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“The More Things Change, the More They Stay the Same”

Over the holidays, I picked up a book that has been on my bookshelf for over 20 years. It was at least that old when I first got it. As I flipped through the pages, I got engrossed in the content yet again. Refreshingly free of jargon, full of good counsel and common sense, it helped me to put the last year of market behavior and misbehavior in perspective.

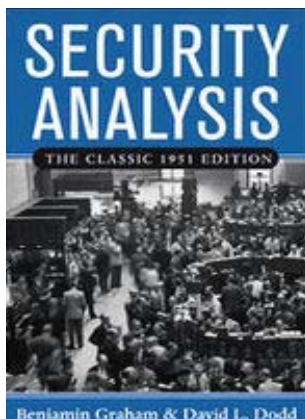
And what a year it was! “Risk on, risk off” ruled the markets as investors stampeded in and out of various markets with dizzying speed. The S&P 500 volatility index (100 day) finished the year at a level seen only three previous times since the 1930’s. Investors endured 12 corrections of at least 5%, almost double the long term average.

Concerns about Europe, the U.S. and China kept the S&P 500 flat for the year, despite good economic numbers. Canada’s TSX underperformed it’s US counterpart. Yields on both US and Canadian government bonds fell to record lows as investors bought these securities in search of a safe haven – at a cost of negative real (inflation adjusted) returns, in many cases.

This is what my investment book had to say about that:

...It is not the wild gyrations of the common stock averages but the precipitate decline in the bond averages that constitutes the really novel and arresting feature of recent financial history - ...The heavy losses taken by conservative investors...warrant the serious question, Is there such a thing as sound and satisfactory investment?”

And that’s really the nub of it all for all investors: is there such a thing as a sound and satisfactory investment anymore? Traditionally safe investments such as bonds and GIC’s pay almost no real return to speak of. Dividend returns in more risky stocks can be found in the 3% to 6% range, but the price to be paid is volatility, and the fear that one may lose some capital in the process.



What’s an investor to do?

The authors of the book spend many chapters to answer that question. Our Adroit View will attempt to consolidate their advice into the next few pages. Oh, the book I’m referring to? Benjamin Graham and David Dodds’ classic “*Security Analysis*”, (published in 1962, 4th Edition, originally published in 1934).

Before the authors provide their advice to investors, they take a jab at speculators: “*That enormous profits should have turned into still more*

*colossal losses, that new theories should have been developed and later discredited, that unlimited optimism should have been succeeded by the deepest despair...we seem to be on firm ground in repeating the old aphorisms that in speculation **when** to buy – and sell – is more important than **what** to buy, ...by mathematical law more speculators must lose than can profit”.*

To my eyes, the resemblance was uncanny between the authors’ words written almost eighty years ago, and the experiences of the last few years. The enormous profits of the mortgage and asset backed securities debacle did indeed turn into “*colossal losses*” for investors around the world. New theories and mathematical constructs espoused by hedge funds were in many cases discredited, as these funds either imploded or disappointed their investors enough that they disappeared from the investment landscape. And finally, the day trading craze defined the “*aphorism that when to buy and sell is more important than what to buy*” as internet based traders bought and sold ‘ticks on tickers’ without a clue in many cases as to what the security behind the ticker symbol actually represented.

The authors’ premise (shared by us) is that the careful investor should spend a considerable amount of time and effort to identify good investment opportunities.

A good investment should be “*one which, upon thorough analysis, promises safety of principal and a satisfactory return:*

...the ‘safety’ sought in investment is not absolute or complete; it means rather, protection against loss under reasonably likely conditions...

...‘satisfactory return’ is a wider expression than adequate income, since it allows for capital appreciation or profit as well as current interest or dividend yield”.

The key to determining the ‘safety’ of an asset as defined above, is to find an investment with a valuation that has limited downside, or a ‘margin of safety’. Two steps are necessary here. First, the investor must confirm the quality of the asset. If the security is common stock, the investors will do the due diligence required to ascertain the company’s viability as a going concern, with reasonable prospects for growth. A careful review of the financial statements and financial ratios is a good starting point.

Once the investor has determined that the asset is indeed of investment quality, he must then determine a reasonable price he is willing to pay for that asset.

This is where things can get tricky, because “*the market is not a **weighting machine**, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its qualities. Rather...the market is a **voting machine**, whereon countless individuals register choices which are the product partly of reason and partly of emotion”.*

There are a number of ratios that an investor can use to determine whether a stock is cheap or expensive. One of the most commonly used is the P/E, or price earnings ratio. It takes the price of one share of common stock, and divides it by the annual earnings per share. Effectively, it tells us how many dollars we are paying for a dollar of company earnings.

It is almost axiomatic that the lower the P/E, the better. However, every stock has more than one P/E ratio at a time. I.e., even with holding the ‘P’, or price constant, a stock has many potential ‘E’s”, or earnings numbers, that can be used. Each is correct, each is valid, and each can be very different, especially in stocks that have highly variable earnings.

Under the “E”, you can have actual (achieved) earnings, either for the calendar year, or for the last four rolling quarters. You can use estimated earnings for the coming calendar year, or for the next four rolling quarters. For the estimates, you can use analysts’ consensus estimates, as compiled by a number of different providers. (Each provider may have a different set of analysts, thus resulting in different consensus numbers.) Or, you may use the estimates of one particular analyst you believe has very good forecasting skills, resulting in yet a different earnings estimate number. Again, we stress each of these numbers is valid, defensible, and could differ greatly.

