EPIC
INVESTMENT MANAGEMENT

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What Goes Up? Part I

How do money managers pick stocks? What attributes should we favor?

These simple questions often elicit complicated answers, which the investment community tries to synthesize into a word or two, fitting it all into a tidy style-box. For every growth style, there is a value style. Contrarians are at odds with momentum investors. Chartists do their own thing, while Quants do something very different. Activists and macro-driven investors seem to be on different planets.

What's easily missed is that all these styles represent the same goal: to own rising stocks while avoiding falling stocks. If that isn't the essence of equity investing, then nothing is. So in this and succeeding studies, we simply ask "what stocks go up?"; or to be more precise, "why do certain stocks outperform others?"

Our proprietary study examines isolated variables and tests conventional wisdom about their usefulness in stock selection over an intermediate timeframe -- one year at a time.

First, a few of the necessary disclaimers. This study is far from all-inclusive:
We examine only a small number of measurable variables. The overall timeframe is fairly brief -- 19 years of annual data from a US market with two centuries of trading history. We also make no attempt to capture more qualitative factors, such as the benefits of strong company management, or favorable tax, regulatory, and competitive structures.

And without a doubt, some observations about past market behavior will not hold up in years to come. This much is certain, the stock market creates enough variability so that even a perfect understanding of the past will not precisely divine the future.

Nevertheless…

Here's our approach: isolate a measurable variable that is often considered important in the stock selection process; each year, starting in 1995, sort the stocks within the Russell 1000 index by this variable; separate the results into 10 equal-sized groups (deciles); and measure the stock market returns of each decile for an entire year. At the turn of the year, start all over again. Then tally the results over the entire 19-year period.

Results are displayed in two forms: a bar-chart with aggregate returns for each decile over the 19-year period; and a line chart showing progressive performance of the top-ranked quintile against the bottom-ranked quintile over the same timeframe.

This study examines variables, exclusive of valuation, that were of greatest interest or produced the most provocative results. The variables include operating margins, return-on-equity, growth rates, and financial leverage.

A subsequent study will examine valuations in the same context.

