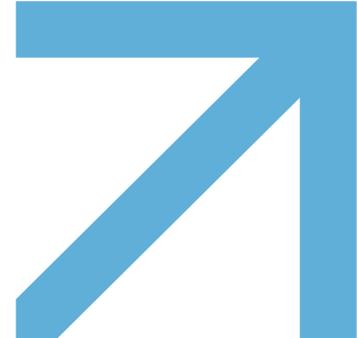


# The Golden Rules

A logical and consistent  
framework for sharemarket  
success

**Stock Doctor**  
Powered by Lincoln Indicators

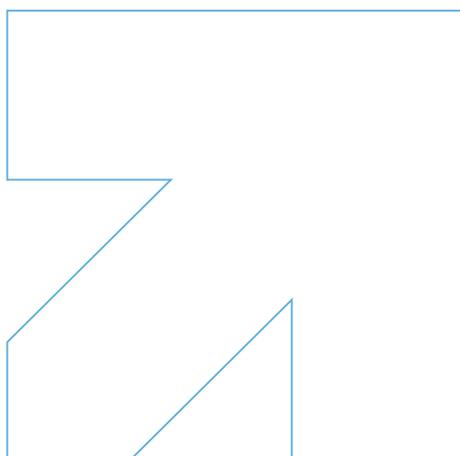
Invest in the numbers



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# About the author



Tim Lincoln

Tim is the Co-founder, Chief Investment Officer, and Managing Director of Lincoln Indicators and the custodian of its proprietary investment methodology and philosophies. Since 1997, he has overseen Lincoln Indicators strategic direction, product innovation, and funds management division.

Tim is motivated by a belief that sharemarket success has nothing to do with luck and everything to do with applied knowledge. He believes everyone can build a stable financial future with the right mindset, education, tools, and support.

He is driven to continue his father's legacy and share his proven investment methodology, coaching, and sharemarket investment solutions with thousands of Australians. Tim aims to continue Lincoln Indicator's mission to empower retail global stock market investors to successfully invest with control, confidence, and peace of mind.

# Brief history of Stock Doctor



Established in 1984, Lincoln Indicators is a specialised equities research house and boutique fund manager. It utilises a proprietary bottom-up quantitative financial screen (90%) with a qualitative risk overlay (10%) to identify high-quality stocks called Star Stocks and avoid potential disasters. It is available to all investors via Stock Doctor – Australia's premier DIY cloud-based sharemarket investment platform.

The cornerstone of the Stock Doctor platform is Lincoln Indicator's proven proprietary Financial Health Model, first developed by Dr Merv Lincoln some 30 years ago. Today, that methodology is available to every investor via Stock Doctor. Without it, conducting research and thorough due diligence across the 2,000-odd stocks on the ASX would not be achievable for many investors.

Stock Doctor is also the core research tool for Lincoln Indicators' Funds Management business. The strategies presented in this white paper are consistently applied to the management of our Australian and US funds.



# Introduction

For many, investing successfully in the sharemarket is jeopardised by a myriad of psychological hurdles. Booms and busts are driven by greed and fear while holding onto losing investments can stem from pride and hope.

Additionally, significant sharemarket events, such as The Global Financial Crisis or the Coronavirus pandemic, can influence investor behaviour and often cause people to make long-term investment decisions out of short-term fear or anxiety.

As a result, many people believe the markets are unpredictable and risky and approach investing with apprehension and timidity.

As well as being unpredictable, sharemarkets can also move with real impact and ferocity that can erode a substantial amount of investor capital in a single event. Unfortunately, in this situation, a well-diversified portfolio of stocks will do little to stem the decline in portfolio value.

It can be tempting to sell shares during a market correction, sit on the sidelines, and attempt to time yourself back in.

But no one has a crystal ball, and the act of re-entering the market is never as well-timed as investors would like.

And therein lies the importance of having a **well-defined investment framework** and, importantly, the discipline to see it through.

Because without a process to organise all the market information available, investors will always struggle to make strategic decisions and keep emotions and behavioural biases in check.

A framework helps investors to maintain focus, especially when exogenous events impact their portfolios.

During periods of uncertainty, the ability to **separate the fact from the noise** and the tenacity to stick to your investment framework could be the difference between achieving mediocre or superb investment performance.

Frameworks minimise the impact of misleading narratives because they use objective data rather than subjective opinions.

Armed with a proper investment framework, behavioural biases can be managed so that the sharemarket becomes a highly **rewarding asset class** rather than a high-risk one.

In this White Paper, we share Lincoln Indicator's investment framework – our **"9 Golden Rules of Investing"**. The first three **Primary Golden Rules** help investors identify exceptional investment opportunities while avoiding high-risk businesses. Our **Secondary Golden Rules** further tailor an investment approach to align with an investor's specific objectives and tolerance to risk.



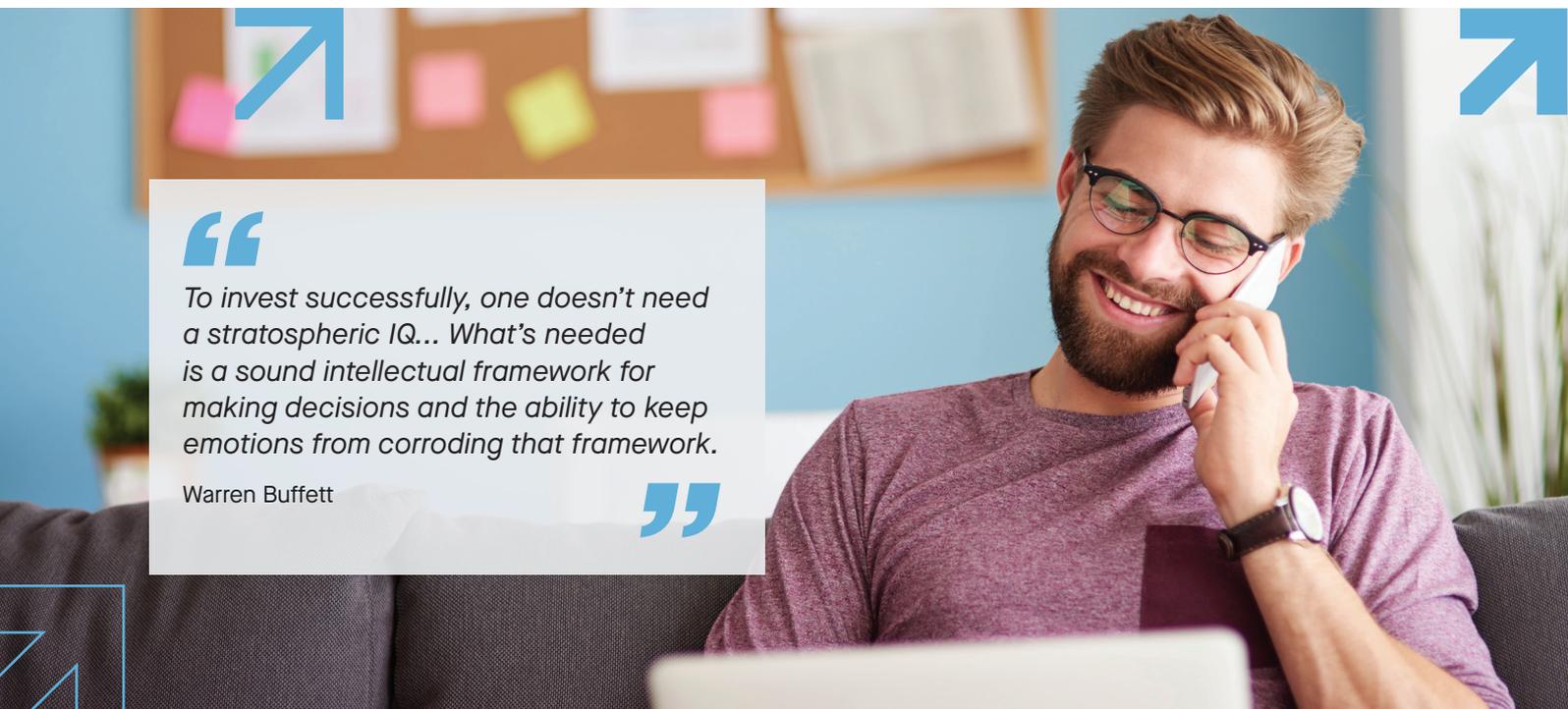
**Tim Lincoln**  
Co-Founder and Managing Director

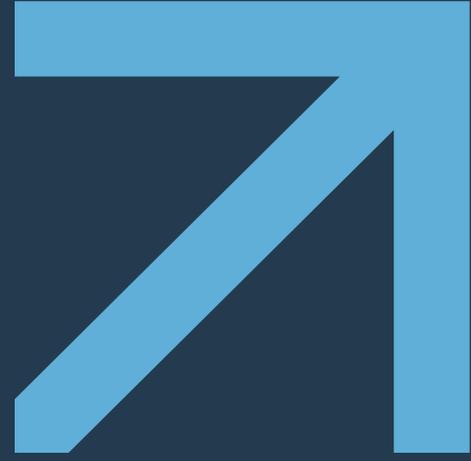
“

*To invest successfully, one doesn't need a stratospheric IQ... What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.*

Warren Buffett

”





# The Three Primary Golden Rules





## The Three Primary Golden Rules

At the core of our investment framework are Lincoln Indicators' **Primary Golden Rules**:

- ▶ **Golden Rule 1:** Financial Health
- ▶ **Golden Rule 2:** Past Financial Performance
- ▶ **Golden Rule 3:** Outlook and Active Risks

These three rules are the core pillars of our high-conviction stock selection strategy. They focus on high-quality businesses with robust fundamentals rather than on opinions and speculation. **Financial Health** remains the cornerstone of our approach and fuels our pursuit to **invest in the numbers**.

