Know When to Buy 'Em. Know When to Sell 'Em.

We would like to present to you a company whose business has performed consistently well for the last decade. We will show you the company's growth in sales and profitability. We will then examine how the stock has performed during this time frame and explore whether there have been any discrepancies between the business performance and the behavior of the stock price and, if so, why.

Before we tell you the name of the company and the nature of its business, let's look at some numbers.

In 2002, this Fortune 500 company had sales of $246.5 billion, net income of $8.0 billion, and earnings per share (EPS) of $1.81. Last year the company reported sales, net income, and EPS of $447.0 billion, $15.5 billion, and $4.45, respectively. This translates to compound annual growth rates (CAGR) of 6.8%, 7.6%, and 10.5%, respectively. The yearly figures are shown below.

Year	Sales ($B)	Net Income ($B)	EPS
2002	246.5	8.0	$1.81
2003	258.7	8.9	$2.03
2004	288.0	10.3	$2.41
2005	315.7	11.0	$2.63
2006	348.7	12.2	$2.92
2007	378.8	12.9	$3.16
2008	405.6	13.5	$3.42
2009	408.2	14.2	$3.66
2010	421.8	14.9	$4.07
2011	447.0	15.5	$4.45
Growth	81%	93%	146%
CAGR	6.8%	7.6%	10.5%

Source: Value Line

Further analysis of the numbers above shows a consistent pattern of profitability for the enterprise, with net income and EPS growing faster than sales. Profit margin (net income divided by sales) has increased from 3.2% in 2002 to 3.5% in 2011.

Coupled with this consistent growth in sales and earnings, the company has rewarded shareholders by paying increasing dividends and buying back shares. In 2002 the firm paid dividends totaling approximately $1.3 billion, or $0.30 per share; by 2011 that figure had grown to $5.0 billion, or $1.46 per share. Below is a summary of the yearly declared dividends per share and the common shares outstanding.

Year	Dividends per Share	Shares Out (B)
2002	$0.30	4.395
2003	$0.35	4.311
2004	$0.48	4.234
2005	$0.58	4.165
2006	$0.65	4.131
2007	$0.83	3.973
2008	$0.93	3.925
2009	$1.06	3.786
2010	$1.21	3.516
2011	$1.46	3.418
Growth	387%	-22%
CAGR	19.2%	-2.8%

Source: Value Line

As can be seen from the table above, dividends per share have increased at a much faster rate than sales and earnings, rising more than 19% a year since 2002. On the other hand, shares outstanding have decreased more than 20%, giving long-term holders of the stock a substantial increase in ownership without committing additional funds throughout the years (this also explains why EPS growth has been faster than net income growth).

Everyday Low Prices

As you may have guessed by now, the company we have been discussing is Wal-Mart Stores (WMT), the world's largest retailer. In 2002, the company operated just over 4,700 stores. Currently, Wal-Mart operates over 10,100 stores all over the world, comprised of 3,029 supercenters, 629 discount stores, 611 Sam's Clubs, and 210 Neighborhood Markets in the U.S., along with 5,651 foreign stores. Wal-Mart is a behemoth among behemoths, employing more than 2 million people. The next biggest employer among Fortune 500 members is IBM, with a little less than half a million employees.

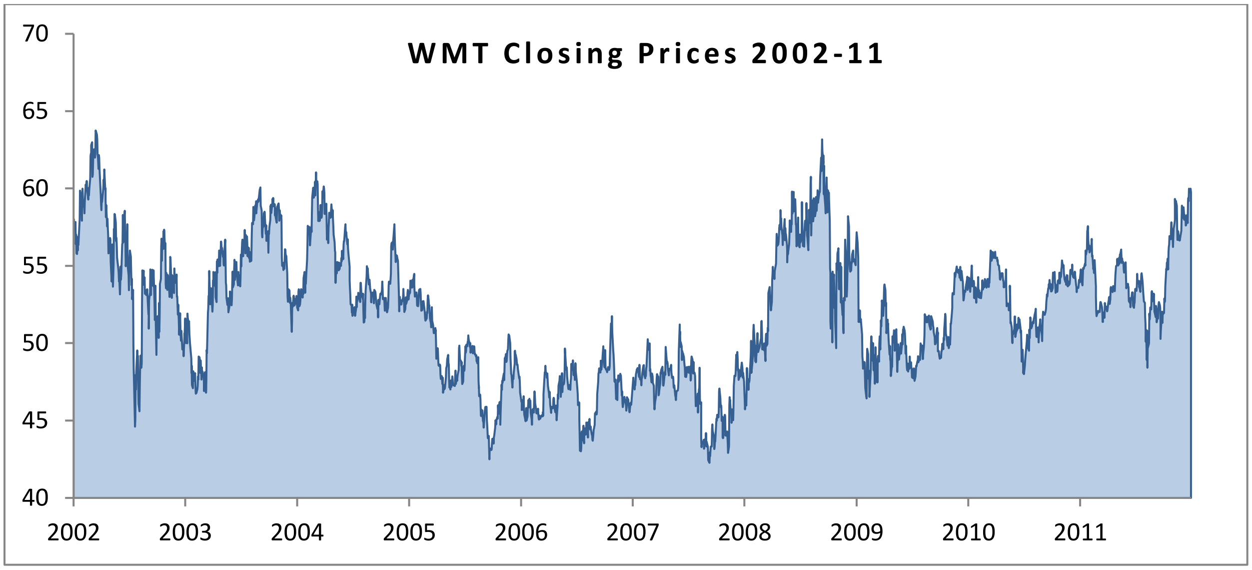
Wal-Mart's size, scope, processes, and efficiencies provide the company with a competitive advantage. Being the 800-pound gorilla in almost every market it competes in, the company is top-notch in every aspect of its business, from location scouting and merchandising to vendor relations, pricing, and inventory management. Though it is one of the largest companies in the world, it continues to grow not only by building new stores but also by continuing to increase its same-store-sales.

