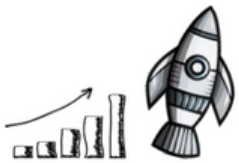


Return on Equity

We have noticed that our newsletter following has grown recently beyond experienced investors and finance professionals. We will include a short lesson on investing or finance terms and explanations with that in mind. Our goal is to create a community of high-quality shareholders and investors. To complete our goal, understanding that some of our audience is newer to the investment game, we will attempt to help educate some people interested in learning more.

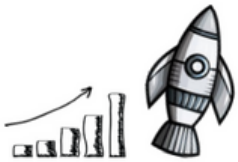
One of our favorite metrics when analyzing a company is **return on equity**. Return on equity (ROE) is significant because it measures how management teams use investors' money. Return on equity will help investors understand how efficient a management team is when generating profits.

The formula for return on equity is quite simple; net income is divided by shareholders' equity. Net income is found on the income statement, and average equity is located on the balance sheet. For example, let's solve Apple's ROE for 2021. The numbers below are in millions:

Net Income In 2021	Notes
$94,680.00	From Income Statement

Total Equity			
2020	2021	Divided by Average Shareholders' Equity	Notes
$65,339.00	$ 63,090.00	$64,214.50	Add 2020 and 2021 together then divided by two to get average

Return On Equity	Notes
147.44%	Net Income Divided by Average



Final step: How do we know if this is a good ROE?

As investors, we would like to invest in companies with a high return on equity ratio because we know that management will take care of our investments and make the capital mean something to the company. The best way to check if this return on equity is good is to look at the industry average. We know that Apple is in the technology industry. We would search for the average return on equity for the technology industry. Once we find that the average of Apple's ROE was greater than the average, we know their management team used investor's money to generate profits better than the rest of the industry. If the return on equity is less than this means, their management team is less effective in generating profits than the rest of the industry.

Other considerations when looking into ROE:

- Return on equity should be considered in combination with a company's debt levels, as high debt could drive a high ROE, which may make the company riskier in a downturn.
- Return on equity can be less helpful for companies that have shrunk their equity base through large share repurchases. Reinvestment prospects and future ROE are also important to analyze.
- A company's growth rate in earnings is equal to its ROE multiplied by retained earnings. So, analyzing its profits which can continue to be invested at the current ROE is important when thinking about future expected returns.