## INVESTING 202

#### **OSHER LIFELONG LEARNING INSTITUTE**

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THE Haertzenteam WEALTHMANAGEMENT







## About Me: Matt Haertzen

#### **Professional Profile**

- MBA from the Carlson School of Management, University of Minnesota.
- Chartered Financial Analyst (CFA), and Certified Financial Planner (CFP)
- Lecturer of Finance at the Eller College of Management, University of Arizona.
- Former Senior Lecturer of Finance at the W.A. Franke College of Business, Northern Arizona University.
- Former Chief Investment Officer, Idaho State Endowment Fund, State Insurance Fund and Judge's Retirement Fund.
- Former Equity Portfolio Manager, Washington Trust Bank.

#### **Community and Volunteer**

- Volunteer Instructor at Osher Lifelong Learning Institute, Sedona and Tucson campuses.
- Former Board Member, Phoenix CFA Society.
- Career Day Presenter, Northland Preparatory Academy.

#### More about Matt

- Matt's son is attending Northern Arizona University.
- Matt's wife recently retired from teaching high school, and together they are figuring out how to be empty-nesters and snow birds in Tucson.
- In his free time, Matt enjoys golf, mountain biking, camping and fishing.







# Introduction to Valuation



#### Introduction to Valuation:

#### • Your ideas: How do you value a stock?





## The Present Value of Money



- The present value of future cash flows
- What money in the future is worth today

$$PV=FVrac{1}{\left( 1+r
ight) ^{n}}$$

Where:

- PV = Present Value
- FV = Future Value
- *R* = *Rate of Return*
- *N* = *Number* of *Periods*



#### Discount Rates: What is appropriate?

- Cost of Financing
- Opportunity cost presented by other investments
- Typically: Risk-free rate + risk premium





#### Warm-Up: The Present Value of Money

#### Warm Up Exercise A

Suppose you can earn a return of 1.75% on a 10-year U.S. Treasury Bond. Would you rather have \$975,000 today, or \$1 million a year from now?





#### Warm-Up: The Present Value of Money

Warm Up Exercises: B

How much will \$975,000 today be worth 5 years from now if invested at the same rate?







## Valuation Models



#### Dividend Discount Model

- Discount all expected future dividend payments.
- The basic DDM equation is:

$$\mathsf{P}_{0} = \frac{\mathsf{D}_{1}}{(1+k)} + \frac{\mathsf{D}_{2}}{(1+k)^{2}} + \frac{\mathsf{D}_{3}}{(1+k)^{3}} + \cdots + \frac{\mathsf{D}_{T}}{(1+k)^{T}}$$

Formula Key:

- P<sub>0</sub> = present value of all future dividends
- Dt = the dividend to be paid *t* years from now
- k = required rate of return





#### DDM: Constant Growth Model

- Assuming that the dividends will grow forever at a constant growth rate g.
- For constant perpetual dividend growth, the DDM formula becomes:

#### Formula Key:

- Po = present value of all future dividends
- D<sub>0</sub> = the dividend in year zero (now)
- D<sub>1</sub> = the dividend in year one
- k = required rate of return
- g = constant growth rate

$$\mathsf{P}_{0} = \frac{\mathsf{D}_{0} \times (1+g)}{k-g} = \frac{\mathsf{D}_{1}}{k-g}$$

(Important : g < k)



#### Warm Up: Constant Growth DDM

#### Warm Up Exercises: C & D





#### Warm Up: Constant Growth DDM

**C.** Suppose a company paid a \$5 annual dividend last year. With a constant growth rate of 2% and a required return of 5%, what is the price of the stock?



#### Warm Up: Constant Growth DDM

**D**. Suppose a company paid a \$0.50 quarterly dividend last year. With a constant growth rate of 5% and a required return of 8%, what is the price of the stock?