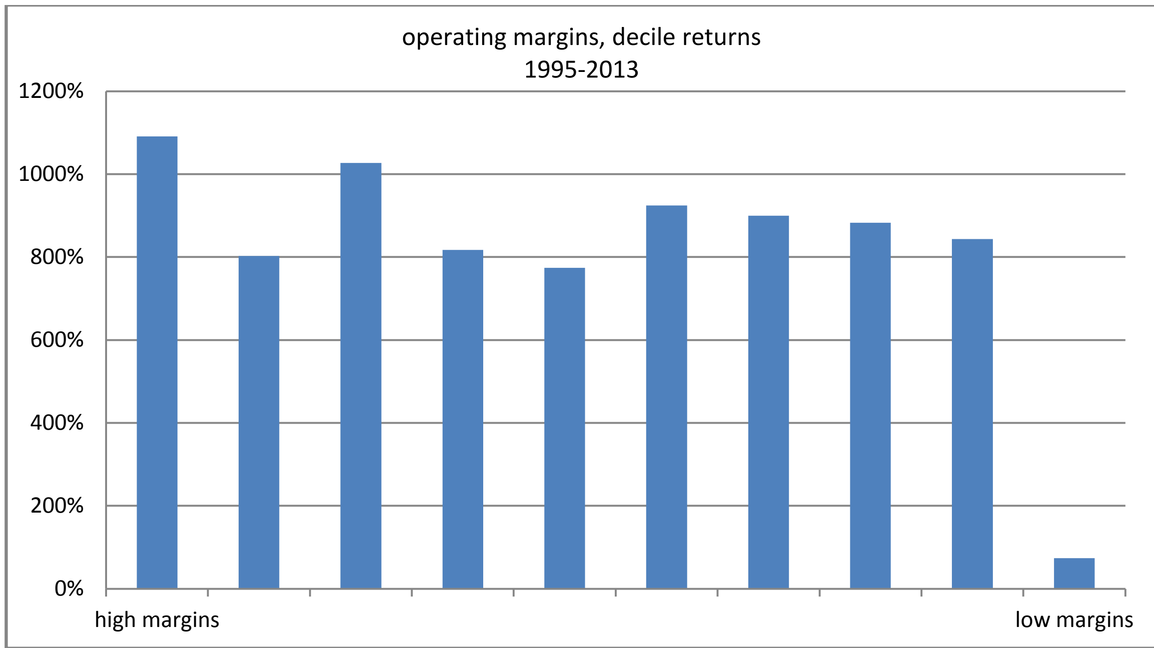
Operating Margins

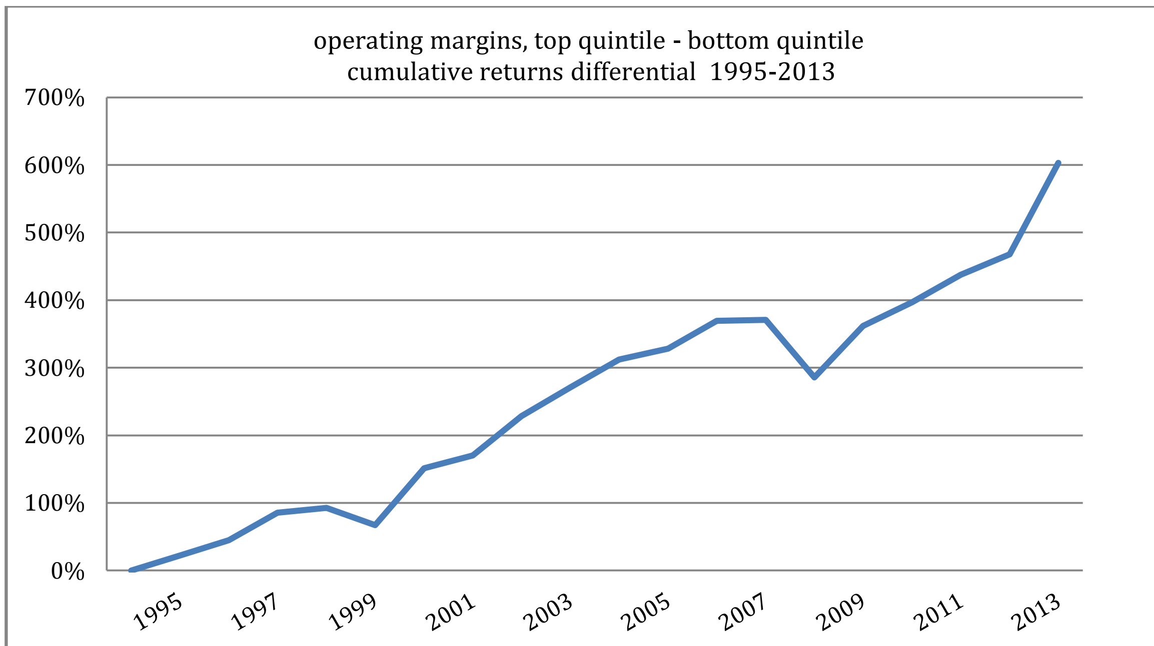
Ask investors what financial qualities they favor and invariably the list will include high operating margins. And why not? Given the choice of investing in a high margin business or a low margin business, intuition says we should prefer the company that turns each dollar of sales into the higher level of profits.

As shown on the following page, recent history supports this concept, but only to a limited degree. The best performing stocks came from the highest ranks of operating margins. However, the spread of results from high margin, medium margin, and low margin companies is fairly small. It was only the lowest ranked stocks -- the companies with tiny or negative operating margins -- that performed poorly.

What is the explanation? Margins are, to a great extent, dependent upon the industry in which each company competes. Supermarkets run a business model based on high turnover and low margins, while software and pharmaceutical companies typically generate robust margins. Even stodgy utilities often produce high operating margins. We might expect margin differentials within an industry to be meaningful, but not margin differentials across all industry groups.