The utilisation of a quantitative approach to investing ensures objectivity, efficiency and, most importantly, **accountability** in decision making.

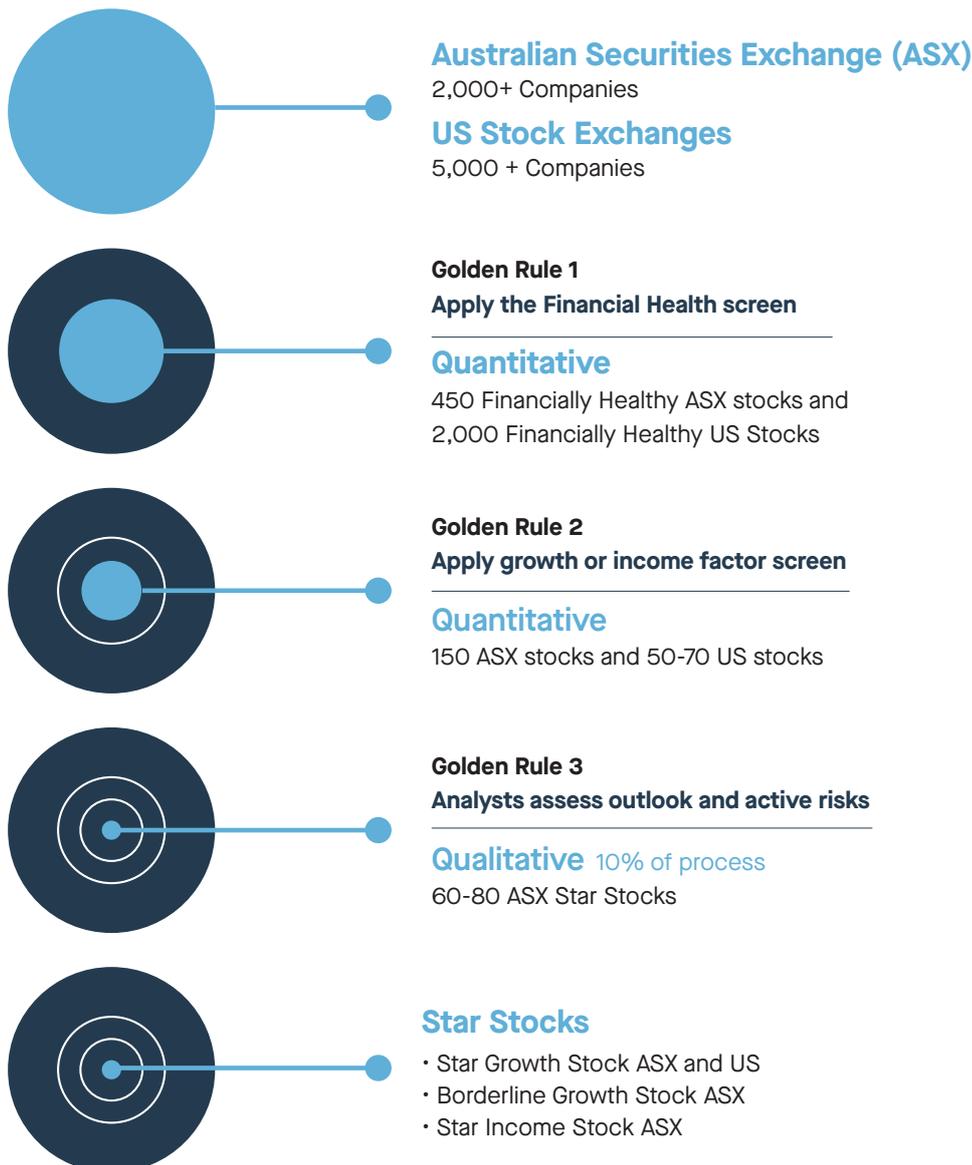
Through our quantitative **data-driven** approach, our **algorithms screen the financial accounts of some 5,000 listed US companies and 2,000 ASX companies**, typically within 24 hours of reporting,

to distinguish investment-grade businesses from speculative and high-risk ones.

From here, our Financial Health screen narrows its focus to 450 Financially Healthy ASX stocks and around 2,000 Financially Healthy US stocks.

But our analyses do not end there. We apply a further growth or income factor quantitative screen - **Golden Rule 2 Past Financial Performance** - that narrows our investment focus to 150 ASX stocks and 50-70 US stocks. From here, our team of analysts then conduct a qualitative assessment of **Outlook and Active Risks**.

It's from this process that our portfolios of Star Stocks are created. **Star Growth** and **Borderline Star Growth Stocks** are suitable for investors seeking long term capital appreciation. And **Star Income Stocks** are suitable for those who prefer a more sustainable income stream. For more information, refer to our [Star Stocks White Paper](#).



Golden Rule 1

# Financial Health

This fundamental investment framework principle encapsulates the thorough due diligence that investors need to undertake on a company's financial position before investing.

Put simply, Financial Health uses proprietary algorithms to analyse companies' financial accounts and calculate industry-specific profit, debt, asset, equity, and cash flow ratios.

The concept was first developed in Australia in 1983 by Lincoln Indicators founder - renowned academic, business leader, and Olympic athlete Dr Merv Lincoln. Later, in the 1990s, it was computerised **and commercialised** by Tim Lincoln, Lincoln Indicators Co-Founder and current Managing Director.

To this day, Financial Health is Lincoln Indicators first and foremost **Golden Rule of Investing**.

And while the process around Financial Health may be different from the 1980s, the focus remains the same: a data-driven objective analysis of a company's financials.

What was initially characterised by reams of paper and hours of individual data entry is today applied through extensive data capture processes and sophisticated computer algorithms.

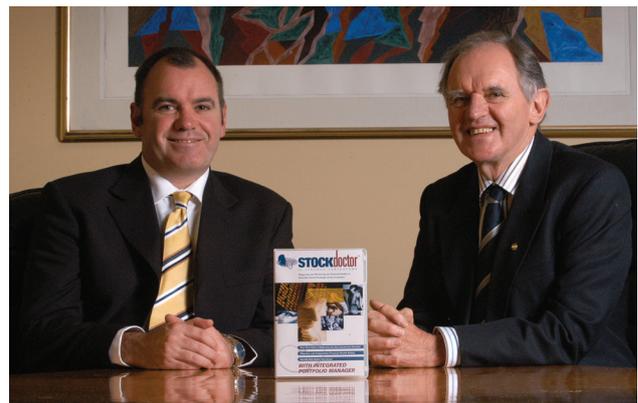
It's the result of years of innovation and investment in robust systems and thorough back-testing - a testament to the ground paved by Lincoln Indicators as one of Australia's first-ever true 'Fintech' companies.

Today, the Financial Health process analyses multiple sources of third-party market information with accuracy and speed, providing investors with objective, fast, quantitative research that cuts through all the market commentary and noise.

Since its inception in the 1980s, Lincoln's Financial Health Model has had approximately 95% **success rate of identifying corporate failures before they occur**.

It's helped investors avoid various significant corporate **collapses**, including Babcock & Brown, Dick Smith, and One.Tel. Investors should note that it is practically impossible to have a model that can predict failures at 100% accuracy as frauds and unforeseen economic disasters (tail events) can impact the assessment.

Many investors do not have the time or the technical expertise to perform **deep financial analysis and adequate due diligence on potential investments**. Knowing this is what drove Tim Lincoln to make the Financial Health model available to every investor - big and small - so that individuals, not just institutions, can benefit from Lincoln Indicators proprietary process.



Pictured above are left, Tim Lincoln, Co-Founder and Managing Director Lincoln Indicators, and right, Dr Merv Lincoln, Co-Founder Lincoln Indicators.

