

Financial Intelligence

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Value Investing

by John McCorvie, CFA

Value Investing is at the heart of Peak's individual stock Model Portfolio.* While there are many long-term portfolio management strategies to choose from, we believe that purchasing a portfolio of the best businesses in the world at attractive prices is a superior path to investment success. There are no guarantees in the stock investment world, but aligning yourself with dominant businesses across multiple industries, at the right price, is a great way to tilt the odds of success in your favor. Additionally, it is an approach that allows you to appreciate the downside volatility in stock prices as a long-term opportunity rather than a short-term risk.

I came across the following article while reading through the website of AAIL. It is

one of the best general descriptions of a value investment approach that I have read. It is a bit lengthy, but it also includes a good summary on page 4 of "Common Elements of Successful Value Screens." I would like to note that the free cash flow metric that Peak likes to focus on is not highlighted in this article, but conceptually it fits nicely into the other elements that the article references. If anyone would like to talk about the approach after reading the article, we encourage you to give us a call – this is one of our passions!

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the client's specific investment objectives and constraints.*

Five Common Traits of Successful Value Screens

by John Bajkowski

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Article Highlights

- Value gurus start by seeking stocks that are trading at price multiples below the market norm or the firm's past average multiple.
- It's important to also look at the firm's growth prospects, financial strength and profitability.
- Value stocks often have low investor expectations and therefore benefit more from a positive earnings surprise.

Wouldn't you love to get Benjamin Graham's thoughts on whether a stock you are considering is priced attractively?

Or how about getting a warning message from David Dreman before you fall for a common emotional trap after a beloved company just missed its earnings target? Who wouldn't want some tips from Warren

Buffett on how to identify if a company has a competitive advantage?

We have adapted the works of the best investing minds on Wall Street and created simple stock selection rules that individuals can use to find attractive investments. AAIL members can learn more about stock market gurus and their strategies and even see which stocks currently match each approach on the Stock Screens segment of AAIL.com or in AAIL's stock screening and analysis tool Stock Investor Pro.

If you look at the approaches of these gurus and stock market experts, you will quickly notice that successful approaches within a given investment style tend to have similar elements. Sure, the Dreman approach on AAIL.com may emphasize the price-earnings ratio to locate value companies while the Piotroski strategy uses the price-to-book-

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value ratio, but every successful value-oriented approach not only looks for a low price-related multiple, but also some measure of expected growth or financial strength.

In this article we focus on the value-oriented stock screens and the five common traits that successful stock screens possess. For the more adventurous investors, we have included information on how value stocks react uniquely to earnings surprises. The stock screens section of AAll.com (www.aall.com/stock-screens) has detailed information on all of the strategies and gurus mentioned in this article.

Trait #1: Reasonable Value

Value investing entails buying shares of unappreciated or neglected companies at attractive prices. Investment gurus such as David Dreman and Benjamin Graham believe that investors have a tendency to pay too much for companies that appear to have the best prospects at the moment and react too negatively to companies considered to have the weakest prospects. This is a behavioral bias that is best overcome by using a quantitative approach or model with rules to help us overcome our natural inclinations. The mispricing of securities tends to be a self-correcting process that contrarian investors can use to their advantage.

If investors want a reasonable chance of better-than average results, they must follow policies that are inherently sound and promising, yet different from the strategies followed by most investors or speculators. Graham warned investors that buying neglected and undervalued securities is generally a protracted and patience-trying experience. However, the possibility of extraordinary gains only exists when the investor disagrees with the market.

Not all value picks pan out and even the value approach falls out of favor at times. Joel Greenblatt warns investors that there is no investing magic bullet that works every time. Sticking to a strategy that is not working in the short run even if it has a good long-term record is difficult. However, some investors feel that occasional underperformance may be why value investing continues to work in the long run, as most investors do not have the patience to stick to an approach consistently.

The valuation process does not have to be complex to be successful. Simple valuation techniques such as price-earnings ratios or price-to-book-value ratios are easy to work with and have been proven effective in numerous studies.

The price-earnings ratio, or earnings multiple, is the most common valuation metric used in the stock screens tracked by AAll. A partial list of guru-oriented approaches incorporating the price-earnings ratio include screens inspired by David Dreman, Philip Fisher, Benjamin Graham, Josef Lakonishok, Peter Lynch, Ronald Muhlenkamp, John Neff, T. Rowe Price, John Templeton, Ralph Wanger and Martin Zweig.