The most telling result is the weak performance of the lowest-margin group of stocks. Companies that are barely profitable or losing money typically end up in the market's trash heap. The message here is simple: weak, unprofitable companies generally make for losing investments.


operating margins, decile returns
1995-2013
1200%
1000%
800%
600%
400%
200%
0%
high margins
low margins

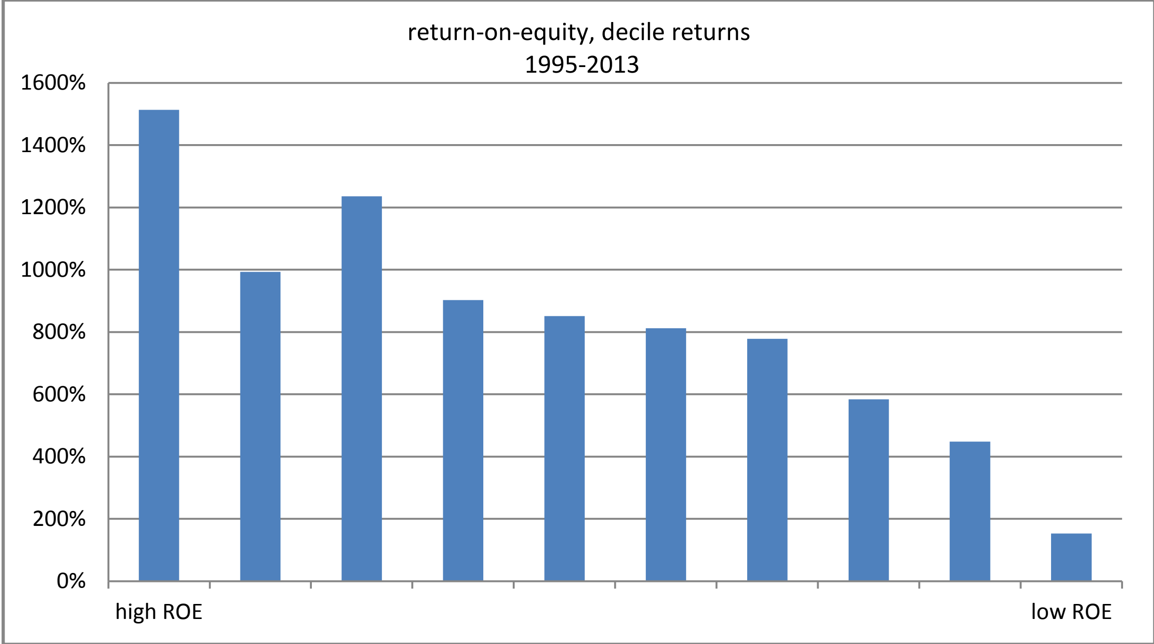

operating margins, top quintile - bottom quintile
cumulative returns differential 1995-2013
700%
600%
500%
400%
300%
200%
100%
0%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