The solid performance of Wal-Mart's business in the last decade raises the question, how has the stock performed? Based on the numbers above, let's see if you can guess.

WMT's stock performance from the beginning of 2002 to the end of 2011 has been:

a) Up 80%
b) Up 150%
c) Up 400%
d) Basically flat

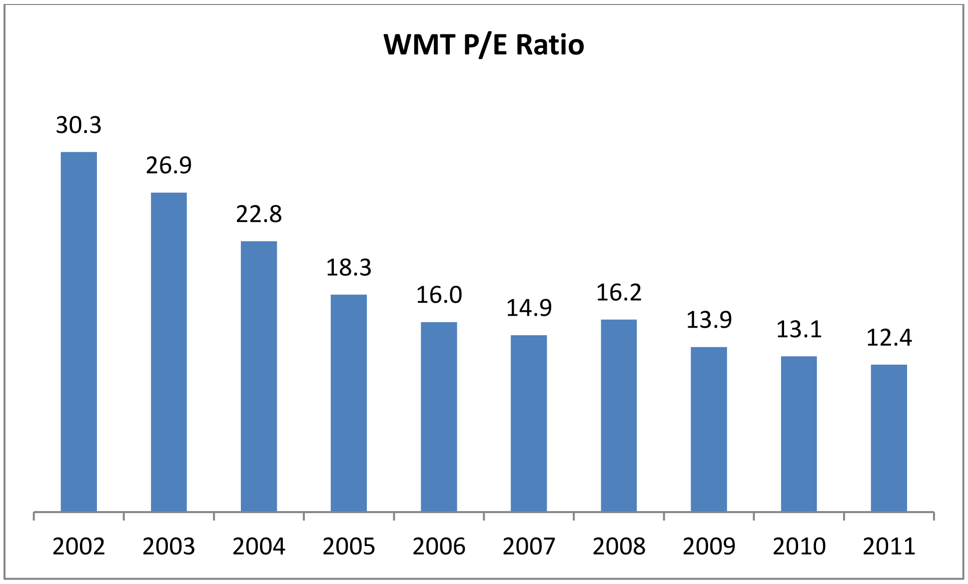
If you answered (b), you're probably thinking that the stock price appreciation mirrored the EPS growth during this period. That's a very logical thing to assume. But, you would be wrong. The actual answer, as illustrated by the graph below, is (d). That's right, WMT stock in the last ten years has basically gone nowhere. Of course, if you held the stock throughout this time, you would have enjoyed all the dividends, but, alas, not much in the area of capital gains.



Source: Yahoo! Finance

How is that possible?

It just so happens that since 2002, even as the business has consistently grown, investors have been willing to pay less and less for Wal-Mart's business performance (see graph below). In fact, the price to earnings ratio (P/E) of WMT in 2002 was 30. That means that in 2002 investors were willing to pay 30 dollars for every dollar of earnings generated by the company. Last year, WMT's P/E was just over 12, the lowest level since at least 1996 (as far back as we have data).



Source: Value Line

The Lesson

When buying a stock, it is not enough to recognize that a company is a great business. A great company does not necessarily equate to a great stock. Valuation is key. To use an analogy from horse racing, it is typically no secret which is the best horse or who is the best jockey in a race. But that does not necessarily mean one should bet on the horse; the odds must be taken into account.

In the case of Wal-Mart, investors were exuberant in their willingness to pay up for the stock a decade ago. Nowadays, investors feel the complete opposite, assigning very low expectations to the company. Starting from the current low valuation, we believe odds are good that the next decade will see better returns for WMT than the last one.

We should also point out that valuing a stock is just one consideration in deciding whether to buy. A valuation analysis should be used together with other qualitative, but equally important, considerations such as: the competitive advantages of a business and the sustainability of those advantages, the current and future dynamics of the industry, and the quality of management and its record in allocating capital.

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