The basic price-earnings ratio is computed by dividing the current stock price by earnings per share for the most recent 12 months. It is followed so closely because it relates the market's expectation of future company performance, embedded in the price component of the equation, to the company's actual recent earnings performance. The greater the expectation, the higher the multiple of current earnings investors are willing to pay for the promise of future earnings. If the market has low earnings growth expectations for a firm, or views earnings as suspect, it will not be willing to pay as much per share as it would for a firm with high and more certain earnings growth expectations.

Dreman points out that stocks with high price-earnings ratios are vulnerable if "tastes" change. Stock rotation can be sudden and dramatic—the darlings of investors one quarter can be dogs the next as institutional investors shift their holdings to another segment that is perceived to be better positioned for the current market environment.

The price-to-book-value ratio is the second most common value filter found in the value screens on AAll.com. The price-to-book-value ratio is determined by dividing market price per share by book value per share. Book value is generally determined by subtracting total liabilities from total assets and then dividing by the number of shares outstanding. It represents the value of the owners' equity based upon historical accounting decisions. If accounting truly captured the current values of the firm, then one would expect the current stock price to sell near its accounting book value. Over the history of a firm, many events occur that can distort the book value figure. For example, inflation may leave the replacement cost of capital goods within the firm far above their stated book value.

Benjamin Graham was a believer in using low price-to-book-value ratios to select stocks and normally required a ratio below 1.5 for the defensive investor. However, he also felt that a low price-earnings ratio could justify a higher price-to-book-value ratio. Joseph Piotroski first limits his universe to the bottom 20% of stocks according to their price-to-book-value ratio and then applies a nine-point financial test.

Note that in general, gurus are not looking for the cheapest stocks, just stocks that are trading below the market norm or below the firm's past average multiple. Investors such as Dreman desire a broad enough universe from which to perform a complete analysis.

We also have examples of successful value stock screens that employ the price-to-sales ratio, the price-to-cash flow ratio or the dividend yield in their approach. The bottom line is that you can identify attractively priced stocks with a number of different price multiples, but successful investors become expert in the strengths and weakness of a given multiple and use their value test as the first step in the selection process.

The difficulty with value investing is separating the “good” stocks that are misunderstood by the market from the “bad” ones that are accurately pegged as losers because of lackluster prospects. Separating the two involves a willingness to roll up your sleeves and dive into mounds of research, analyzing many different industries and reviewing individual company financial statements.

Successful value screens start with a core value requirement and then perform additional tests to select inexpensive stocks of companies with good prospects.

Trait #2: Growth & Consistency

Successful value screens require minimum levels of growth in factors such as earnings, sales, dividends or cash flow, but also levels that are not too high.

Benjamin Graham felt that it would be difficult for investors to beat the market by identifying which stocks will grow faster than the market ahead of time. The problem for investors, he reasoned, is twofold. First, even stocks with obvious growth prospects don’t necessarily translate into extra profits for an investor because those prospects are generally incorporated into the price of the stock (“discounted into the stock price,” to use Wall Street jargon). Second, there is the risk that the investor will be wrong about the firm’s growth prospects. Graham felt that this risk is accentuated by the psychology of the stock market.

Graham recommended a minimum increase in per share earnings in the past 10 years that translates into about a 3% annual growth rate—a rate that roughly keeps pace with inflation over the long term. Graham argued that without such a criterion, a screen looking for companies with low multiples may come up with companies with poor prospects.

Peter Lynch prefers to invest in companies with earnings expanding at moderately fast rates in non-growth industries. He reasons that extremely high levels of earnings growth rates are not sustainable, but continued high growth may be falsely factored into the price. A high level of growth for a company and industry will attract a great deal of attention from both investors, who bid up the stock price, and competitors, who provide a more difficult business environment.

John Neff believes that investors must learn to visualize prospects for the company and its industry and look for confirmation or contradiction of the market’s view in the company’s fundamentals. Neff requires strong growth forecasts, but not so strong that growth compromised risk; he therefore establishes a ceiling for any growth forecasts. Neff focuses on estimated growth rates in sales and earnings between 7% and 20% to avoid stocks that are too risky, a high rate of annual growth, but not too high.