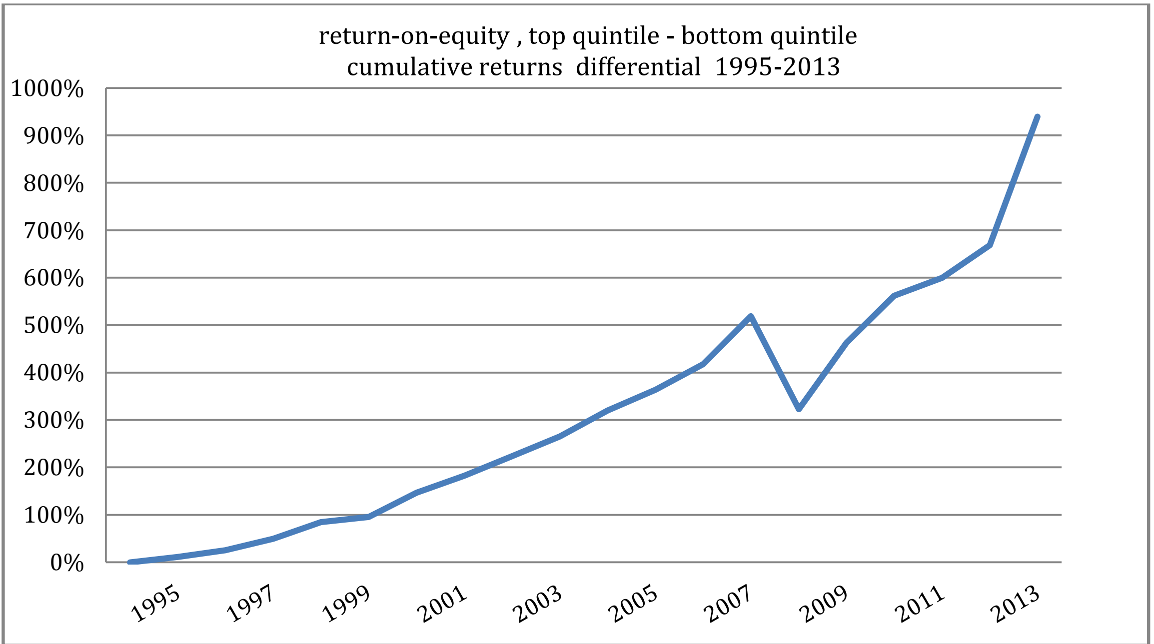
Return-On-Equity

Another popular measure of any company's financial performance is return-on-equity (ROE). The concept here is deeply-rooted in financial theory. Management raises and retains equity capital, deploys that capital to run the business, and hopes to attain an adequate return on the equity. Otherwise, why would anyone invest in the company?

For investors with a few years' experience and a healthy degree of skepticism, the return-on-equity model poses several problems. First, it reflects recent profitability of a company, not future results. If earnings turn lower, ROE will follow. Second, the easiest way for a company to boost its ROE is to use excess cash or borrowings to repurchase stock. The buyback activity shrinks the equity base, creating a lower denominator in the ROE equation, while earnings are basically unaffected. Presto, higher ROE!

Skeptical yet? Well, ROE has turned out to be a great predictor of stock returns over the past 19 years. As shown on the following page, the three highest-ranked groups generated the strongest investment results. In contrast, the lowest-ranked groups produced the worst returns; again warning investors that struggling companies, for the most part, are better left alone.


return-on-equity, decile returns
1995-2013
1600%
1400%
1200%
1000%
800%
600%
400%
200%
0%
high ROE
low ROE


return-on-equity , top quintile - bottom quintile
cumulative returns differential 1995-2013
1000%
900%
800%
700%
600%
500%
400%
300%
200%
100%
0%
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2007
2009
2011
2013

