Financial Tailor

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Getting to the Bottom Line

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President

Last week the markets continued to creep higher. In recent months, attention has been fixated on whether or not the Fed would continue with it's easy money policy. Fears of a slowing of the Fed's purchase of treasury bonds and mortgage backed securities led to a sharp rise in bond yields following June's Federal Open Market Committee (FOMC) meeting. However, the most recent July meeting showed little change to Fed policy except for a slight change in wording. The fed changed its wording of economic growth from "moderate" to "modest". This apparent wording downgrade to economic activity led many to believe that the Fed will not begin slowing its bond purchases any time soon. Later in the week, payroll data pointed to slower jobs growth which also helped drive interest rates back down.

Despite all the focus on Fedspeak and subtle interpretations in wording, there exists a real economy where businesses generate revenue and earn profits. This week we will focus on some of the fundamentals that will help explain earnings season.

S&P 500 Index

21.68 **1.28%**

Dow Jones Industrial Average

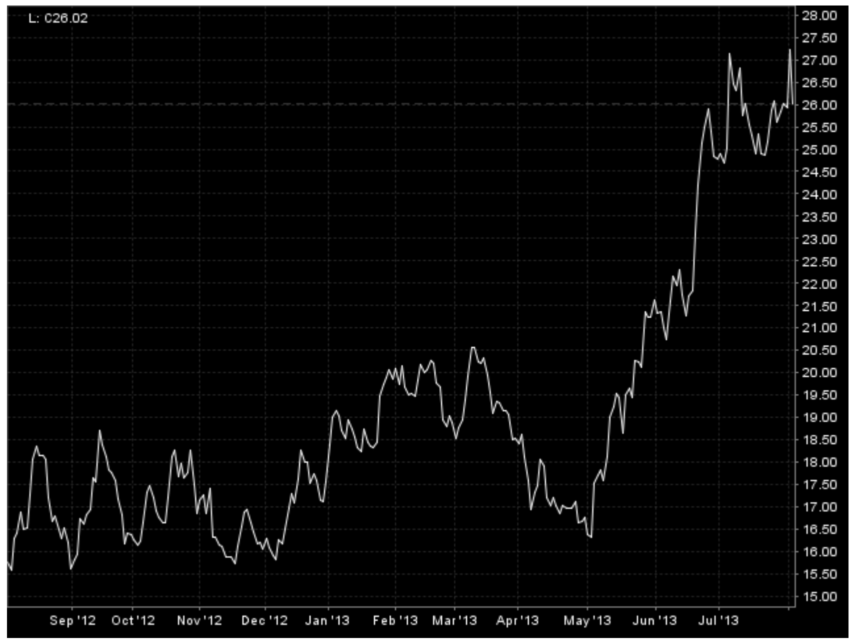
140.15 **0.90%**

NASDAQ Composite

82.8 **2.30%**

CBOE Ten Year Treasury Index

A reading of 26.00 is equivalent to 2.60% on the Ten Year Treasury



Earnings, Revenue, and Guidance

When a company reports earnings, investors look for information that will tell them how the company performed in the previous quarter. Since we are currently in the 3rd quarter, companies are now reporting 2nd quarter earnings. There is a lot of information that can be found in an earnings report, and depending on the type of company certain items may be more important than others, but typically the three most important pieces of information are earnings, revenue and forward guidance.

Revenue, also referred to as sales, gross income or top line, represents the total amount of money that a company derives from selling its product or service. After deducting costs associated with the sale known as 'cost of revenue' you can determine a company's gross profit.

Period Ending	**Jun 29, 2013**
Total Revenue	**35,323,000**
Cost of Revenue	22,299,000
Gross Profit	**13,024,000**

After determining gross profit, you can go on to determine a company's operating income which accounts for other operating expenses such as research and development and administrative expenses.

Gross Profit	**13,024,000**
Operating Expenses	
Research Development	1,178,000
Selling General and Administrative	2,645,000
Non Recurring	-
Others	-
Total Operating Expenses	-
Operating Income or Loss	**9,201,000**

At the very bottom you will find net income, which is why it is referred to as the bottom line. Net income represents a company's total earnings after accounting for taxes. Net income is the most commonly reported type of earnings. However, careful investors will look at the whole income statement as it can reveal issues with earnings quality. For example, a company's net income may seem better because of a large one time charge off such as an uncollectable debt.

Operating Income or Loss	**9,201,000**
Income from Continuing Operations	
Total Other Income/Expenses Net	234,000
Earnings Before Interest And Taxes	9,435,000
Interest Expense	-
Income Before Tax	9,435,000
Income Tax Expense	2,535,000
Minority Interest	-
Net Income From Continuing Ops	6,900,000
Non-recurring Events	
Discontinued Operations	-
Extraordinary Items	-
Effect Of Accounting Changes	-
Other Items	-
Net Income	**6,900,000**

Determining net income is more helpful if you know how many shares are available. Therefore, companies will report earnings per share (EPS), which is useful because it will show how much net income is earned per share of the business. The calculation is on the right.

EPS = Net Income* ÷ Average Outstanding Shares

While revenue and earnings will tell the investor about last quarter's performance, company's will often issue guidance on next quarter's earnings. An example of Apple's most recent guidance is shown in the box on the right. Analyst's will base next quarter's earnings and revenue expectations based on guidance. Novice investors are often perplexed when a company reports better than expected earnings and revenues, but the stock price falls the next day. This can often be attributed to forward guidance. If a company has a great quarter but expects to make less next quarter, that can be a big negative for a stock.

Apple is providing the following guidance for its fiscal 2013 fourth quarter:

• revenue between $34 billion and $37 billion

• gross margin between 36 percent and 37 percent

• operating expenses between $3.9 billion and $3.95 billion

• other income/(expense) of $200 million

• tax rate of 26.5%

Conclusion

In order to understand earnings season it is absolutely essential that investors understand at least the very basics of an income statement. Otherwise, investors can be left scratching their heads when the markets interpret good news as bad news. Next week we will look at some ratios that can help investors make sense of earnings and earnings quality.

* The full formula is Net Income minus the dividends on preferred stock. Dividends on preferred stock are a required payment if the company is profitable, while dividends on common stock are optional.

Strategic Allocation

Conservative   Aggressive

RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Neutral short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Neutral intermediate term debt

Overweight Long Term Debt, this asset class has been oversold as a result of market expectations of Fed tightening, we are slowly purchasing more long dated treasuries and TIPS at the higher yields.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Neutral Small Capitalization Stocks, we are recommending smaller companies with strong balance sheets and little need for short term debt financing.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Underweight Large Cap Stocks, We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will start looking to slowly increase REIT holdings now that selling has begun.

Overweight Commodities, we believe that we are now in a period of deflation, and that the selloff in commodities is largely tied to China. This selloff is likely overdone especially with respect to precious metals. We are bearish on oil prices.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are holding higher levels of U.S. dollars, but will begin reinvesting those dollars on future weakness.