Looking beyond the annual rate of growth, many guru inves-

tors look for consistency in annual increases. Lynch indicates that it is important to examine the historical record of earnings. Stock prices cannot deviate very long from the level of earnings, so the pattern of earnings growth will help to reveal the stability and strength of the company. Ideally, earnings should move up consistently.

Templeton believed the income statement should show consistent earnings growth. Graham had a preference for companies that avoided losses during recessionary periods. Graham recommended 10 years of positive earnings in his screen for investors. Buffett warns that wild swings in earnings are characteristic of commodity businesses. Zweig also seeks companies with persistent, rising earnings on an annual basis.

The bottom line for investors is to look for moderate growth and positive more aggressive, seek out companies able to show upward changes in sales and earnings year after year.

Trait #3: Financial Strength

David Dreman feels that it is important to consider the financial strength of a company when pursuing a contrarian investment strategy. A strong financial position enables a company to work through a period of operating difficulty often experienced by out-of-favor stocks.

Templeton also monitored the balance sheet, looking for companies showing good financial strength. Like Dreman, Templeton believed a strong financial position gives companies a financial cushion.

Lynch adds that a strong balance sheet provides maneuvering room as the company expands or experiences trouble. Lynch is especially wary of bank debt, which can usually be called in by the bank on demand.

Zweig made a point of mentioning that you should not pay too much for a company that has a high level of debt. Companies that carry higher levels of debt also carry higher risk levels, mainly due to the higher fixed costs associated with interest expense.

The place to look is the company’s balance sheet, specifically debt. Prudent use of debt allows companies to expand and increase return on shareholder equity. However, the balance sheet should be examined to see if the company has too much debt or if debt is rising to dangerous levels. Appropriate debt levels vary from industry to industry, so it is best to screen against industry norms. For example, utilities can typically carry higher levels of debt than highly cyclical firms can. Most of the value screens look for debt ratios below the industry norm.

Common measures of the longer-term obligations of the company include the debt-to-equity ratio (which compares the level of long-term debt to owner’s equity), debt as a per-

Common Elements of Successful Value Screen

Reasonable Value

Investors have a tendency to pay too much for companies that appear to have the best prospects at the moment and react too negatively to companies considered to have the weakest prospects. Simple valuation techniques such as price-earnings ratios or price-to-book value ratios are easy to work with and have been proven effective in numerous studies.

- Look for low ratios of price to earnings, book value, cash flow, sales or dividend yield
- Look for low ratios on an absolute basis or, more likely, compared to the market average or historical average for the company
- Look for a low price-earnings ratio relative to the growth rate

Growth and Consistency

Investors often overpay for high expected or historical growth when companies with moderate and consistent growth are often more attractive investments.

- Require moderate growth in sales, cash flow, earnings and dividends with an emphasis on consistency rather than high rates of growth
- Look for a long record of year-after-year profitability over a range of economic situations

Financial Strength

A strong financial position gives a company a financial cushion that enables it to work through a period of operating difficulty or expansion. Higher debt equates to higher risk.

- Specify maximum level of debt to assets, capital or equity
- Specify minimum level of the current or quick ratio
- Require improvements in financial leverage or working

capital over time

- Compare company ratios to industry norms
- Require positive cash flow

Unique Niche

Seek out companies with competitive advantages and that dominate a special niche. These niches can be geographical, a technological niche supported by patents, or simply be a strong marketing presence that makes it difficult for new competitors to gain market share.

- Require profit margin above industry norm
- Require increasing or stable profit margin over time
- Require strong or improving return on assets or return on equity
- Require projected earnings growth above industry norm

History of Paying Dividends

Dividends provide protection against a significant price drop and contribute to the total return on your investment.

- Look for a dividend yield above the stock's long-term average yield
- Look for a dividend yield above the market average yield
- Require a high dividend yield relative to bond interest yield

Earnings Revisions

Value stocks often have low investor expectations and benefit more from a positive earnings surprise, yet don't get penalized as much when they have a negative earnings surprise.

- Seek out value-priced stocks with a recent positive earnings surprise
- Seek out value-priced stocks with a significant upward revision to the consensus earnings estimate

cent of capital structure (long-term debt divided by capital, which includes long-term sources of financing such as bonds, capitalized leases and equity), and total liabilities to total assets. The ratio of total liabilities to assets includes short-term obligations and long-term liabilities, both of which should be considered when testing for financial strength. Alternatively, we see the use of both a measure for short-term financial strength, such as the current ratio (current assets divided by current liabilities), and a measure that examines the long-term obligations of the firm, such as the debt-to-equity ratio.

