EPIC
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What Goes Up? Part 2

In “What Goes Up? Part I” (Issue 23, July 2014), we examined four isolated variables commonly perceived as important to the stock selection process. Three of these variables -- operating margins, sales growth, and financial leverage -- were found to be of limited value on a stand-alone basis. The fourth, return-on-equity, proved surprisingly useful, but left us a bit skeptical.

In this second study, we focus exclusively on valuation. In a sense, the prior study asked “what measures of a company’s financial performance are important to stock selection?” This study asks “do cheap stocks outperform expensive stocks, and if so, how should we measure valuation?”

All the prior disclaimers apply, and the methodology is the same.

Results are displayed in two forms: a bar-chart with aggregate returns for each decile grouping from 1995 through 2013; and a line chart showing progressive performance of the top-ranked quintile against the bottom-ranked quintile over the same timeframe.

The valuation methods include price-to-earnings ratio, price-to-book value, price-to-cash flow, price-to-sales, and dividend yield.

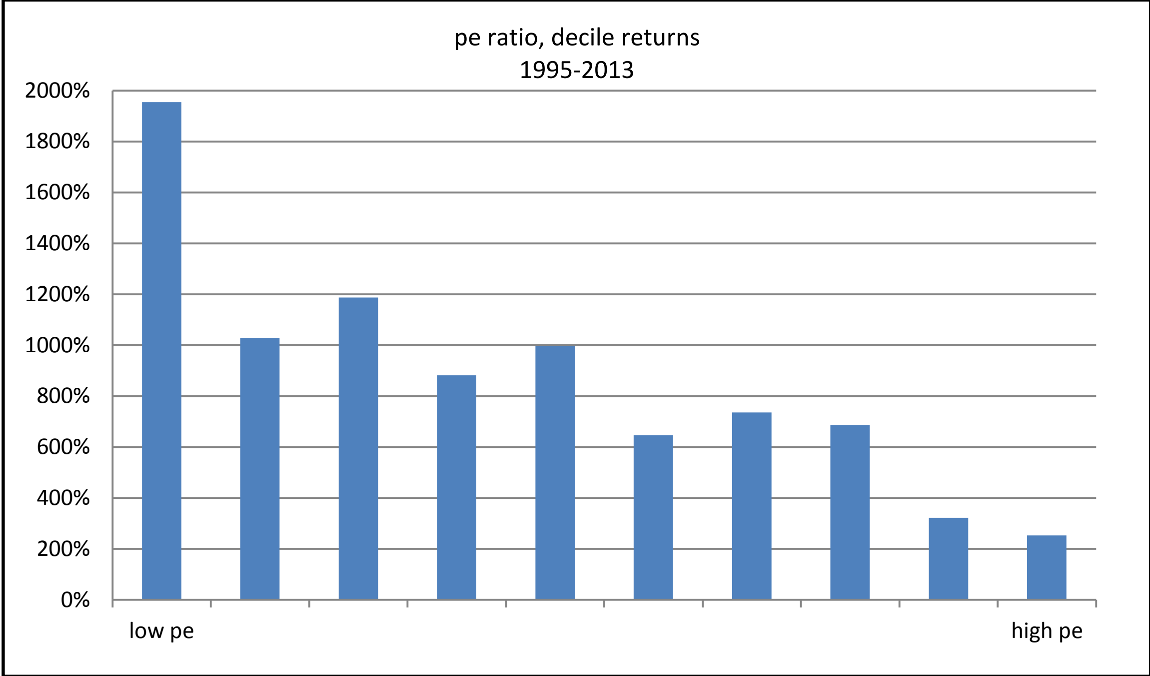
Price to Earnings

Perhaps the oldest and simplest measure of a company's valuation is its price-to-earnings ratio, commonly shortened to 'PE'. There is wiggle room for debate about whether to use trailing 12-months earnings or projected earnings for the next year, but this does not change the basic concept. In our study, we use trailing 12-month results for all valuation measures.