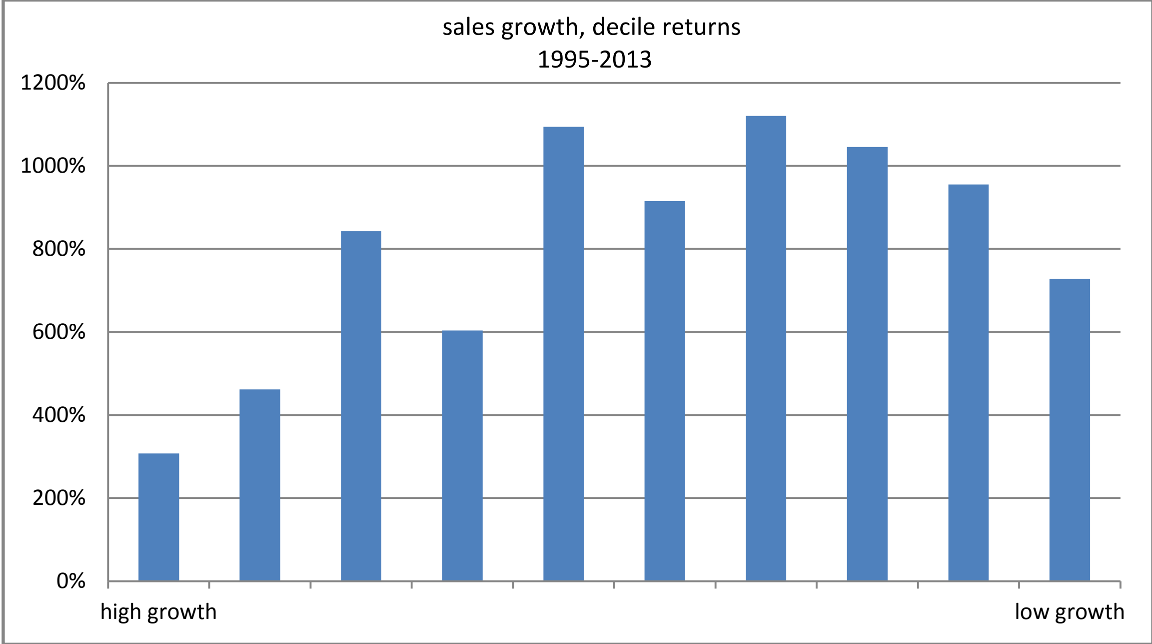
Growth Rates

Investment history is replete with stories of great growth companies generating outsized returns for savvy, long-term investors. To spice up the story, the company may become iconic if it started on a shoe-string budget, or in a garage, or in California. Put all three together and you have the makings of a legendary tale.

Yet for every Hewlett-Packard or Apple Computer there are thousands of ventures buried in business graveyards. Most of these failures offered the promise of exceptional growth at one time or another.

So is growth investing a viable strategy? In the right hands, probably so. Maybe.

As shown on the following page, our study is unconvincing. For the past 19 years, stocks of slow growth companies have outperformed high growth stocks. But before we give up on growth investing altogether, a caveat is in order. Our study uses prior-three year sales growth as a proxy for growth. This may be a case of using the wrong measure; perhaps earnings growth would be more appropriate, or a different time frame. Unfortunately those alternative data sets are not available to us. For now, the best we can conclude is that the growth-stock debate is unresolved -- legends and graveyards notwithstanding.


sales growth, decile returns
1995-2013
1200%
1000%
800%
600%
400%
200%
0%
high growth
low growth

sales growth, top quintile - bottom quintile
cumulative returns differential 1995-2013
200%
100%
0%
-100%
-200%
-300%
-400%
-500%
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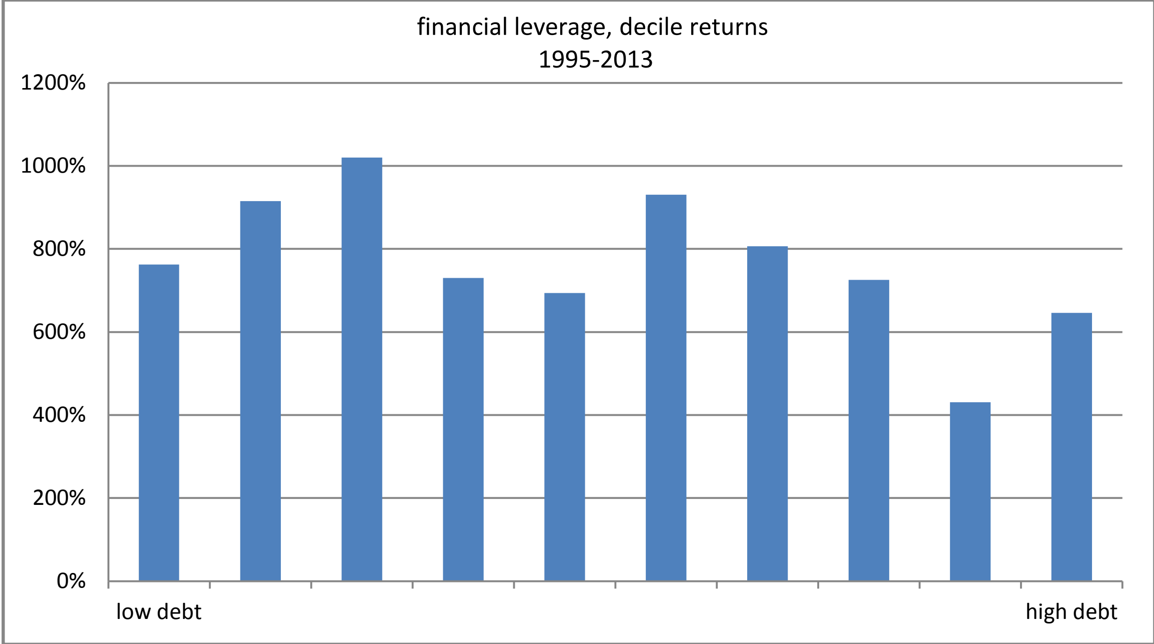
Financial Leverage