## Corporate failures we avoided



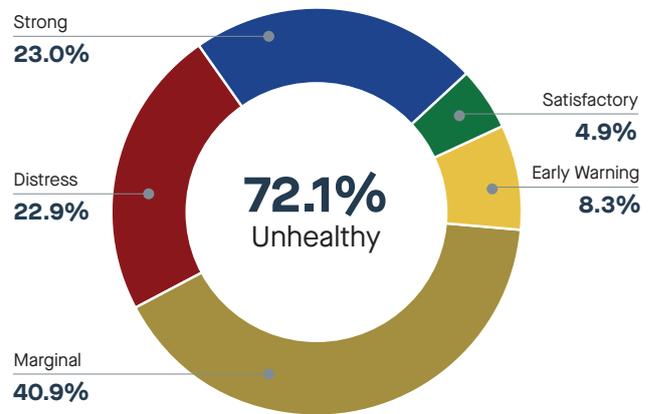
### How it works

A company's investment rating and insolvency risk is calculated by combining **14 key accounting ratios** extracted from its financial statements. The inputs encompass **debt, cash flow, and profit ratios**. Put simply, if a company is profitable, has manageable debt levels and strong cash flows, chances are it will be **Healthy**. However, if a company is loss-making, has high debt and poor cash flows it would almost certainly rank as **Unhealthy** and therefore not be investment grade.

It's no exaggeration to say that without understanding the financial health of a company investors are walking into a minefield - purely speculating and risking serious loss.

And, it's a minefield that has the potential to trap many. Currently, around **three-quarters of the market exhibit unacceptable levels of Financial Health**. This is one of the reasons why many people avoid the sharemarket, believing it is a high-risk asset class.

### Financial Health of the Market



As at 1 November 2021

[Click here to download the Financial Health White Paper](#)



*Without understanding the Financial Health and true quality of a business, investors are purely speculating and at risk of serious loss.*



Tim Lincoln

#### ★☆☆ ADH Adairs Limited



#### VAH Virgin Australia Holdings Limited



	Dec 16 (I)	Jun 17 (A)	Dec 19 ind. target	Dec 19 Rating	Jun 19 ind. group avg.	Dec 19 ind. group avg.
<b>Profit and Loss</b>						
RPTAI	-0.09	-0.13	> 0	Early Warning	-0.13	-0.13
PDACL	0.17	0.11	> 0.2	Satisfactory	0.71	0.60
<b>Balance Sheet</b>						
TLTAI	0.79	0.83	< 0.3283	Distress	1.55	1.43
CBTL	0.33	0.29	> 1	Early Warning	0.11	0.12
CATAI	0.36	0.31	< 0.54	Satisfactory	0.28	0.28
QLCL	0.85	0.88	> 0.96	Marginal	0.79	0.66
QACA	0.98	0.97	> 0.97	Early Warning	0.91	0.90
CLTL	0.45	0.49	< 0.7	Strong	0.28	0.28
CBTA	0.24	0.22	> 0.23	Early Warning	0.06	0.07
<b>Cash Flow</b>						
OCFTAI	0.03	0.05	> 0.045	Satisfactory	0.13	0.12
CTCCL	0.29	0.12	> 0.16	Marginal	-0.02	0.65
OCFCL	0.10	0.12	> 0.18	Early Warning	0.61	0.49
<b>Financial Health</b>	0.27	0.50		Marginal	0.52	0.49

Financial Health Ratio Table is the engine room of Stock Doctor and used to determine the Financial Health Score.

### Golden Rule 1

Stock Doctor members can easily identify the Financial Health of a listed ASX company using our colour-coded display.

Golden Rule 2

# Past Financial Performance

Lincoln Indicators research has shown that a company's track record and past performance metrics can be a reliable indicator of its future performance.

When combined with **Golden Rule 1 Financial Health**, past financial performance is an essential quantitative barometer to help further measure the true fundamental quality and investment potential of **growth** and **income** stocks.

The specific growth factors used to assess quality **growth** opportunities are:

- ▶ Return on Equity (ROE),
- ▶ Return on Invested Capital (ROIC),
- ▶ Return on Assets (ROA),
- ▶ Net Profit Margins (NPM),
- ▶ Earnings Quality (EQ),
- ▶ Revenue Growth (REVG), and
- ▶ Earnings Per Share Growth (EPSG).

In identifying **income** opportunities, it is vital that companies demonstrate sustainable and dependable dividends via a history of consistent dividend payments, cash flow margins above dividend payments, and a stable dividend outlook.

The sector-specific income factors used to assess this include:

- ▶ Operating Cash Flow Per Share (OCFPS),
- ▶ Free Cash Flow (FCF),
- ▶ Earnings Per Share (EPS),
- ▶ Dividends Per Share Growth (DPSG),
- ▶ Dividend Payout Ratio (DPR) and
- ▶ Gross Dividend Yield (GDY)

Investors should understand that factor investing can experience bouts of short-term under-performance due to the cyclical nature and factor rotation that can often occur in markets over time.



*It is far better to focus on what you know with a degree of certainty than what you don't know with uncertainty.*

Kien Trinh  
Lincoln Indicators Head of Research

★☆☆ NCK Nick Scali Limited

nicksca

**1 Financial Health**

Current Period - Jun 21 (A)

L Score  
Dr Merv Lincoln Health Model

**STRONG**

L Score (Dec 16 - Jun 21) Distress

Strong

2 Past Financial Performance		More							
	Dec 17 (I)	Jun 18 (A)	Dec 18 (I)	Jun 19 (A)	Dec 19 (I)	Jun 20 (A)	Dec 20 (I)	Jun 21 (A)	Latest
★ Growth Criteria									
Return on Equity (%)	55.92	53.20	51.40	49.89	45.68	52.40	65.49	88.94	
Net Profit Margin (%)	16.55	16.26	16.16	15.63	14.23	15.77	19.34	22.51	
Earnings Quality	Weak	Weak	Neutral	Neutral	Strong	Strong	Strong	Strong	
Revenue Growth (%)	10.75	7.67	8.83	6.88	0.23	-2.07	11.92	42.12	
EPS Growth (%)	24.11	10.05	6.34	2.77	-11.04	-0.09	51.38	100.21	
EPS Fcst 3m Revision (%)									
★ Income Criteria									
									Next Forecast Ex Div Date: 08/03/2022 (127 days away)
Free Cash Flow PS (¢)	10.29	17.57	51.83	49.48	58.78	103.13	137.06	154.06	
Annualised DPS (¢)	36.00	40.00	49.00	45.00	45.00	47.50	62.50	65.00	
Div Payout Ratio (%)	72.36	79.06	92.62	86.55	95.62	91.44	87.73	62.50	
Dividend Yield (%)	5.14	5.99	8.45	6.92	5.66	5.45	5.71	5.33	4.36
Gross Div Yield (%)	7.34	8.55	12.07	9.89	8.09	7.79	8.16	7.61	6.23
Mkt Avg Gross DY (%)	4.24	4.25	4.40	4.16	3.81	4.60	2.84	2.56	2.88
Franking (%)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	

Past performance is not an indicator of future performance

Golden Rule 2

Golden Rule 3

# Outlook and Active Risks

Despite the benefits, there are some limitations to quantitative investing. Both **Golden Rule 1 Financial Health** and **Golden Rule 2 Past Financial Performance** are based on backward-looking (historical) data. To overcome this backward-looking bias, we apply **Golden Rule 3 Outlook and Active Risks**.

The intention of this rule is not to make assumptions about the future profitability of a company as this is difficult to predict, especially among cyclical businesses.

Instead, this approach focuses on assessing **known facts** to ensure a company can maintain its **Financial Health (Golden Rule 1)** and **Past Financial Performance (Golden Rule 2)**.

This involves assessing the active risks of a business and its earnings revisions to understand whether a company's consensus expectations (where available) – that is the assessment of independent global research houses – and the share price, have fully factored in these risks.

We refer to these steps as our **qualitative overlay**. Lincoln Indicators has a team of in-house research analysts. They spend a significant amount of time talking to management, attending industry events, and speaking to industry peers to determine whether a business is likely to meet the grade moving forward.

Stock Doctor members have phone and email access to our analysts to ask specific questions on any company, especially around the qualitative aspects, including management, competitive advantages, capital management structure, and potential future investment opportunities.