We’ve used Alcoa, an aluminum producer, as our example. It has highly variable earnings quarter to quarter, and year to year. We hope the following table illustrates our point:

P/E calculations for Alcoa			Earnings	P/E
<i>Stock price as at Dec. 15/2011</i>			\$ 8.78	
1	Earnings - actual, calendar year (to Dec. 31, 2010)		\$ 0.53	16.57
2	Earnings - actual, rolling 4 quarters (to Sep. 30, 2011)		\$ 0.96	9.15
3	Earnings - consensus estimate, calendar year (to Dec. 31, 2012)		\$ 0.76	11.55
4	Earnings - consensus estimate, rolling 4 quarters (to Sep. 30, 2012)		\$ 0.60	14.63

You can see that in this example, Alcoa’s P/E was highest (16.5) when the actual annual earnings were the lowest (\$.53). If you look at actual earnings for the past four full quarters, the P/E is almost 50% lower at 9.1. Yet both could be labeled “current P/E”.

Sometimes a low P/E results from investors bringing the price of a stock down in anticipation of sharply lower earnings to come. In this case, the P/E based on actual earnings will be low, but based on the lower forward estimated earnings, the P/E would be high.

Or, a forward P/E based on very optimistic estimated earnings might seem enticingly low. Comparing it to current modest earnings would show how much earnings needed to grow just to meet expectations, giving the careful investor reason to pause and re-examine the opportunity.

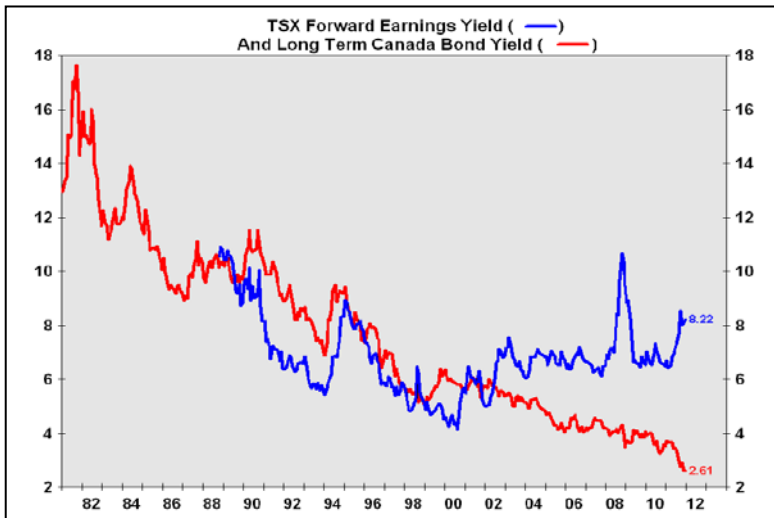
As a general rule, investors (the “market voting machine”) will give a company a higher P/E if the “E” is expected to grow at a faster clip than the average. This higher P/E would only be justified if the stock met or exceeded these high expectations. Disappointment over negative earnings surprises often leads to stock price drops well out of proportion to the size of the earnings miss.

Thus, a high P/E, in general, is best avoided by the careful investor as it does not provide much of a margin of safety. A low P/E is no guarantee of safety, but is a helpful indicator of value.

There are other valuation ratios that can be used, such as the fairly common P/B (Price to Book) and P/S (Price to Sales), along with a large number of more complex metrics and calculations. We will spare our readers further technical content, and move on.

Let us return to the second part of what constitutes a good investment opportunity, as per Graham and Dodd. This is the concept of satisfactory return.

A useful way to evaluate the level of return on equities is to look at the “earnings yield”. We can determine the earnings yield on the Canadian market, as represented by the TSX Index, by taking the expected earnings for the coming year, and dividing this by the market price. (The astute reader will note that this is the inverse of the P/E calculation).



The chart at left, which many of our clients will be familiar with, shows that the TSX market’s forward earnings yield near the end of 2011 was 8.2%. (The blue line is the earnings yield; the red line shows the yield on a long term Canada Bond).

As we write this View, the yield on a Government of Canada 10 year bond is 1.94%. Investing in perceived safety is still very expensive!

The difference between the yield available on stocks, and that provided on bonds, is now very high. This provides a solid “margin of safety” on stocks, and allowing for growth in dividend payments.

*“It is our belief that stockholders should demand of the managements ...a normal payout of earnings on the order of, say, two thirds....
 ...Analytical studies have shown that in the typical case a dollar paid out in dividends had as much as four times the positive effect on market price as had a dollar of undistributed earnings”.*

The average dividend yield on the TSX at the time of writing is 2.76%. This is well above the 10 year Canada bond yield of 1.94%. The average payout ratio is in the order of 30% to 35%, about half that which Graham & Dodd recommend investors demand. There is plenty of room for companies to increase dividends, even if they only pay out 50% of earnings. There is also room for earnings to fall without affecting dividend yields, given the low level of payouts.

As another New Year begins, we hope we have made you think. Advice and concerns from eighty years ago (other than the slightly old fashioned language) could have come from today’s headlines. Chasing “risk on, risk off” trades will likely continue to beguile and then hurt speculators. On the other hand, the careful investor should find many equities that are “reasonably safe” and should provide “a satisfactory return”, at least by Graham & Dodd standards.

Every one of us at Adroit would like to take this opportunity to wish you a Happy and Prosperous New Year!