## Multi-Stage DDM

- The two-stage dividend growth model:
  - Initial growth phase
  - Perpetual growth stage
- The Two-Stage Dividend Growth Model formula is:

Formula Key:

- P<sub>0</sub> = present value of all future dividends
- D<sub>0</sub> = the dividend in year zero (now)
- k = required rate of return
- g<sub>s</sub> = initial growth rate
- g g = perpetual growth rate

$$\label{eq:Horizon value for stock} \text{Horizon value for stock} = \widehat{P}_{T} = \frac{D_{T+1}}{\textbf{k}_{s} - \textbf{g}_{L}} = \frac{D_{T}(1 + \textbf{g}_{L})}{\textbf{k}_{s} - \textbf{g}_{L}}$$

Value of stock =  $\widehat{P}_0 = PV$  of expected future dividends

$$= \frac{D_1}{(1 + k_s)^1} + \frac{D_2}{(1 + k_s)^2} + \dots + \frac{D_{\infty}}{(1 + k_s)^{\infty}}$$
$$= \sum_{t=1}^{\infty} \frac{D_t}{(1 + k_s)^t}$$

### Growth Rate: What is Appropriate?

The growth rate in dividends can be estimated by:

- Using the company's historical average growth rate.
- Using an industry median or average growth rate.
- Using the sustainable growth rate.

#### Free Cash Flow Model

• Simple formula to calculate Free Cash Flow, FCF:

FCF = EBIT\*(1-T) + Depreciation – Capital Spending – Change in Net Working Capital

- Possible for: Net Income < 0 and FCF > 0
- Depreciation and Capital Spending matter in FCF.

Formula Key:

- FCF = "free cash flow"
- EBIT = "earnings before interest & taxes"
- (1-T) = "1 minus the tax rate"



## FCF Approach: Inputs

- Estimate FCF:
  - Net Income
  - Depreciation
  - Capital Expenditures
- The growth rate of FCF
- The proper discount rate
- Tax rate
- Debt/Equity ratio
- Equity beta
- Calculate value using a "DDM" formula





## DDM vs FCF

#### • DDM

- Calculate a value of the equity only
- Use dividends, a cash flow only to equity holders
- DDM's use the CAPM to estimate required return
- DDM's use an equity beta to account for risk

#### • FCF

- Calculate a value for the firm
- Free cash flow can be paid to debt holders and to stockholders
- We can still calculate the value of equity using FCF
  - Calculate the value of the entire firm
  - Subtract out the value of debt and preferred stock
- Use beta for assets, not the equity, to account for risk







## Relative Valuation



## **Financial Ratios**

## Why do we use ratios?

- Reveal insights regarding profitability, liquidity, operational efficiency, and solvency
- Great for comparison of companies within similar industries
- Great for comparison of companies of different sizes





### Price Ratio Analysis

- Price-earnings ratio (P/E ratio)
  - Current stock price divided by annual earnings per share (EPS)

- Earnings yield
  - Inverse of the P/E ratio: earnings divided by price (E/P)
- High-P/E stocks are often referred to as growth stocks, while low-P/E stocks are often referred to as value stocks.

#### **Price/Earnings:**

- Consumer Discretionary
- Consumer Staples
- Healthcare
- Energy
- Technology
- Industrials
- Telecom



#### Shiller PE Ratio



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### Price Ratio Analysis

- Price-cash flow ratio (P/CF ratio)
  - Current stock price divided by current cash flow per share
  - In this context, cash flow is usually taken to be net income plus depreciation.
- Cash flow can be more informative than net income.
- Earnings and cash flows that are far from each other may be a signal of low-quality earnings.

#### **Price/Cash Flow:**

- Health Care
- Telecom
- Consumer Staples



## Price Ratio Analysis

#### • Price-sales ratio (P/S ratio)

- Current stock price divided by annual sales per share
- A high P/S ratio suggests high sales growth, while a low P/S ratio suggests sluggish sales growth.
- Price-book ratio (P/B ratio)
  - Market value of a company's common stock divided by its book (accounting) value of equity
  - A ratio bigger than 1.0 indicates that the firm is creating value for its stockholders.