Golden Rule 3

**1 Financial Health**

Current Period - Jun 21 (A)

L Score  
Dr Merv Lincoln Health Model

L Score (Dec 16 - Jun 21) Distress

**2 Past Financial Performance**

	Dec 17 (I)	Jun 18 (A)	Dec 18 (I)	Jun 19 (A)	Dec 19 (I)	Jun 20 (A)	Dec 20 (I)	Jun 21 (A)	Latest
<b>★ Growth Criteria</b>									
Return on Equity (%)	55.92	53.20	51.40	49.89	45.68	52.40	65.49	88.94	
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Mkt Avg Gross DY (%)	4.24	4.25	4.40	4.16	3.81	4.60	2.84	2.56	2.88
Franking (%)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	

Next Forecast Ex Div Date: 08/03/2022 (127 days away)

**3 Outlook**

	Jun 22 (A)	Jun 23 (A)
	50.28	50.15
	N/A	N/A
	N/A	N/A
	7.46	16.55
	-26.44	15.95
	10.55	-
	0.32	73.27
	64.50	68.30
	84.31	77.00
	4.33	4.58
	6.18	6.55
	3.56	3.91
	100.00	100.00



**Analyst Comments**

Research Analyst: Ryan Lim  
Last update: 25 Oct 21

Strategic Key Updates Active Risks

06 May 21

As with any potential investment decision, investors need to be aware of dynamic risks that can negatively impact the future returns of the investment. These can include but not limited to:

- COVID-19** - We are concerned about COVID-19's impact on the consumer discretionary sector and believe the retail environment could deteriorate further if government stimulus fails to arrest the fall in consumer confidence. A shutdown extension across Australia may place a further strain on the company and have a material impact on earnings and the sustainability of its dividends.
- Competitive retail environment** - Competitors can open stores that compete directly with NCK. These include both domestic players (Amar, Freedom, Harvey Norman, FocusOn) and international players (IKEA), as well as increased prevalence of online furniture players (Temple and Webster).
- Foreign exchange** - the majority of inventory purchases are denominated in USD; therefore, any adverse currency movements (appreciation in USD relative to the AUD) may negatively impact margins. This risk is partially mitigated by entering forward and option contracts to manage its currency exposure. The company hedges currency 6-9 months forward to keep prices stable.
- Supply chain risk** - Most of the company's inventory is sourced from Asia, with ~50% from China. Two of the suppliers account for ~40% of products sold. Any breakdown in supplier agreement or delays/cancellations in deliveries could impact margins. NCK noted in May that shipping delays and container availability have caused supply chain issues.
- The health of the property market** - Revenue is positively correlated towards the residential

Past performance is not an indicator of future performance

## Star Stocks

Representing approximately just five per cent of the entire Australian stock market, Stock Doctor's Star Stocks are a select group of companies that provide a robust and reliable base for investors to construct, manage, and optimise sharemarket portfolios.

Star Stocks are high-quality growth and income businesses identified by Lincoln Indicator's proprietary methodology, which has been proven, trusted, and relied upon for more than 25 years.

There are three categories of Star Stocks:

Each Star Stock category caters to investors with different investment objectives and tolerance to risk.

But whatever an investor's focus, each Star Stock – despite the category – has been identified because of its quality financial factors demonstrated by meeting **Golden Rules 1, 2, and 3**.

### **Star Growth Stocks**

Stock Doctor's top-ranking growth businesses that suit investors seeking to achieve long-term capital growth.

### **Borderline Star Growth Stocks**

Ranked outside of the Star Growth Stocks universe and can be used to help diversify a portfolio to alternative high-quality growth stocks depending on risk profile and preference. Like Star Growth Stocks, these are regarded as high-quality growth businesses that suit investors who seek capital appreciation over the long-term.

### **Star Income Stocks**

Stock Doctor's high-quality income-producing businesses that suit investors seeking sustainable and attractive dividend yields over the long-term.



## Star Stock Performance

Stock Doctor  
Star **Growth** Stocks

**17.89%**

Total return<sup>(b)</sup> per annum since inception  
01/09/1995<sup>(a)</sup> - 31/10/2021

Cumulative value of \$100,000 invested from 01/09/1995<sup>(a)</sup> - 31/10/2021

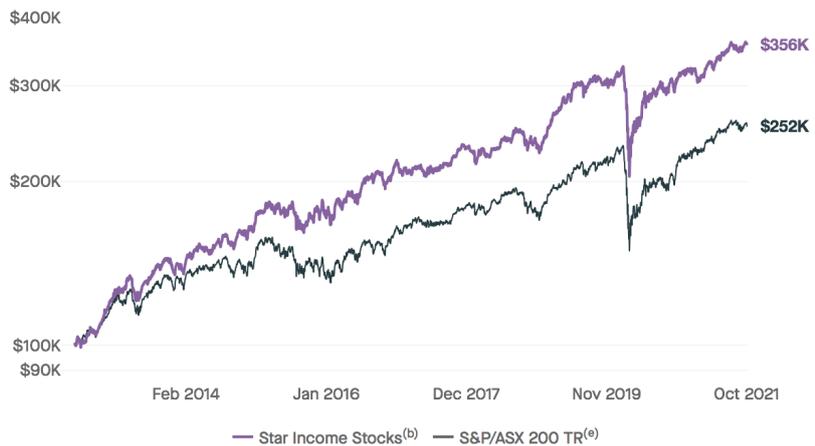


Stock Doctor  
Star **Income** Stocks

**14.75%**

Total return<sup>(b)</sup> per annum since inception  
07/08/2012<sup>(d)</sup> - 31/10/2021

Cumulative value of \$100,000 invested from 07/08/2012<sup>(d)</sup> - 31/10/2021



## Yield per annum since inception (excluding franking credits)

02/04/2012<sup>(a)</sup> - 31/10/2021



Yield per annum since inception.

(a) 01/09/1995 is the inception date of the Star Growth Stock notional portfolio.

(b) This is the investment performance for each notional portfolio over the period shown and includes capital returns, dividend income and estimated transaction costs (but excludes distributions, fees, charges or tax). The portfolio assumes a full equities allocation at all times, the reinvestment of dividends and the rebalancing of the portfolio to equal weight each time a change is made to the notional portfolio (i.e. when stocks come in and out of the portfolio). All trades assume enough liquidity to purchase the required volume of stock at the volume-weighted average price (VWAP) on the day following a star stock in/out event or on a rebalance. These past performance figures are not a reliable indicator of future performance of the notional portfolio, or any stocks included in the portfolio. In shorter time periods, the investment performance of the notional portfolio can vary to the figures shown. You should not make investment decisions based on performance figures alone. For more detailed information about how these figures are calculated, including the assumptions used, click here.

(c) ASX All Ordinaries Accumulation and S&P/ASX Small Ordinaries Accumulation indexes are sourced from Standard and Poor's.

(d) 07/08/2012 is the date of inception of the Star Income Stock notional portfolio.

(e) S&P/ASX 200 Accumulation and Yield index is sourced from Standard and Poor's.

Deep Dive

### Outlook and Active Risk Assessment

**Golden Rule 3** applies a qualitative overlay to explore all the current active business risks and whether these risks could negatively impact the business' performance and outlook in the year ahead.

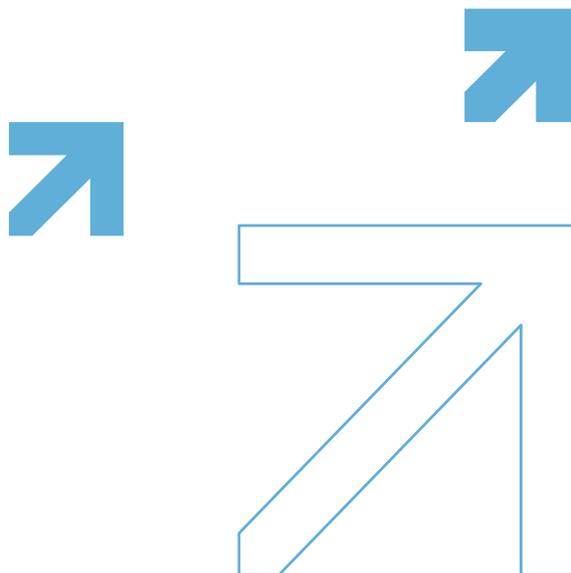
Such risks may impact a company's ability to remain financially healthy and its ability to continue to deliver on the needs of growth or income investors - and therefore retain its Star Stock status.

Lincoln's expert team of qualified stock research analysts continuously monitor the likelihood of active risks becoming a major concern. Examples of active risks include:

- ▶ Probability of continued Financial Health,
- ▶ Risks to outlook and forecasts,
- ▶ Regulatory and geographical risks,
- ▶ Change of sentiment in analysis consensus earnings forecasts (where available),
- ▶ Trends in short selling activity,
- ▶ Liquidity and suitability for retail investors,
- ▶ Ownership and CEO and director's trading activity,
- ▶ Senior management remuneration structures,
- ▶ Company news and announcements,
- ▶ Competitive landscape,
- ▶ Currency and commodity price risk, and,
- ▶ Openness and transparency.

To monitor this range of activities, a Lincoln analyst may:

- ▶ Speak to the management of a company,
- ▶ Attend investor briefings,
- ▶ Closely scrutinise announcements,
- ▶ Monitor company peers in the same sector, and,
- ▶ Review research produced by other analysts.





# The Secondary Golden Rules

The [Three Primary Golden Rules](#) provide the core framework for investors to build a portfolio of high-quality financially healthy Stock Doctor Star Stocks for capital growth or to provide a sustainable dividend stream. The Secondary Golden Rules are then used to tailor these stocks to an investor's own personal preference, tolerance to risk, style, and investment goals.

Not all secondary Golden Rules will be relevant to every investor. Proactive investors are encouraged to use a combination of these rules to help refine their own stock selection strategy.