As a test of short-term liquidity, Graham specified a current ratio of 2.0 or higher for industrial firms. To measure the use of long-term debt, Graham required that long-term debt for industrial firms not exceed net current assets, or working capital. Working capital is defined as current assets minus current liabilities. Graham also looked at the debt-to-equity ratio, especially for capital-intensive industries such as utilities. He specified that debt should not exceed twice the stock equity (at book value, not market value).

Ralph Wanger avoids marginal, underfunded companies of any size. He feels that financial strength makes corporate growth sustainable. Wanger looks for companies with low debt, adequate working capital and conservative accounting practices. Financial strength tends to be a characteristic of established companies, which is why Wanger avoids turnarounds, start-ups and initial public offerings (IPOs).

As a further test of financial strength, as well as a confirmation of the quality of earnings, a number of value screens include a requirement of positive operating cash flow. Cash flow from operations is the sum of net income, depreciation, and the change in accounts payable minus the change in accounts receivable. Earnings can be influenced by many management assumptions trickling through the accounting books. Cash flow is less influenced by these types of varying assumptions, making it more comparable across a wide range of companies.

Trait #4: Unique Niche

While Buffett is a value investor, he passes up the stocks of

commodity-based firms even if they can be purchased at a price below the intrinsic value of the firm. An enterprise with poor inherent economics often remains that way. He feels that the stock of a mediocre business treads water. Buffett defines commodity-based firms as those selling products where price is the single most important factor determining a purchase by the customer. They are characterized with high levels of competition in which the low-cost producer wins because of the freedom to establish prices. Management is key for the long-term success of these types of firms.

Buffett instead seeks out consumer monopolies selling products in which there is no effective competitor, either due to a patent or brand name or similar intangible that makes the product unique. Investors can seek these companies by identifying the manufacturers of products that seem indispensable.

Templeton also sought companies with competitive advantages. This can be detected by comparing a stock's forecasted earnings growth figures to the forecasted growth of its industry; firms with earnings growth estimates greater than or equal to the industry median are more likely have a competitive advantage.

Wanger states that the companies he invests in "rest on a solid tripod" based on growth potential, financial strength, and fundamental value. For a company to grow, it must have quality products, an expanding market for these products and the ability to efficiently manufacture and market its products. He states that the best way for a company to ensure continued growth is to establish a special niche for itself in the market and to dominate that niche. The niches make it difficult for the entry of additional competition and, in that way, the company will not have to rely on lowering prices as sole means of increasing sales. These niches can be geographical, as in the case of a regional bank, a technological niche supported by patents, or it could simply be a strong marketing presence that makes it costly for new competitors to gain market share. Be aware of the fact that a niche's appeal has nothing to do with its glamour, or lack thereof. "Boring" stocks are more likely to fit this description than glamour stocks.

Ralph Wanger seeks out companies with a dominant market position. He suggests that it is best to stick with only the leaders in the industry and avoid the weak "me too" companies. He believes it is better to own the best company in a marginal industry than the third runner-up in a major industry.

These types of firms typically have high profit margins because of their unique niche; however, simple screens for high margins may simply highlight firms within industries with traditionally high margins. When screening with margins, it is best to look for companies with operating margins and net profit margins above their industry norms. Robust operating

margins also help to shield a stock against negative surprises.

The operating margin concerns itself with the costs directly associated with production of the goods and services, while the net margin takes all of the company activities and actions into account. Additional screens for strong earnings and high return on equity will also help to identify consumer monopolies. Follow-up examinations should include a detailed study of the firm's position in the industry and how it might change over time.

To help guard against companies with just a strong one-time showing, many screens filter for companies whose current operating margin is greater than or equal to their average operating margin over the last few years.

Trait #5: History of Paying Dividends

While not found in all of the value screens on AAll.com, many of the successful value gurus look for companies that have a history of rewarding their shareholders with dividends.

Dreman seeks out companies with a high dividend yield that the company could sustain and possibly raise. He feels that the yield helps to provide protection against a significant price drop and also contributes to the total return of the investment. Neff also found that high dividend yields serve as price protection: If stock prices fall, a strong dividend yield can help heal many wounds. For that reason Neff considers dividends a free "plus," meaning that when you purchase a stock paying a dividend, you do not shell out a red cent for that dividend payment.