#### **Price/Sales:**

- Consumer Discretionary
- Technology

#### **Price/Book:**

• Financials



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## **INVESTING 202**

DAY 2



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## Case Study





## **GENUINE PARTS COMPANY** (NYSE: GPC)

Current Stock Price: \$116.62





## Cost of Equity: Terminology

- **Risk Free Rate:** Rate of return attainable with no risk, commonly the 10-year treasury bond
- **Beta Coefficient:** volatility of a security compared to the overall market (Market = 1.0)
- **Expected Market Return:** Rate of return investors expect
- Cost of Equity: compensation market demands in exchange for owning the asset and bearing the risk of ownership



Risk % (Standard Deviation)

Source: corporate finance institute.com



## Application: Cost of Equity

/	A	В		
3	Cost of Equity			
4	Risk-free (rf)			
5	Beta (B)	1.26		
6	Exp. Market Return (rm)	7.25%		
7	Market Risk Premium (Mrp)			
8	Cost of Equity			

#### Risk Free Rate (10 Year Treasury Yield)



Cost of Equity= Risk Free Rate + Beta \* (Exp. Market Return – Risk Free Rate)

Excel Spreadsheet (Cell B8): =B4+B5\*(B6-B4)



### Application: Cost of Equity

#### Beta (measure of risk in comparison to overall market)



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## Solution: Cost of Equity

_	А	В
3	Cost of Equity	
4	Risk-free (rf)	1.54%
5	Beta (B)	1.26
6	Exp. Market Return (rm)	7.25%
7	Market Risk Premium (Mrp)	5.71%
8	Cost of Equity	8.74%

#### **Cost of Equity:**

8.74%



## Application: DDM Perpetual Growth

_	A	В	С
10	DDM - Perpetual Growth		
11	Do		Dividend in year zero
12	G		Dividend growth rate (5 year)
13	D1		
14	Stock Value		** Note: won't work if G > K

Stock Value = Dividend in first year (D1)/ Cost of Equity (K) - Growth Rate (G)

Excel Spreadsheet (Cell B14): B13/(B8-B12)



## Solution: DDM Perpetual Growth

/	A	В	С		
10	DDM - Perpetual Growth				
11	Do	3.16	Dividend in year zero		
12	G	5.50%	Dividend growth rate (5 year)		
13	D1	3.33			
14	Stock Value	103.05	** Note: won't work if G > K		

**Stock Price:** \$103.05



## Sustainable Growth Rate: Terminology

- **Return on Equity (ROE)** measure of profitability in relation to stockholder's equity. Calculated by dividing net income/ shareholder's equity (assets-debt)
- **Payout Ratio** Percentage of earnings that a company pays out as dividends
- **Retention Ratio** Opposite of payout ratio. Percentage of net income kept as retained earnings
- **Sustainable Growth Rate** The growth rate a company can sustain without having to finance growth with additional debt or equity





### Application: Sustainable Growth Rate

	D	E	F	G		
10	Sustainable Growth Rate					
11	ROE	20.66% *average of 2015-2019				
12	Payout Ratio		(Dividend/Earnings			
13	<b>Retention Ratio</b>		(1- Payout Ratio)			
14	SGR					
12 13 14	Retention Ratio		(1- Payout Ratio)	s rei Slid		

SGR = Return on Equity (ROE)\*(Retention Ratio)

Excel Spreadsheet (Cell E14): =E11\*E13



#### Solution: Sustainable Growth Rate

1	D	E	F	G	
10	Sustainable Growth	Rate			Sustainable
11	ROE	20.66%	*average of 2015	-2019	Growth Rate:
12	Payout Ratio	59.96%	(Dividend/Earning	8 27%	
13	<b>Retention Ratio</b>	40.04%	(1- Payout Ratio)		0.2770
14	SGR	8.27%			



## Application: DDM Two Stage

	А	В	С	D	E	F
16	DDM - Two Stage					
17	Rapid Growth Years	3	Group Estimate			
18	Growth Rate		Rapid growth estimate			
19	Terminal Growth Rate		Rate dividends will grow after the i	nitial phase?		
20						
21		Do	D1	D2	D3	D4
22	Dividend Forecast	2020	2021	2022	2023	2024
23		-				
24						
25	Terminal Value		Value of all dividends after the initial phase			
26						
27	PV Terminal Value		Discount at the cost of equity			
28	PV Div (1-3)		Discount at the cost of equity			
29	Stock Price					