Golden Rule 4

# Share Price Sentiment

The Efficient Market Hypothesis (EMH) asserts that it is virtually impossible to achieve excess returns because all news regarding a company is instantly reflected in the underlying share price. This theory assumes that all investors and traders are rational. This is a bold statement and a far cry from the real world. During periods of high macroeconomic uncertainty, share price falls often don't discriminate between high and low-quality businesses. As an investor, this is where the opportunity arises.

Although Lincoln Indicators does not subscribe to EMH, we understand that stock prices represent the market's perception of value, based on the future expectations of a company's earnings. The share price trend can therefore help highlight the fundamental qualities and active risks in a business. When the share price is declining relative to the market, this often means heightened risks in the business that should be investigated.

And while this can create a great opportunity to buy quality businesses - such as Stock Doctor's Star Stocks at lower prices - investors will need to conduct thorough due diligence on a weak trending stock to ensure they are comfortable with **Outlook and Active Risks (Golden Rule 3)** and to establish confidence in the business.

However, at times, investor psychology or stage of life may mean that investors are unable to tolerate sharemarket volatility and temporary declines in the value of their portfolios. In this instance, trend sensitive investors may wish to protect their capital and reduce their exposure to a stock once it breaches a certain negative share price threshold or has triggered a bearish trend on a technical indicator. Lincoln Indicators **Entry and Exit Strategies White Paper** provides more analysis and helpful guidance around timing, buying and selling activity.

Stock Doctor has two unique indicators – **SDMAX** (Stock Doctor Simple Moving Average Crossover) **for the highly trend-sensitive investor** and **SD30TSR<sup>^</sup>** (Stock Doctor 30% Trailing Stop Loss/Re-Entry indicator) **for the moderately trend-sensitive investor** that can be applied to help investors avoid negative and potentially significant share price declines.



Golden Rule 4

SDMAX & SD30TSR technical indicators

“Volatility creates opportunity for the non trend sensitive investor.”  
Tim Lincoln”

Golden Rule 5

# Share Price Value

The investment world is perennially focusing on value. Intuitively, this makes sense. We're wired towards bargain purchases because it can maximise return, assuming the price eventually reverts towards analyst price targets. But this concept is often elusive and misleading.

Unlike physical assets, the value of a company can be hard to quantify because it relies on numerous forward assumptions. Cash flows need to be projected into the future and discounted at an internal rate of return. As a result, determining share price value involves subjective decisions.

At Lincoln Indicators, instead of concentrating on inherent biases in opinion, we focus on the facts – and high-quality businesses tend to cost more based on these facts. When a company is financially healthy (**Golden Rule 1**), generates high returns on equity, and has a competitive advantage via wide net-profit margins (**Golden Rule 2**), then these facts mean that it tends to trade at a premium to valuation or, at high valuation multiples.

Therefore, to own these high-quality growth and income companies, investors should be prepared to pay a premium.

A sample of Star Stocks trading at a premium - as identified by Stock Doctor's Filter tool

Code	Name	Industry Group	Last Period Analysed	Trading Status	Star Stock Status	Price to Cons Tgt (%)
★ LYC	Lynas Rare Earths Limited	Materials	30/06/2021	Trading	Star Growth Stock	120.79
★ ALU	Altium Limited	Software & Services	30/06/2021	Trading	Star Growth Stock	120.20
★☆☆ ASX	ASX Limited	Diversified Financials	30/06/2021	Trading	Borderline Star Stock...	117.27
★ BWP	BWP Trust	Real Estate	30/06/2021	Trading	Star Income Stock	116.78
★ BLX	Beacon Lighting Group Limi...	Retailing	30/06/2021	Trading	Star Growth Stock	114.78
★ FMG	Fortescue Metals Group Ltd	Materials	30/06/2021	Trading	Star Income Stock	112.72
★ ARF	Arena REIT	Real Estate	30/06/2021	Trading	Star Income Stock	111.08
★ ARB	ARB Corporation Limited	Automobile & Components	30/06/2021	Trading	Borderline Star Stock	108.50
★☆☆ JIN	Jumbo Interactive Limited	Consumer Services	30/06/2021	Trading	Star Growth Stock And...	105.18
★ RFF	Rural Funds Group	Real Estate	30/06/2021	Trading	Star Income Stock	104.81
★ OZL	OZ Minerals Limited	Materials	30/06/2021	Trading	Star Growth Stock	103.46
★ PWH	PWR Holdings Limited	Automobile & Components	30/06/2021	Trading	Borderline Star Stock	103.21
★☆☆ CBA	Commonwealth Bank of Austr...	Banks	30/06/2021	Trading	Borderline Star Stock...	102.83
★ CQE	Charter Hall Social Infrac...	Real Estate	30/06/2021	Trading	Star Income Stock	102.43
★☆☆ PMV	Premier Investments Limite...	Retailing	31/07/2021	Trading	Star Growth Stock And...	101.93
★ PME	Pro Medicus Limited	Health Care Equipment & Se...	30/06/2021	Trading	Star Growth Stock	99.55
★☆☆ MQG	Macquarie Group Limited	Diversified Financials	30/09/2021	Trading	Star Growth Stock And...	99.35
★ WOW	Woolworths Group Limited	Food & Staples Retailing	30/06/2021	Trading	Star Income Stock	98.20
★☆☆ WES	Wesfarmers Limited	Retailing	30/06/2021	Trading	Borderline Star Stock...	97.73

List of Star Stocks trading at a premium: Note the column to the far right treats fair value as 100%

Take for example Pro Medicus (PME), a provider of state-of-the-art radiology imaging software that is experiencing significant growth off the back of an ageing yet growing population, chronic disease spread, and mandatory requirements for electronic medical records in US hospitals.

PME is a Star Growth Stock that has consistently traded at a premium to consensus price targets. In fact, analyst price targets tend to revert to the share price rather than vice versa, as seen in this chart. In addition, the stock historically trades at high-valuation multiples, with its price to earnings multiple currently over 100x.

If investors avoided PME because of its price, they would have missed out on significant returns.

Most stocks will trade at a discount following a market correction. This can present an excellent opportunity for opportunistic investors.

## Golden Rule 4



Pro Medicus (PME) share price has consistently traded above its Consensus Price Target, as displayed under Golden Rule 4 Share Price Sentiment

If, as part of a correction, the market mistakenly oversells a quality stock – such as a Star Stock - then investors should be alert to the opportunity it presents to buy quality stocks at a discount price.

On these occasions, **Analyst Comments (Golden Rule 4 Share Price Sentiment)** play a particularly vital role in providing insight regarding the factors impacting the stock price and the rationale for why the discounted stock has retained Star Stock status.

In contrast with Star Stocks, a stock that does not have a healthy Financial Health score trading at a significant discount to its target price usually tells a different story.

Such a discount raises important questions for investors, such as ‘is the large discount to the target price on a stock highlighting risk to the business that I am unaware of?’

The reality is that value stocks tend to be cheap for a reason, and it is usually because of heightened active risks that could lead to further losses - a concept known as the “value trap”.

The chart on page 19 provides a historical comparison of a portfolio of stocks selected from various factors. Over the long term, companies selected on quality and growth factors have significantly outperformed a portfolio of stocks chosen purely on value.

Lincoln Indicators Star Growth Stocks benefit from this because they are selected from high-quality and growth factors. And, similarly, our Star Income Stocks look at high-quality and sustainable yield rather than yield at all costs.

**Analyst Comments**

**Research Analyst:** Jason Yin  
**Last update:** 19 Nov 21

Strategic
Key Updates
Active Risks

19 Nov 21

Accent Group Limited (AX1) is a Star Growth and Star Income Stock (GR1, GR2, GR3) suitable for both growth and yield-oriented investors who would like exposure to a vertically integrated footwear retailer. Its operations span across retail and wholesale divisions. The company has sole distribution rights for Sketchers, Doc Martins, Vans, Caterpillar, and Timberland. A recent extension into horizontal categories such as The Trybe (targeting kids wear), Shoe Care & Accessories (high margin products), and Pivot (a value-conscious consumer brand) has enabled more differentiation and reinvigorated the company's growth profile.

AX1 maintained Strong Financial Health (GR1). Gearing levels remained low if we excluded the impact of lease liabilities from its leverage ratios. On balance, we believe AX1 is exposed to minimal levels of insolvency risk (GR1).

Analyst Comments provide important analysis regarding why a Star Stock stock might be trading at a discount, while retaining its Star Stock Status.

**5 Share Price Value**

**Consensus Price Target**

**\$2.98**

40%
20%
20%
40%

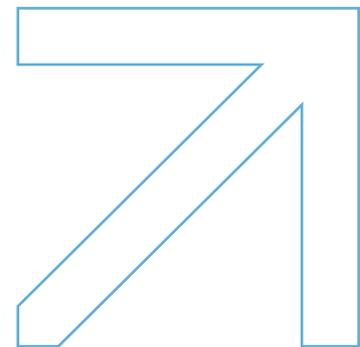
DISCOUNT
FAIR VALUE
PREMIUM

Price **\$2.50**

**DISC 15.97%**

	Jun 21 (A)	Latest	Jun 22 F'cast	Jun 23 F'cast
PE	15.96	18.30	22.12	15.24
Ind Avg PE	27.43	22.25	24.55	23.12
Mkt Avg PE	23.60	21.01	20.41	16.82
PEG	0.42	0.48	N/A	0.34

As demonstrated under Golden Rule 5 Share Price Value, Consensus Price Target demonstrates that, in this instance, the stock price is trading at a significant discount to Fair Value.