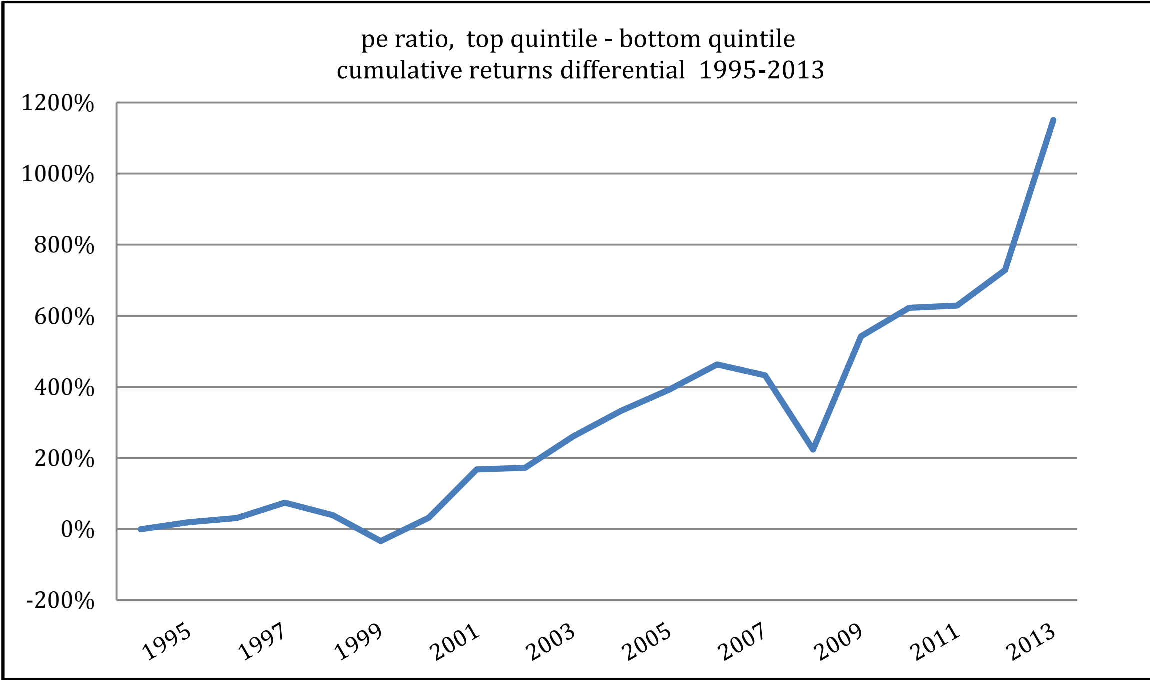
We should expect little of value from a PE approach to stock selection; in fact we should expect little from any valuation measure that does not account for each company's quality and growth rate. "You get what you pay for" is generally considered a valid insight on Wall Street.

The results say otherwise. Over the 19-year period studied, the lowest-valued stocks as measured by PE handily outperformed the most expensive stocks. Owning the cheapest quintile would have produced cumulative returns more than 1100 percent higher than the richly-priced quintile.

As shown on the following pages -- applying valuations based on earnings, book value, cash flow, and sales -- excess returns have been produced simply by owning 'cheap stocks'. There is no forecasting involved, no examination of financial statements, no vetting of company management. The process could not be more basic, almost befitting a rank amateur. Yet the performance is real. Every time we scrub the numbers, the results are the same.



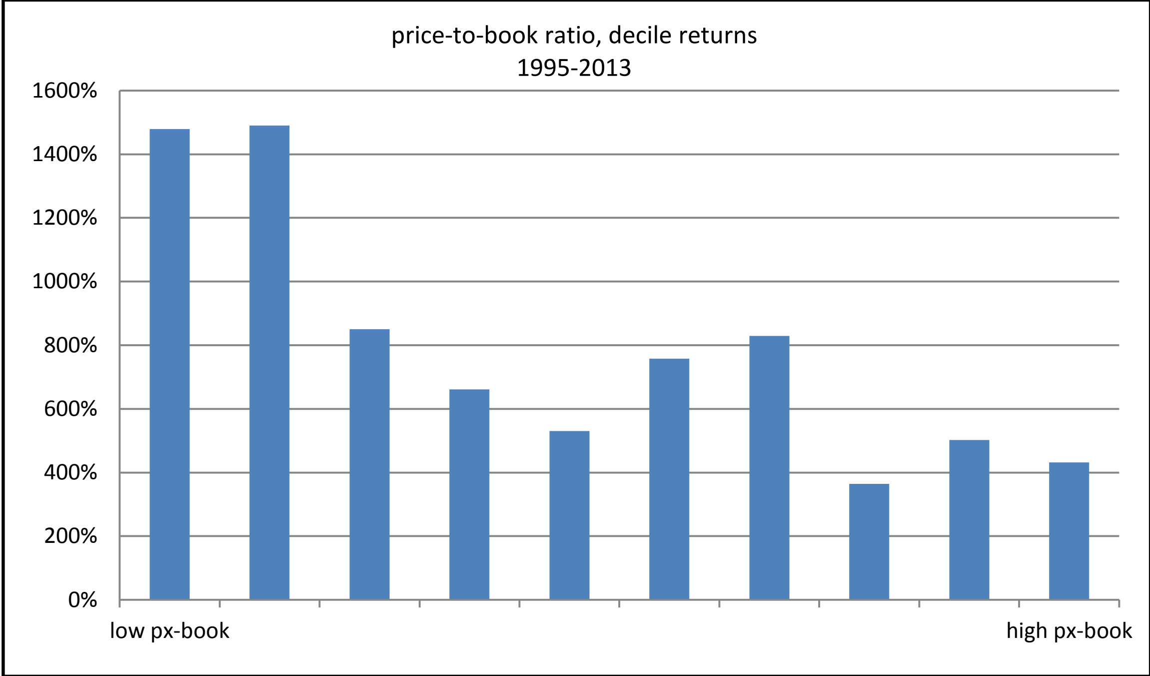
pe ratio, decile returns
1995-2013
2000%
1800%
1600%
1400%
1200%
1000%
800%
600%
400%
200%
0%
low pe
high pe