Excel Spreadsheet (Cell B25): Terminal Value= F23/(B8-B19)

Excel Spreadsheet (Cell B27): PV Terminal Value= PV(B8,3,0,-B25)

Excel Spreadsheet (Cell B28) : PV Dividends (1-3)= NPV(B8, C23:E23)



## Solution: DDM Two Stage

	А	В	С	D	E	F
16	DDM - Two Stage					
17	Rapid Growth Years	3	Group Estimate			
18	Growth Rate	8.27%	Rapid growth estimate			
19	Terminal Growth Rate	5.00%	Rate dividends will grow after the	initial phase?		
20						
21		Do	D1	D2	D3	D4
22	Dividend Forecast	2020	2021	2022	2023	2024
23		3.16	3.42	3.70	4.01	4.21
24						
25	Terminal Value	112.75	Value of all dividends after the init	ial phase		
26						
27	PV Terminal Value	\$87.70	Discount at the cost of equity			
28	PV Div (1-3)	\$9.40	Discount at the cost of equity			
29	Stock Price	\$97.10				
30						

#### **Stock Price:** \$97.10



### Free Cash Flow: Terminology

- **EBIT ("Earnings Before Interest and Taxes")** Revenue minus expenses excluding taxes and interest, a.k.a. operating profit
- Capital Expenditures (CapEx) funds used by a company to acquire, upgrade, and maintain physical assets like property, plant, and equipment
- Net Working Capital (NWC) difference between operating current assets and operating current liabilities. Measure of liquidity, operating efficiency, and short-term financial health
- **Terminal Growth Rate** The rate at which a company will continue to grow in perpetuity (should not exceed GDP)





## Where can I find this Info?

- **10K (Annual), and 10Q (Quarterly) Reports** Reports pertinent business information, including financials
- Publicly traded companies are required by the SEC to provide information to their shareholders (and the public)
- Commonly found within an "investors" tab on a company's website
- *Read the fine print!*
- GPC Investor Relations

	UNITED STATES SECURITIES A	ND EXCHANO	GE COMMIS	SSIC	ON		
	washington	, D.C. 20549					
_	Form	10-K					
	ANNUAL REPORT PURSUANT TO SE OF 1934	CTION 13 OR 15	d) OF THE SE	CU	RITIES EXCH/	ANG	EACT
,	or the fiscal year ended December 31, 2020						
	TRANSITION REPORT PURSUANT TO ACT OF 1934	o Section 13 O	R 15(d) OF TH	E SI	ECURITIES EX	сн	ANGE
1	For the transition period from to						
	Commission file	number: 1-5690					
	GENUINE PAR (Exoct name of registrant	as specified in its charter)	PANY				
	GA				58-0254510		
(State or other juris	diction of incorporation or		(I.F	LS. E	mployer Identifica	tion N	io.)
or g	mization)						
2999 WILDV	/OOD PARKWAY,				20220		
(Address of prin	cipal executive offices)				(Zip Code)		
	Genuine Parts Compa Consolidated State	any and Subsidiaries ements of Income					
	(In Thousands, Except	per Share Amounts	)				
			30000	'ear E	Ended December 3	1,	2010
Net sales		s	16 537 433	\$	17 522 234	\$	2018
Cost of goods sold		3	10.882.592	φ	11,662,551	φ	11.311.85
Gross profit			5.654.841		5,859,683		5,519,75
Operating expenses:							
Selling, administrative and o	her expenses		4,386,739		4,577,610		4,241,203
Depreciation and amortization	n		272,842		257,263		227,584
Provision for doubtful account	nts		23,577		13,876		15,929
Restructuring costs			50,019		100,023		-
Goodwill impairment charge			506,721			_	
Total operating expenses			5,239,898		4,948,772		4,484,710
Non-operating expenses (incor	ne):		02 712		05 593		101.70
Other			(58 138)		95,505		(61.39)
Special termination costs			(50,150)		42.757		(01,000
Total non-operating expenses (	income)		35,575	-	51.628	_	40.40
Income before income taxes	,		379,368		859,283		994,63
Income taxes			215,973		212,808		245,10
Net income from continuing of	perations		163,395	_	646,475	_	749,53
Net (loss) income from discon	inued operations		(192,497)	_	(25,390)		60,940
Net (loss) income		\$	(29,102)	\$	621,085	\$	810,474
Basic (loss) earnings per sha	re:						
Continuing operations		\$	1.13	\$	4.44	\$	5.1
Discontinued operations			(1.33)	_	(0.18)		0.43
Basic (loss) earnings per share		\$	(0.20)	\$	4.26	\$	5.53
Diluted (loss) earnings per sh	are:						
Continuing operations		\$	1.13	\$	4.42	\$	5.09
Discontinued operations			(1.33)	_	(0.18)	_	0.4
Diluted (loss) earnings per sha	re	\$	(0.20)	\$	4.24	\$	5.5
Weighted average common sha	ires outstanding		144,474		145,736		146,653
Dilutive effect of stock options	and non-vested restricted stock awards		641	_	681	_	58-
Weighted average common sha	res outstanding — assuming dilution		145,115	_	146,417	_	147,24
						_	