Graham looked for a long period of uninterrupted dividends as a test for financial strength over time. Graham recommended uninterrupted payments of at least the past 20 years.

There are many ways to screen for dividend yield: You can simply establish a minimum level, or perform a relative screen that compares the current yield to the market level or to the company's historical norm. Yield screens typically exclude small, high-growth companies because they need all cash generated through operations to expand.

Special Value Twist: Earnings Surprise

The goal of analyzing growth forecasts, Neff argues, is to establish credible growth expectations. Monitoring published earnings estimates and consensus estimates also enhances one's clairvoyance. Neff refers to these consensus estimates as prevailing wisdom in its most literal form.

David Dreman studied earnings surprises and their effect on stock prices. Missing an analyst estimate by a few cents can send a stock price down sharply. Positive earnings surprises occur when actual reported earnings are significantly above the forecasted earnings per share. Negative earnings surprises occur when reported earnings per share are significantly

below the earnings expectations.

In a study of quarterly earnings estimates, Dreman found an average error of 44% annually. Only 29% of the estimates were plus or minus 5% of the actual earnings announcement, 47% were within 10% plus or minus of the actual earnings figure, and 58% were within a 15% plus or minus band. That means that there is a high probability that you will experience an earnings surprise for a company that you own.

Dreman finds that the best way to take advantage of the high rate of analyst forecast error is to simply invest in out-of-favor stocks. In his studies of earnings surprises, David Dreman found that stocks with low price-earnings ratios reacted more strongly to positive earnings surprises than did high price-earnings stocks. As it turns out, a positive earnings surprise for a stock with high expectations (as measured by factors such as high price-earnings ratios) is not truly a surprise. It is a reinforcing event that does not change perceptions about a stock.

Positive earnings surprises for out-of-favor stocks, however, are perceived by the market as significant events. Dreman terms them “event triggers” because they initiate a perceptual change among investors.

The impact of a negative earnings surprise is reversed. Out-of-favor stocks barely flinch, while highly favored stocks generally have significant declines. With out-of-favor stocks, negative surprises are reinforcing events that do not lead to reevaluations. However, negative earnings surprises are event triggers for highly valued stocks that typically lead to a downward reevaluation of the firm’s prospects.

Not surprisingly, large firms tend to adjust to surprises more quickly than small firms do. Firms with a significant quarterly earnings surprise also often have earnings surprises in subsequent quarters. When a firm has a surprise, it often is a sign that other similar surprises will follow.

Changes in stock price resulting from an earnings surprise can be felt immediately, but the surprise also has a long-term effect. Studies indicate that the effect can persist for as long as a year after the announcement. This means that it does not make sense to buy a stock after the initial price decline due to a negative earnings surprise. There is a good chance that the stock will continue to underperform the market for some time. It also indicates that it may not be too late to

buy into an attractive company after a better-than-expected earnings report is released.

Conclusion

Value investors argue that although the market may be efficient in the long term, emotions often dominate in the short run. These emotions can overtake rational analysis, pushing a stock’s price above its intrinsic value during periods of euphoria and below its true worth when reacting to bad news.

Much can be learned by studying the strategies of investors with successful long-term records. Investors must learn to separate the company from the stock. It is desirable to invest in a good company, but only if the company can be purchased at an attractive price. Price multiples help to point out companies that may be trading at bargain-basement prices. Then the investor must look at the growth prospect, financial strength, and profitability of the company to determine if the stock truly is a value. Many value investors prefer to invest in companies that pay a dividend. The dividend yield helps to provide protection against a significant price drop and also contributes to the total return of the investment. Also keep in mind that value stocks typically have had more positive earnings surprises than high growth stocks and the reaction was typically more significant. Furthermore, when a value stock had a negative earnings surprise, its price drop was typically not as severe as that for a growth stock.

You do not have to use sophisticated models to succeed. Complex models based upon the increasing amounts of financial data have not led to investing success. The increased information and sophisticated models only serve to increase investor confidence, not accuracy.

However, you still must do your homework before investing in a stock. Lynch observes that many people follow a hunch or a tip and invest in a company without doing any research. Very often these are the same individuals who spend many hours researching which coffee maker is the best on the market and scouring the Internet to discover which store offers the best price. Finding a good company is only half of the battle in making a successful investment. Buying at a reasonable price is the other. The common traits of these successful value screens should provide you with a framework to make rewarding investments. æ

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