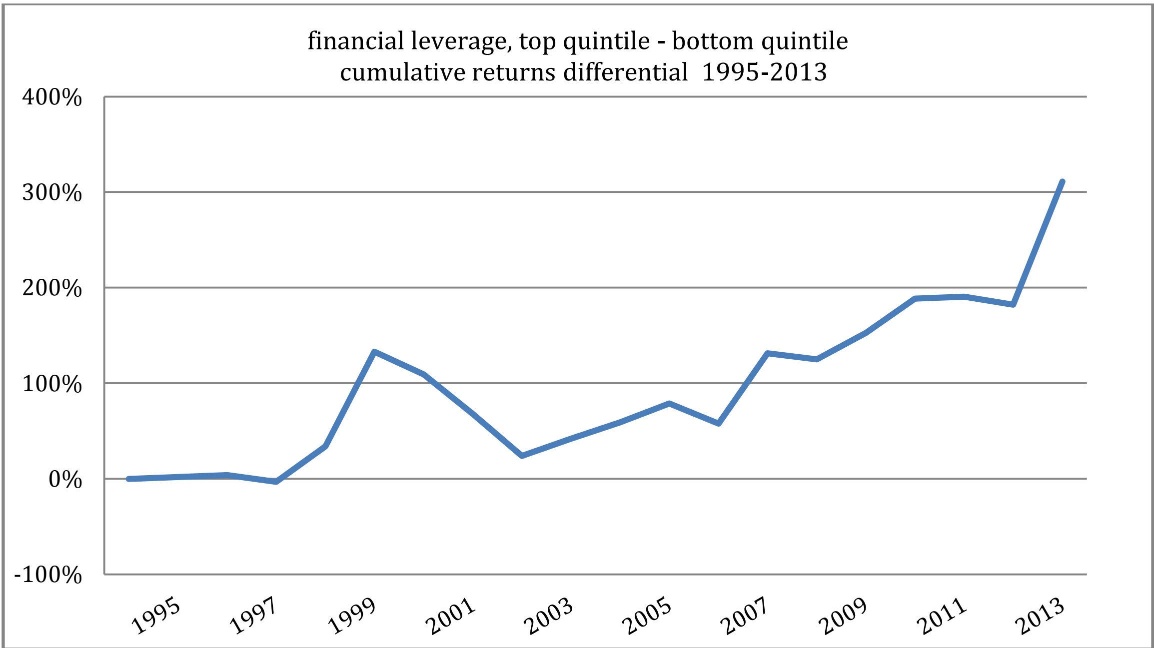
Perhaps no double-edged sword is sharper than financial leverage. Use it wisely, and a company can increase its profitability, return on equity, and earnings growth rate. These benefits all accrue to owners, with an assist from bondholders.

Use leverage poorly, and a business may be buried in debt payments, unable to fund expansion, and susceptible to competitive threats. In extreme cases, shareholders are wiped out and creditors are awarded ownership of the company.

For this reason, seasoned investors often consider the balance sheet to hold equal importance to income and cash flow statements.

As shown on the following page, attention to financial leverage should be less than paramount for equity investors. Stocks of low-leveraged companies have generally outperformed those of high-leveraged entities, yet only slightly. Of the four data sets examined in this study, financial leverage shows the tightest spread between outcomes. While investors may question a company's financial leverage before any new purchase, a hard-and-fast rule on the use of leverage seems misplaced.


financial leverage, decile returns
1995-2013
1200%
1000%
800%
600%
400%
200%
0%
low debt
high debt


financial leverage, top quintile - bottom quintile
cumulative returns differential 1995-2013
400%
300%
200%
100%
0%
-100%
1995
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2013

For just under two decades, a US equity investor would have earned excess returns following the simple rule of buying stocks of companies generating high returns-on-equity (ROE). Using this as a long-only strategy, cumulative returns more than doubled those of the market.