See accompanying notes.



## Application: Free Cash Flows

	А	В	С	D	E	F
31	FCF Valuation					
32	Year	2020	2019	2018		
33	Operating Profit (EBIT)	1,009	1,076	1,145		
34					*tax rate (Value I	_ine)
35	EBIT * (1-T)				Calculate	
36	+ Depreciation			Value Line		
37	- CapEx			Value Line		
38	- Change in NWC				Value Line	
39	FCF				Calculate	
40						
41	Growth Rate (full period)					
42	Value Line Growth Est		Value Line			
43	Terminal Growth Rate	3.00%	Rate cash flows will grow after the i	nitial phase?		

#### Excel Spreadsheet (Cell B41): RATE(2,0,-D39,B39)



## Solution: Free Cash Flows

	А	В	С	D	E
31	FCF Valuation				
32	Year	2020	2019	2018	
33	<b>Operating Profit (EBIT)</b>	1,009	1,076	1,145	
34		24.00%	24.50%	24.10%	Value Line
35	EBIT * (1-T)	767	812	869	Calculate
36	+ Depreciation	273	270	242	Value Line
37	- CapEx	153	295	229	Value Line
38	- Change in NWC	(325)	(131)	(164)	Value Line
39	FCF	1,212	918	1,046	
40					
41	Growth Rate (full period)	7.64%	Calculate		
42	Value Line Growth Est	7.00%	Value Line		
43	Terminal Growth Rate	3.00%	Rate cash flows will grow after the	e initial phase?	



#### Application: Free Cash Flow Forecast & Present Values

1	А	В	C	D	E
45	FCF Forecast	2021	2022	2023	2024
46	FCF (use rate forecast)				
47					
48	Terminal Value		Value of all FCF after the initial pha	se	
49					
50	PV Terminal Value		Discount at the cost of equity		
51	PV CF (1-3)		Discount at the cost of equity		
52	Firm Value				
53	- Value of Debt		Value Line		
54	Value of Equity				
55					
56	Shares Outstanding		Value Line, in millions		
57	Price per Share				



#### Application: Free Cash Flow Forecast & Terminal Values

#### Let's do it together: Present Value Calculations in Excel

	A	В	C	
48	Terminal Value		Value of all FCF after the initial phase	B48 = E46/(B8-B43)
49				
50	PV Terminal Value		Discount at the cost of equity	<b>B50</b> = PV(B8,3,0,-B48)
51	PV CF (1-3)		Discount at the cost of equity	<b>B51</b> = NPV(B8, B46:D46)



#### Application: Free Cash Flow Forecast & Terminal Values

#### Let's do it together: Present Value Calculations in Excel





## Solution: Free Cash Flow

	А	В	C	D	E		
44							
45	FCF Forecast	2021	2022	2023	2024		
46	FCF (use rate forecast)	1,297	1,388	1,485	1,529		
47							
48	Terminal Value	26,665	Value of all FCF after the initial pha	/alue of all FCF after the initial phase			
49							
50	PV Terminal Value	20,741	Discount at the cost of equity				
51	PV CF (1-3)	3,521	Discount at the cost of equity				
52	Firm Value	24,262					
53	- Value of Debt	2,677	Value Line				
54	Value of Equity	21,585					
55							
56	Shares Outstanding	144	Value Line (in millions)				
57	Price per Share	149.90					

