Combining Growth, Yield and Quality

P/Es With a Value Twist

by Adam Ritt, Editor, BetterInvesting

Estimating the high and low price-earnings ratios, a vital component of BetterInvesting methodology, can be difficult even in the best of markets. During sideways or bear markets, P/E forecasts for many companies can be quite tricky because the basis of your estimates are historical P/Es achieved during a relatively optimistic period.

And for Vitaliy N. Katsenelson, CFA, author of the new book *Active Value Investing* (Wiley Finance, 2007), we're definitely amid what he refers to as a range-bound market. This is a common development after a bull market, he says, and is marked by small cycles within a basically flat market.

"There's growth in earnings, but there's also P/E compression," he says. What happens with stocks in a range-bound market is similar to what occurred with Wal-Mart's stock over the past decade. Wal-Mart's earnings have tripled from $.99 a share in 1998 to $3.16 in 2007, yet its average annual P/E ratio decreased from 31.2 to 14.9 during this period, Value Line says. *(Companies are mentioned for educational purposes only. No investment recommendation is intended.)*

In range-bound markets, earnings growth and dividends become more important sources of returns. In fact, dividends account for 19 percent of total return in bull markets but 90 percent of return in range-bound ones, Katsenelson says. Meanwhile, investors should temper their expectations for return from P/E expansion.

Stocks with lower P/Es to begin with suffer less multiple compression than ones with relatively high P/Es. "If a stock has a higher P/E than average, you need to be confident the company can maintain a high growth rate over time," he says. "For every Microsoft there are a hundred Ataris."

The Fair Value P/E

Because of the limited help investors should expect P/Es to provide during range-bound markets, the starting valuation is a vital consideration. Katsenelson assigns a "fair value" P/E to a stock, then seeks a margin of safety in the valuation. The fair value P/E is based mainly on a company's earnings growth and dividend yield, with business risk, financial risk and earnings visibility also considered.

The starting point for valuation is what a stock for an average company would trade for if the company has no growth and doesn't pay a dividend. In Katsenelson's model, the P/E is 8, compared with the 8.5 suggested by Benjamin Graham, the father of modern securities analysis. Then for every percentage point of expected long-term earnings growth up to 16 percent, the P/E goes up by 0.65.

Above the 16-percent level, the basic P/E rises by only 0.50 for each percentage point. This is because investors tend to pay less for incremental growth beyond this point, Katsenelson says.

"The fair value P/E is based on a company's earnings growth and dividend yield, with risk and earnings visibility also considered."

Then Katsenelson adds in the dividend component. Investors value yield more than earnings growth, he says, because dividends are cash paid from actual earnings — they're more tangible. So for each percentage point of yield, the P/E goes up by a corresponding point.

For example, a stock with a current yield of 2 percent for a company expected to grow earnings by 10 percent would have a basic P/E of 16.5 — 8 plus 6.5 (10 times 0.65) plus 2.

Katsenelson then assigns a premium (or a negative value) to the P/E based on the earnings visibility, business risk and financial risk. He limits the premium to 30 percent of the basic P/E. For the stock with a basic P/E of 16.5, the maximum fair value P/E would be 21.5. (His model assumes average future inflation and interest rates. You'd need to make adjustments if rates are expected to change significantly.)

Individual investors have the tools at their disposal to perform these calculations, he says. For example, they can use Value Line to assess a company's financial strength.

After determining the fair value P/E, you would then assign a margin of safety to create a "buy" P/E. The higher a company's quality, earnings growth and dividend yield, the less margin of safety Katsenelson requires on the fair value P/E.

Katsenelson also develops a "sell" P/E by multiplying the fair value P/E by 1 plus the combined expected yield and earnings growth rate. So if a stock's fair value P/E is 20 and a company is expected to pay a 2-percent yield and grow earnings by 15 percent, the "sell" P/E would be 23.4 — 20 multiplied by 1.17.

One of the benefits to this approach is that it helps keep you from falling into value traps by relying too heavily on past valuations, Katsenelson says. It also helps keep your emotions in check by providing a more objective system for valuation.

Recurring Revenues = Quality

Many value-based analysts use a discounted-cash-flow model for deriving a reasonable stock price, and Katsenelson is no exception. But he's drawn to using P/Es because they're simple to use and calculate. DCF "works fairly well at the extremes" when a stock is significantly over- or undervalued, he says, but it isn't a precise tool. So he uses it in conjunction with his absolute P/E model.

Company quality is important, though he places less emphasis on the consistency of a company's earnings growth than many BetterInvesting members might because of cases in which firms have cooked the numbers to maintain stable growth.

Instead, he looks for the qualities that create consistent growth. Recurring revenues, for example, are an important trait. Insurance brokers often have them, while a computer retailer likely doesn't.

The importance of quality growth at least partially explains why many large bank companies have sported solid growth numbers but have had surprisingly low P/E ratios. But the P/Es make more sense when studying the industry's history. "The quality of growth wasn't there," Katsenelson says. They typically have grown mainly through acquisitions instead of organically.

Other factors contribute to banks' historically low P/Es, such as uncertainties about how they make money. "If you own a bank, you own a black box," he says.

BetterInvesting's Stock Selection Guide may emphasize historical valuations rather than an objective analysis of the "proper" valuation. But those who use the tool should find Katsenelson's methodology helpful when trying to forecast future valuations. ■

We've changed our name, but not our investment philosophy. The NAIC Growth Fund is now...

EAGLE CAPITAL GROWTH FUND, INC.

The Fund invests in high quality growth companies with a long-term perspective.

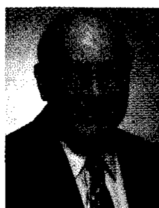
For more information, please visit www.naicgrowthfund.com or www.eaglecapitalgrowthfund.com.

The Fund's stock trading symbol remains GRF.

Do Your Stocks Need A "Repair Shop"?

Have your portfolio professionally managed following BetterInvesting principles.

SEGER Elvekrog™
Personal Money Management



Get The Details Now
Contact Dan Krstevski
1-800-449-6970
www.seger-elvekrog.com