Deep Dive

### What are Value and Dividend Traps?

A **Value Trap** refers to a stock where the price appears cheap relative to a range of factors including to its peers, asset base, or earnings forecast. An investor may be fooled into believing they have discovered a company that the market has grossly mis-priced, when in fact the 'value' on offer may be illusionary. This is because the share price may be factoring in elevated risks within the company.

Take the example of **Sezzle Inc (SZL)** - a technology-driven payments company based in the United States, with operations in the United States, Canada, and start-up operations in India and Europe. At first glance, the stock looks like it could be a bargain, trading at a significant discount with a share price in decline – currently \$5.09, down from \$9.77 just six months earlier. But it could also be a Value Trap. It fails **Golden Rule 1** and exhibits unacceptable levels of financial risk due to a below benchmark Financial Health Score (distress), and it fails **Golden Rule 2** and has a poor record of past financial performance.

There are a myriad of reasons that could transform a company's stock into value traps.

The most common factors include:

- 1) loss of competitive advantage from lack of innovation, or,
- 2) industry in structural decline – such as Kodak when digital cameras were introduced to the market, or again, Myer with its persistence bricks and mortar-focused philosophy.

**Dividend traps or yield traps** are similar to value traps, but the focus is on a stock's dividend yield potential rather than capital appreciation.

When the share price of a stock experiences a substantial decline, the forward dividend yield would often appear attractive, especially if analysts or company management have not updated their forecasts.

Such high-yielding stocks may fool income-seeking investors into believing the forecast yield is sustainable when often, the dividend tends to revert in line with a fall in earnings and underlying quality of the business.

If the dividend looks too good to be true it usually is.

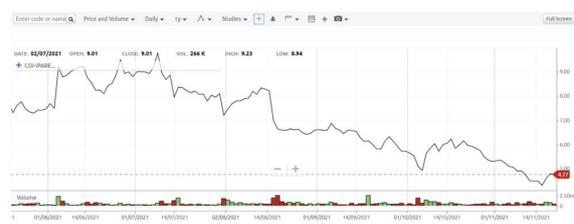
**Service Stream Limited (SSM)** is a good example. The company is a provider of essential network services to the telecommunications, energy, and water industries. It fails **Golden Rule 1** with a Marginal Financial Health score and **Golden Rule 2** on its past financial performance. Its share price has fallen significantly making the dividend – albeit slightly reduced – still look more attractive than it may be long-term.

To avoid value or yield traps, an investor should seek to understand why a stock's price or dividend yield looks attractive. Perform thorough due diligence – assess a company's financial position and apply **Golden Rules 1 and 2**, and apply **Golden Rule 3** to understand the active risks and whether there will be an impact to future earnings.

Poor quality companies that fail Golden Rule 1 Financial Health, have a declining share price (Golden Rule 4 Share Price Sentiment), and are trading at a significant discount to value (Golden Rule 5 Share Price Value) present investors with a potential Value Trap.

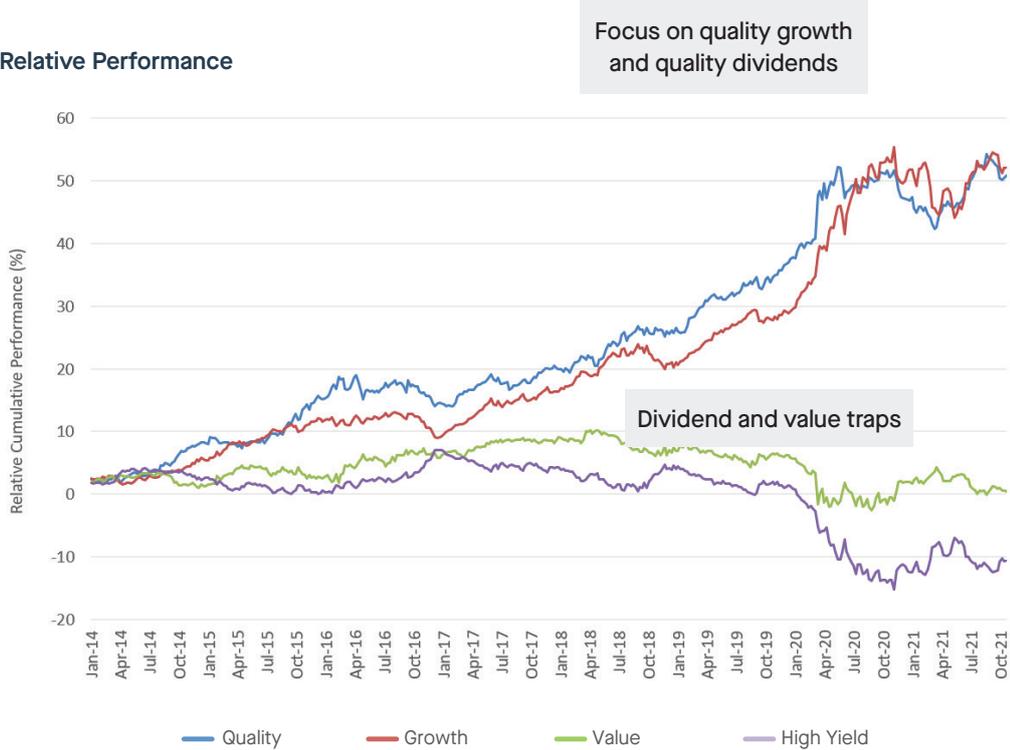


A company with a failing Financial Health Score (Early Warning, Marginal, or Distress) is always the most significant cause for investor concern and an important indicator that a stock trading at a discount to Price Target or Inflated Dividend Yield could be a potential Value or Dividend Trap.



A share price trading at a significant discount to premium – coupled with a share price declining (Golden Rule 4) and unhealthy Financial Health score (Golden Rule 1) - is indicative of a potential Value Trap.

Factor Style Relative Performance



Past performance is not an indicator of future performance.

Deep Dive

Quality versus value investing

History has shown that value investing is not a dependable means of attaining long-term wealth in the Australian sharemarket. Often a stock is 'cheap' or trading at a discount to its *price target* for a good reason. At Lincoln Indicators, we are quality investors. We do not rely on valuations as our sole determinant for stock selection. It is not even a primary Golden Rule; it ranks as **Golden Rule 5**. Rather, we believe that a high-quality business with strong **Financial Health (Golden Rule 1)** will often do well over the long term.

With investing, as in life, you often get what you pay for. Investors should, therefore, be prepared to pay a premium for quality. Stocks trading at significant discounts to *its price target*, especially after share price declines, are often high-risk propositions and, as outlined above, potentially value traps.

That said, sometimes quality stocks are oversold, whether that be through ignorance or panic during a market correction. If the market is naive enough to oversell a quality Star Stock, we adopt a contrarian and opportunistic mindset: buy high-conviction high-quality stocks.



**Golden Rule 6**

# Liquidity and Size

Investors need to determine if there is a liquidity constraint on the shares they wish to transact. The volume of share transactions must be high enough (liquid) so investors can enter, and more importantly – exit within the timeframe and at the price they want.

This fluidity allows investors to deploy sufficient capital into an investment and buy stocks, while also ensuring there are enough buyers on the other side of the ‘order book’ when it comes time to sell. Traditionally, larger market capitalised stocks tend to be less volatile and have a higher volume traded, versus smaller market capitalised companies.

To ensure investors can exit at any time, we suggest the average ‘daily volume traded’ figure is at least 5x the amount you want to trade, although in practice investors should aim for 10x to ensure they can exit during periods of financial disruptions that can lead to a liquidity crunch.

Liquidity is an important consideration, for instance, for investors considering buying **1300 Smiles Limited (ONT)**. The business owns and operates full-service dental facilities in New South Wales, South Australia, and in the 10 major population centres in Queensland and Adelaide. It has a market capitalisation of \$190.8m and is trading at fair value of around \$8. It has Strong Financial Health and a consistent upward-trending share price

But it has low average daily traded amount of just \$37,067 (**Golden Rule 6**), is tightly held (**Golden Rule 7**) with the majority of stock owned by only a few individuals (some 60% held by the Managing Director), and it has only a small number of covering consensus analysts (**Golden Rule 3**) – all of which make it a potential example of a liquidity constrained stock.

