turnarounds, like IBM (poor financial health including high debt currently, but in the process of improving financial situation)
6. Asset Plays, like Disney (lots of strong assets including land, films, and its brand)

A more detailed description of the six stages:

- Slow Growers: Large and aging companies expected to grow only slightly faster than the U.S. economy as a whole, but often paying large regular dividends. These are not among his favorites. Coca-Cola (KO) could be considered a slow grower as of 2020, but in Lynch's day it was considered a Stalwart.
- Stalwarts: Large companies that are still able to grow, with annual earnings growth rates of around 10% to 12%; examples include Coca-Cola, Procter & Gamble, and Bristol-Myers. If

Fast Growers: Small, aggressive new firms with annual earnings growth of 20% to 25% a year. These do not have to be in fast-growing industries, and in fact Lynch prefers those that are not. Fast-growers are among Lynch's favorites, and he says that an investor's biggest gains will come from this type of stock. However, they also carry considerable risk. Alibaba (BABA), Netflix (NFLX) and Amazon (AMZN) could be considered Fast Growers of 2020.

- Cyclicals: Companies in which sales and profits tend to rise and fall in somewhat predictable patterns based on the economic cycle; examples include companies in the auto industry, airlines and steel. Lynch warns that these firms can be mistaken for stalwarts by inexperienced investors, but share prices of cyclicals can drop dramatically during hard times. Thus, timing is crucial when investing in these firms, and Lynch says that investors must learn to detect the early signs that business is starting to turn down. Three of my favorite Cyclicals for 2020 include Toyota, Delta Airlines and Nissan.
- Turnarounds: Companies that have been battered down or depressed–Lynch calls these "no-growers"; his examples include Chrysler, Penn Central and General Public Utilities (owner of Three Mile Island). The stocks of successful turnarounds can move back up quickly, and Lynch points out that of all the categories, these upturns are least related to the general market. IBM, Lending Club (LC) and Hanesbrands (HBI) are examples of turnarounds in 2020.
- Asset opportunities: Companies that have assets that Wall Street analysts and others have overlooked. Lynch points to several general areas where asset plays can often be found–metals

source: California State University, https://www.csulb.edu/, 12/20/2020

Figure out what stage a company is in before investing in that company. Peter Lynch diversifies by investing in companies that are in these different stages.

Do you see a particular company opening up all over the place? That's a good sign and could indicate it's a fast grower.

Or, are you seeing stores shut down, like back in the Blockbuster days, or more recently Toys Are Us days? That's a bad sign.

Where will the future growth come from if the store is already on every corner in all countries? If the company can't keep growing, you may not want to invest in it, unless it pays a generous dividend and has a robust dividend track record and you're looking for an income paying stock.

These are some of the questions you need to ask yourself before investing in a company. Also, evaluate how a company performed during bad times, not just considering a company during good times. For example, how did the company hold up during 2008, 2009, and following, after financial disaster hit?

You can check a company's annual report and search for where it says "stock outstanding or Average # of shares of Capital." See if this number is getting lower. If the shares are shrinking, that means the company is buying back shares and is a great sign.

Peter Lynch Says, "Stop Listening to the Professionals!"

Lynch explains:

"Twenty years in this business convinces me that any average person using the customary three percent of the brain can select stocks just as well, if not better, than the average Wall Street stockbroker. I know you don't expect the plastic surgeon to advise you to do your own facelift, nor the plumber to tell you to install your hot-water tank, nor the hairdresser to recommend that you trim your own bangs, but this isn't surgery or plumbing or hairdressing. This is investing, where the smart money isn't so smart, and the dumb money isn't as dumb as it thinks. Dumb money is only dumb when it listens to smart money. "

Final Tips of the Intro-Chapter.

chooses to listen to the stockbroker that called him out of the blue the other day about Asynchronous Backward Compatibility.

You can easily be the analyst that tests out Hanes underwear and quickly realize that they are very comfortable and a great seller. You don't have to wait until a stockbroker calls you saying, "I just finished analyzing Hanes Underwear, and they are great!"

After a lifetime of buying cars, cameras, and computers, you start to realize what's low quality and what's high quality.

Researching Dunkin Donuts includes sipping their coffee. Why wait for a Morgan Stanley stock analyst to analyze the company when you can do it on your own. You've sipped the coffee and ate all of their donuts a hundred times and can see that new Dunkin Donuts franchises have just recently opened up in multiple towns nearby.

Of course, before buying any stock, Peter Lynch says:

"Just because the Cabbage Patch doll was the best-selling toy of this century, it couldn't save a mediocre company with a bad balance sheet."

You, as an individual investor, has multiple advantages over the Wall Street Analysts.

1. Morgan Stanley won't recommend a stock until the stock goes from at least $2 per share to $10 per share. The edge you have is that you noticed it at the $2 per share and can buy it at that low price. Some institutions can't recommend smaller companies, so when waiting for analysts to recommend them, you could miss all of the early years of growth.
2. You are free from the bureaucratic rules and short-term performance concerns that restrict Wall Street Analysts. Institutional investors don't want to look bad. They would rather buy a safe company that they can be confident knowing will give you a 3%-6% return (like IBM), rather than taking a chance investing in a "less established" company that could eventually produce results of tenfold. Nobody's going to get mad at their investment advisor if some unexpected result occurs that brings down IBM, but on the other side of the coin if Upwork or Twilio flops, a person may get very upset with their investment advisor because they never heard of these companies and will consider these "risky investments". But the truth is, in the last year both Upwork and Twilio could have doubled your money, while IBM not so much.
3. More restrictions: some institutional investors are not allowed to invest in companies that have a union, non-growth stocks, oil, and steel stocks. These restrictions can prevent you from taking advantage of many great opportunities when going through an investment firm. Institutions, like Fidelity, are regulated by the SEC. SEC says certain institutional investors cannot own more than

4. The local edge: Maybe it's a company that you use every day for your job, and you thoroughly understand this company better than any Wall Street Analyst.

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