For an investor employing a hedged strategy, buying high-ROE companies and shorting low-ROE companies would have earned returns slightly less than double the market, with a net-neutral market exposure.

In either case, those are significant excess returns. Can it really be so simple?

Of the four variables presented in this study, return-on-equity as a basis of stock selection produced by far the most compelling outcomes. The results are so strong, they are almost too good to be true. At some point in the past 19 years, we would have expected market efficiency to recognize the value of high ROEs, adjusting valuations and pricing away much of the excess returns. This has not happened. Should we rely heavily upon ROE in our stock selection? We remain skeptical. Should we consider ROE in our evaluation of companies? Absolutely.

Among the three other variables tested, operating margins show the strongest results, but for a peculiar reason. It was only the weakest of margins -- producing poor investment results -- that created clear separation of the top nine deciles from the bottom one.

Our growth rate study shows stocks of slow-growth companies outperforming stocks of high-growth companies. While this outcome is feasible, our necessitated use of three-year trailing sales growth as a proxy for growth companies may render the results meaningless.

Low financial leverage proved modestly useful in stock selection, but the outperformance of low-leveraged companies versus medium- and high-leveraged companies was too mild to pique our interest.

The strongest message from our study is that bottom-fishing for stocks in the weakest of the rankings is a dangerous game. Investing in the lowest margin companies produced horrible results; likewise for low ROEs. These low-ranked laggards represent companies that are losing money or barely profitable; and for the most part they represent turn-around situations that did not turn. There is an art to contrarian investing -- to distinguishing between good companies on the discount table, and lousy companies on the trash heap. For most investors, this is a part of the market where "don't touch the trash" is a good rule.

Epic proprietary study, data source: Bloomberg

Tidbits source:
Bloomberg
Wall Street Journal

Tidbits..

Target CEO Gregg Steinhafel is ousted five months after massive data security breach at retailer.
Ford Motor Company CEO Alan Mulally retires after highly-acclaimed tenure at automaker.

Portugal follows Ireland in exiting international bailout program, returning to traditional debt markets to meet financing needs.
Spain, Greece receive credit rating upgrades.
European bond markets rally; plummeting yields approach multi-century lows.

EuroZone exits crisis programs, still seeking measurable growth.

European Central Bank cuts rates, sets deposit interest rate below zero.

Theoreticians' heads spin, as interest rates go negative.

Energy Future Holdings, largest Leveraged Buyout in US history, files bankruptcy.

Moral: beware blockbuster buyout deals at market peaks. Duh.

AT&T agrees to acquire Direct TV for 49 billion dollars.
Medtronic to purchase Covidien for 43 billion dollars, gain Ireland tax domicile.
UK drug company AstraZeneca rebuffs Pfizer's 120 billion dollar buyout offer.

Big money -- really big -- getting thrown at merger activity.

Credit Suisse pleads guilty to US tax-evasion charges, pays 2.6 billion dollar fine.
US Justice Department obtains guilty plea, 9 billion dollar legal settlement, from BNP Paribas.

US Government flexes its muscle -- against foreign banks.

Penny-stock trading sets record volumes as investors pour money into speculative companies.
Yield on Spain's 10-year benchmark note drops below yield on similar US Treasurys.
Ecuador returns to bond market six years after default.
Frontier nations find global debt markets willing to lend long-term at single-digit interest rates.

A fool and his money…

First quarter GDP report shows US economy in sharp, temporary downturn.
International Monetary Fund, World Bank cut growth forecasts for US and global economy.

Still waiting for that global economic surge.

US auto sales hit nine year high.
General Motors recall program grows to 28 million vehicles; company ousts 15 employees in wake of product recall probe; management answers to second Congressional photo-op hearings.

And sales volumes accelerate.

Small Business Optimism reaches highest level since 2007.

Net worth of US households reaches 82 trillion dollars, record level.

The rich get richer, and the rest get?