**Golden Rule 6**



**Golden Rule 7**

**Executive Leaders**

<b>Dr Daryl Shane Holmes</b> Managing Director (Since 18/09/2000)	<b>Mr Robert Francis Jones</b> Non-Executive Chairman, Non-Executive Director (Since 26/09/2007)
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**Remuneration from 2021 annual report (AUD)**

Primary	91,326	42,160
Incentives	0	0
<b>Total</b>	<b>91,326</b>	<b>42,160</b>

**Holdings**

Current holding (direct and indirect) (AUD)	119,606,357	329,436
12 month change in holding	0.00%	0.00%
Percentage of all stock on issue	62.13%	0.17%

As displayed under Golden Rule 7 Principal Activities, an example of a tightly held stock, as highlighted by the percentage of all stock on issue held by the company's executive leaders.

**Golden Rule 3**

**3** Outlook 1

	Jun 22 (A)	Jun 23 (A)
	23.13	22.63
	N/A	N/A
	N/A	N/A
	11.05	3.93
	18.89	2.22
	42.62	48.09
	35.00	36.00
	77.78	78.26
	4.31	4.43
	6.15	6.33
	3.58	3.98
	100.00	100.00

Low number of covering analysts as highlighted under Golden Rule 3 Outlook and Active Risks.

Golden Rule 7

# Principal Activities

Golden Rule 7 states that an investor should understand a company’s principal activities before investing. As an owner of stock, an investor is a part-owner in the business. As such, investors need to ensure they understand its operational model (e.g., how it generates sales), gain familiarity with the products or services it provides, and ensure it aligns with their values.

Furthermore, investors should seek an understanding of the opportunities and threats that may impact the earnings potential of the company, as well as its industry. For example, if an investor has significant **ethical considerations**, they may want to understand whether a business’ principal activities involve gambling, weapons, or fossil fuels.

Ideally, company leaders should also have their ‘own skin’ in the company through personal holdings which demonstrates their belief in the company and its future – this is more prevalent and important in smaller to mid-size companies. **It’s always a bonus to see** that the founder is still involved, whether running the business as CEO or as chairman. Lastly, the remuneration of senior executives is also scrutinised to determine whether their remuneration is appropriate relative the level of shareholder returns generated in the past.

The Stock Doctor platform combines information from every ASX listed company’s operations and principal activities with analyst comments, company director statements, and extensive financial data to help investors better understand the business behind the stock.

## Golden Rule 7

Key information regarding the company’s Principal Activities, executive stock holdings, and breakdown of the company’s earnings are all displayed as part of Golden Rule 7 Principal Activities.

**Principal Activities** (Last update: 30 Oct 2021)

**Company Details:**  
 Website: www.promed.com.au  
 Head Office: 450 Swan St, Richmond, VIC, 3121  
 Listed: 10/10/2000  
 Status: Trading  
 Industry Group: Health Care Equipment & Services

**DOCUMENT:** Annual Report 2021

**Executive Leaders**

<b>Dr Sam Aaron Hupert</b> Chief Executive Officer, Managing Director (Since 01/10/2007)	<b>Mr Peter Terence Kempen</b> Non-Executive Chairman, Non-Executive Director (Since 12/03/2008)
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**Remuneration from 2021 annual report (AUD)**

Primary	507,938	196,470
Incentives	0	0
<b>Total</b>	<b>507,938</b>	<b>196,470</b>

**Holdings**

Current holding (direct and indirect) (AUD)	1,500,169,845	37,484,373
12 month change in holding	-3.55%	0.00%
Percentage of all stock on issue	26.00%	0.65%

**Principal Activities** (Last update: 30 Oct 2021)

Pro Medicus Limited [ASX: PME] is a health imaging IT provider. Founded in 1983, the company provides a range of software and services to hospitals, imaging centres, and health care groups in Australia, North America and Europe.

**Visage RIS:** Visage RIS is a comprehensive, enterprise-class and state-of-the-art radiology information system (RIS). The Visage RIS architecture leverages modern, open-source, standard-based technology such as: RESTful Web Services, stateless URL connectivity, integrated workflow engine, powerful rules engine, PostgreSQL database and CalDAV scheduling. As an enterprise-class RIS, Visage RIS includes the following expected capabilities: Patient Registration; Billing (e.g., Private, DVA, TAC, HIC Online, Bulk-billing and Eclipse); Scheduling; Typing; HL7 Integration; Financial Reporting; PACS Integration; Digital Dictation and Voice Recognition Integration.

**Earnings Breakdown** (Jun 2021)

By Division	Revenue (\$M)	Profit (\$M)
Other	0.05	N/A
Picture Archiving Communications System (Visage 7/ Radiology Information System (RIS))	55.31	N/A
	12.53	N/A

By Region	Revenue (\$M)	Profit (\$M)
Australia	13.51	38.08
Europe	4.16	3.30
North America	50.22	1.31

### Deep Dive

## The Founders Effect

Tracking the activities of key executives and directors through **Golden Rule 7** can help investors understand a company’s vision, and more importantly, the people driving it. However, it can be difficult deciphering what is and isn’t important.

There has been a significant amount of academic research that supports a concept known as **the ‘founder’s effect’ as being positive for the company’s prospects**, particularly in the formative years of a company’s life when it is on a strong growth trajectory.

The positive impact of the ‘founder’s effect’ tends to be more prominent in small to mid-cap stocks where the vision, drive, and experience of the Founder can

have the most impact. Often, by the time a company becomes large, the amount of complexity can reduce the impact of entrepreneurship. This can in turn lead to a reduced impact or the Founder leaving the business.

And, knowing that the key Executives and Directors have their interests aligned to that of shareholders through ownership of the business’ stock is also important. While there may be a perfectly good reason for selling, significant transactions may warn of an Executive or Director’s impending lack of commitment.

Golden Rule 8

# Price Sensitive Announcements

Investors also need to stay abreast of company news and announcements, as these events can have a material impact on a company's stock price (both positively and negatively).

Investing in the sharemarket is difficult at the best of times, let alone when investors are investing in companies with grey clouds on the horizon.

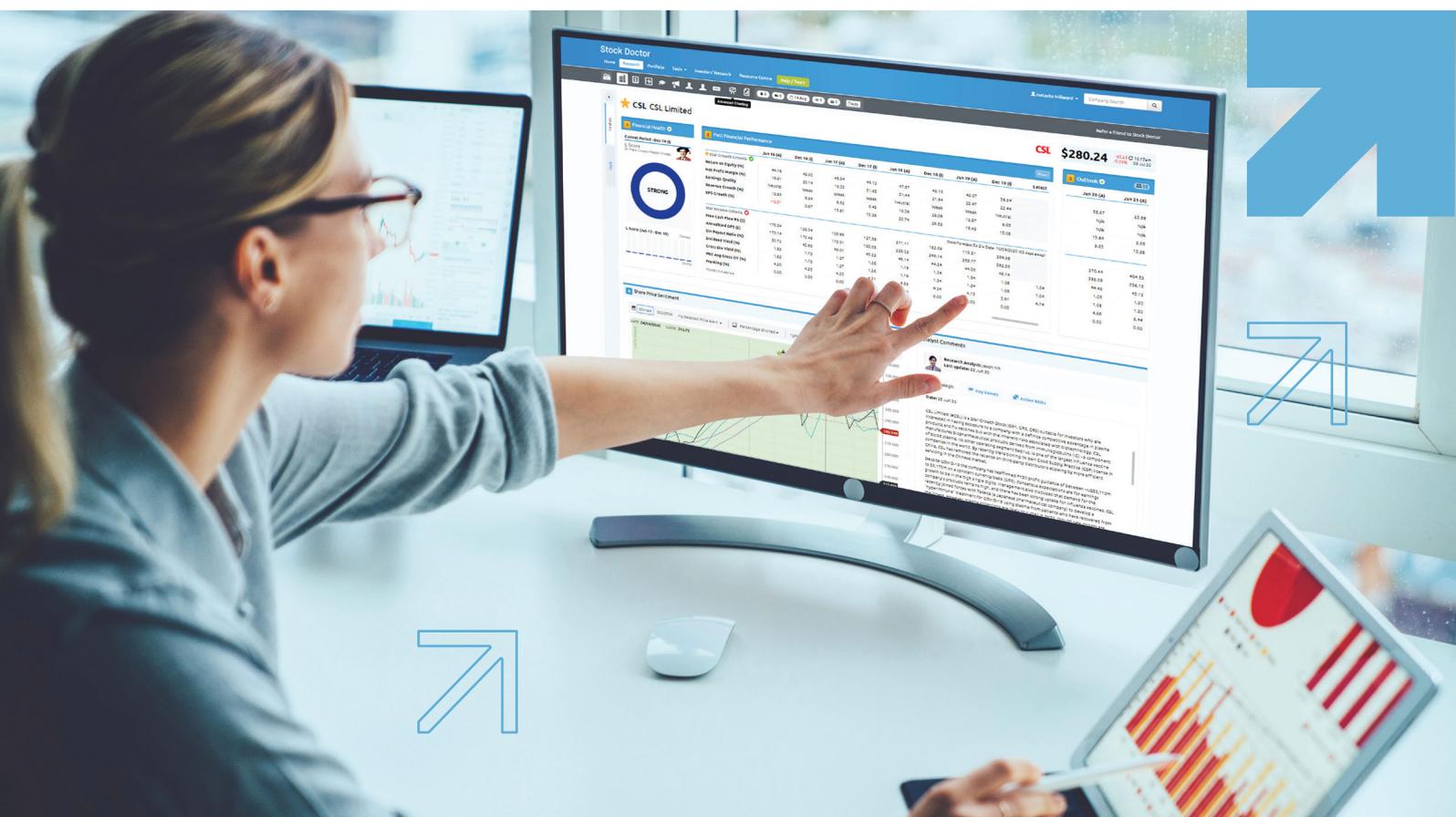
Investors should ensure companies have robust, transparent, and thorough disclosure processes in place that ensure the market is updated in a timely and accurate way.