#### **Stock Price:** \$149.90



	А	В	С	D	E	F
59	Multiple Valuation					
60						
61	Year	2020	2019	2018	Average	
62	Year End Price	101.08	106.60	95.09		
63	EPS					Value Line
64	P/E Multiple					Calculate
65						
66	Sales per Share					Value Line
67	P/Sales Multiple					Calculate
68						
69	FCFF per Share					Value Line
70	P/Cash Flow Multiple					Calulate



	A	В	С	D	E	F
61	Year	2020	2019	2018	Average	
62	Year End Price	101.08	106.60	95.09		
63	EPS	5.27	5.69	5.68		Value Line
64	P/E Multiple	19.18	18.73	16.74	18.22	Calculate
65	EPS Growth Rates	-7.38%	-0.18%			Calculate
66						
67	Sales per Share	114.56	133.39	128.38		Value Line
68	P/Sales Multiple	0.88	0.80	0.74	0.81	Calculate
69	Sales Growth Rates	-14.12%	3.90%			Calculate
70						
71	FCFF per Share	7.19	7.59	7.39		Value Line
72	P/Cash Flow Multiple	14.06	14.04	12.87	13.66	Calulate
73	Cash Flow Growth Rates	-5.27%	2.71%			Calulate



#### **Question:**

## What are the right multiples to use? How Does GPC compare to competitors?





/	А	В	С	D	E	F
75	Forecast - Value Line	2021	Multiple	Price Forecast		
76	2021 EPS					Average
77	2021 Sales					
78	2021 Cash Flow					

#### Use average multiples (calculated above):

- P/E: 18.22
- P/S: 0.81
- P/CF: 13.66



## Solution: Multiple Valuation

1	А	В	С	D	E	F
75	Forecast - Value Line	2021	Multiple	<b>Price Forecast</b>		
76	2021 EPS	5.70	18.22	103.85		Average
77	2021 Sales	122.40	0.81	98.83		102.15
78	2021 Cash Flow	7.60	13.66	103.79		

#### Average Stock Price: \$102.15



#### Application: Comparable Companies

	A	В	С	D	E
80 Compa	rable Companies	ORLY	AZO	KMX	Average
81 P/E		21.6	18.0	28.5	22.7
82 P/S		3.2	2.5	1.1	2.3
83 P/CF		13.2	10.6	29.9	17.9









### Application: Comparable Companies

	А	В	C	D	E	F
88	Forecast- Comparables	2021	Multiple	Price Forecast		
89	2021 EPS					Average
90	2021 Sales					
91	2021 Cash Flow					

#### Use average multiples (calculated above):

- P/E: 22.7
- P/S: 2.27
- P/CF: 17.9





### **Solution:** Comparable Companies

Α	В	С	D	E	F
86 Forecast- Comparables	2021	Multiple	<b>Price Forecast</b>		
87 2021 EPS	5.70	22.7	129.39		Average
88 2021 Sales	122.40	2.27	277.44		180.96
89 2021 Cash Flow	7.60	17.9	136.04		
89 2021 Cash Flow	7.60	17.9	136.04		

#### Average Stock Price: \$180.96



## Application: Valuation Summary

#### And finally: putting it all together!

	А	В
94	Valuation Summary	
95	2-Stage DDM	
96	FCF	
97	Multiple Valuation	
98	Comparable Companies	
99	Average	
100	Current Stock Price	
101	Return Potential	



## Solution: Valuation Summary

	A	 В
92	Valuation Summary	
93	2-Stage DDM	\$ 99.83
94	FCF	\$ 155.49
95	Multiple Valuation	\$ 102.15
96	<b>Comparable Companies</b>	\$ 180.96
97	Average	\$ 134.61
98	Current Stock Price	116.62
99	Return Potential	15.42%



#### Conclusion: Your Rating

#### As a new analyst, what is your investment recommendation?





#### FOR JOINING US!



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