Once confident in the reliability of information being shared, investors should then focus on companies that are delivering positive news to the market and management teams that under-promise and over-deliver.

Lincoln analysts proactively and promptly alert members as relevant and material news is disclosed that may impact a company's stock price **and Star Stock rating**.

8 Latest Price Sensitive Announcements <span>More</span>	
Announced	Headline
25/10/2021 12:01 pm	<a href="#">Chairman and Managing Director's Address to Shareholders</a>
04/10/2021 8:33 am	<a href="#">Acquisition of Plush-Think Sofas</a>
06/08/2021 5:04 pm	<a href="#">Clarification of Media Comment</a>
05/08/2021 8:22 am	<a href="#">Nick Scali FY21 Company Presentation</a>
05/08/2021 8:22 am	<a href="#">Nick Scali Ltd FY21 Results Announcement</a>

Golden Rule 8



Golden Rule 9

# Follow Your Appropriate Rules

The final rule - although it may seem trivial - is among the most important. **Golden Rule 9** states investors should apply Stock Doctor's Golden Rule framework to their own investment objectives and tolerance to risk, and, that they should be disciplined in their portfolio decision making

process. In other words, be systematic with buy and sell decisions, and – while difficult at times – do not let emotions such as fear or greed interfere.

**1 Financial Health**  
L Score: STRONG

**2 Past Financial Performance**

	Dec 17 (20)	Jun 18 (21)	Dec 18 (20)	Jun 19 (21)	Dec 19 (20)	Jun 20 (21)	Dec 20 (20)	Jun 21 (21)	Latest
Revenue (\$M)	53.92	53.20	51.40	49.89	43.68	32.40	65.49	88.94	50.28
Net Profit Margin (%)	16.50	16.26	16.16	15.63	14.23	13.77	19.34	22.51	N/A
Earnings Quality	Weak	Weak	Neutral	Neutral	Strong	Strong	Strong	Strong	N/A
Revenue Growth (%)	19.71	2.82	8.83	6.86	9.33	2.87	11.92	42.12	7.46
EPS Growth (%)	24.11	10.05	6.34	2.77	-1.04	-0.09	51.38	100.21	-16.44
EPS Fcst. vs Revision (%)									10.55

**3 Outlook**  
Jun 22 (21) Jun 23 (21)

**4 Share Price Sentiment**  
Share Price Chart

**5 Share Price Value**  
Consensus Price Target: \$16.80

**6 Liquidity and Size**  
Market Cap (\$M): 1,207

**7 Principal Activities**  
NCK Scali Limited (NCK) is engaged in sourcing and retailing of household furniture and related accessories.

**8 Latest Price Sensitive Announcements**

**9 Follow your appropriate rules**

**Peer Comparison**

Company	Health	ROE (%)	Net Profit Margin (%)	Earnings Quality	Rev Growth (%)	EPS Growth (%)	Dividend Yield (%)	Div Payout (%)	Price Change 1Y (%)	Jun 2021 P/E	Price to Target (%)
NCK Nick Scali Limited	STRONG	88.94	22.51	Strong	42.12	100.21	4.37	62.50	78.32	3.95x	14.32
AME Equestrian Limited	STRONG	42.56	5.76	Neutral	12.39	68.91	5.60	64.58	6.39	26.07x	11.36
AME Equestrian Limited	STRONG	27.14	8.72	Strong	22.32	94.42	6.46	64.67	11.62	16.29x	16.88
AME Equestrian Limited	STRONG	43.71	4.23	Neutral	17.45	351.62	2.97	28.96	33.13	6.82x	9.75
AME Equestrian Limited	STRONG	18.24	17.76	Strong	18.65	63.43	2.57	48.58	40.15	5.64x	18.89
AME Equestrian Limited	STRONG	46.74	14.27	Strong	28.50	105.89	6.17	56.31	0.54	5.82x	9.13
AME Equestrian Limited	STRONG	18.31	7.75	Strong	19.80	37.87	4.50	82.36	42.86	3.80x	18.30
AME Equestrian Limited	STRONG	18.21	8.34	Neutral	32.90	98.20	N/A	6.00	126.97	3.70x	64.47
AME Equestrian Limited	STRONG	48.18	8.66	Strong	18.84	27.22	1.77	143.69	174.20	3.64x	92.42
AME Equestrian Limited	STRONG	25.86	5.52	Neutral	15.80	36.73	2.39	71.13	38.73	2.82x	38.65

Stock Doctor's 9 Golden Rules in practice

Dig Deeper into each Golden Rule

# Your complete investment compass

Frameworks organise information into knowledge and, over time, allow people to generate unique insight. It is this knowledge and insight that is consistently monetisable because it allows investors to observe and learn, and thereby tilt the probability of a positive outcome in their favour.

Lincoln Indicators **Golden Rules** – the **Three Primary Golden Rules** and the **Secondary Golden Rules** – ensure investors have a sound, intelligent, and objective stock selection framework that can be tailored to each individual investor's needs – in other words, an **investment compass**.

**The Golden Rules** have underpinned the success of Lincoln Indicators and our ability to deliver strong out-performance in bull and bear markets for more than 25 years.

Every investor can now move forward into the market with **confidence, control, and peace of mind**, knowing what it takes to create long-term sharemarket success.

For more information please contact  
[Lincoln Indicators](#) | 1300 676 333  
[lincolnindicators.com.au](http://lincolnindicators.com.au)

Start a **FREE trial** to Stock Doctor to experience 9 Golden Rules in action.



*We don't have to be smarter than the rest, we just have to be more disciplined*

Warren Buffett



#### Important Information:

Information presented in the Golden Rules White Paper (Communication) is as at 10 November 2021 unless otherwise indicated.

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Unless indicated otherwise, Lincoln is the source for all graphs, charts, case studies, illustrations and photos used in this Communication.

Past performance is not an indicator of future performance.

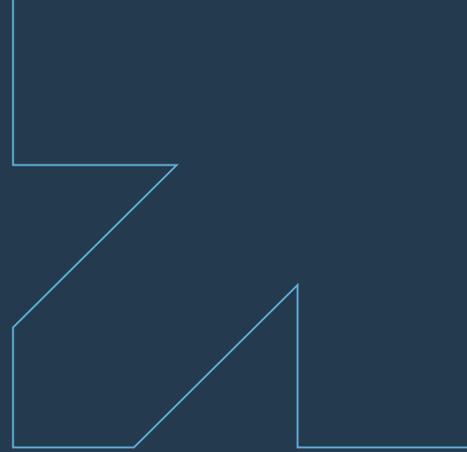
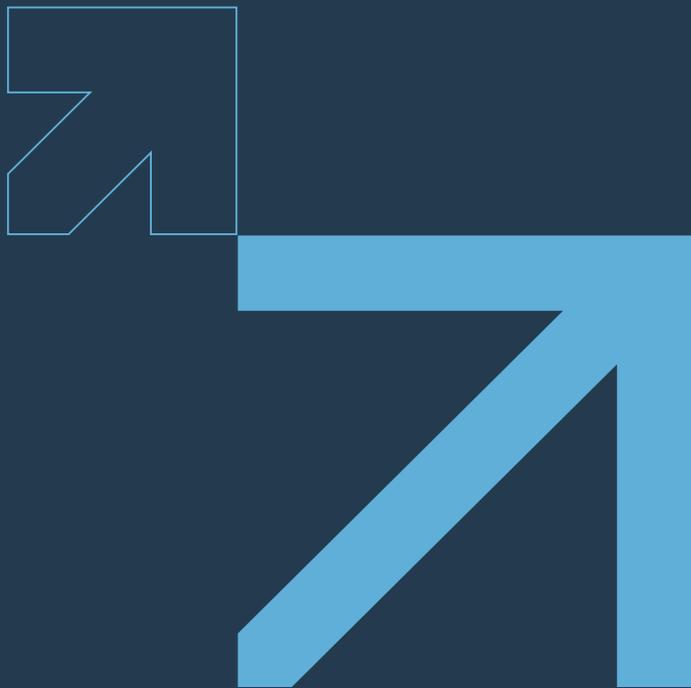
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