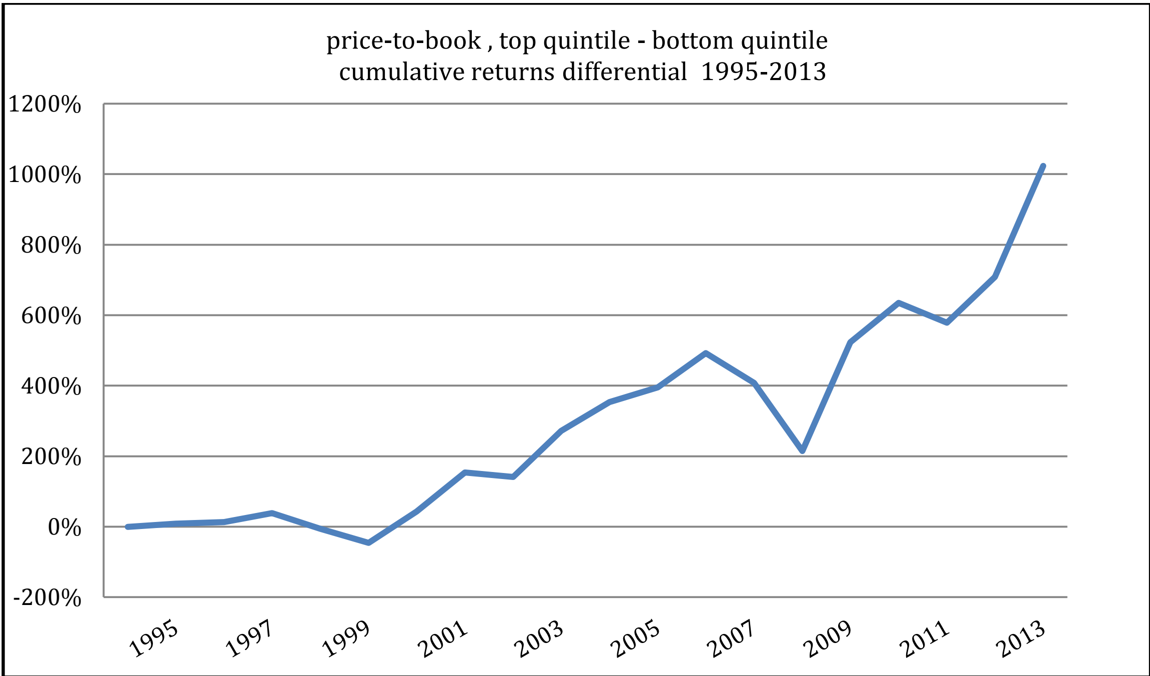


pe ratio, top quintile - bottom quintile
cumulative returns differential 1995-2013
1200%
1000%
800%
600%
400%
200%
0%
-200%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

Price to Book

Buying stocks on a low price-to-book-value basis also proved surprisingly rewarding. Over the 19-year period studied, owning the cheapest quintile every year would have produced cumulative returns more than 1000 percent higher than the richly-priced quintile.

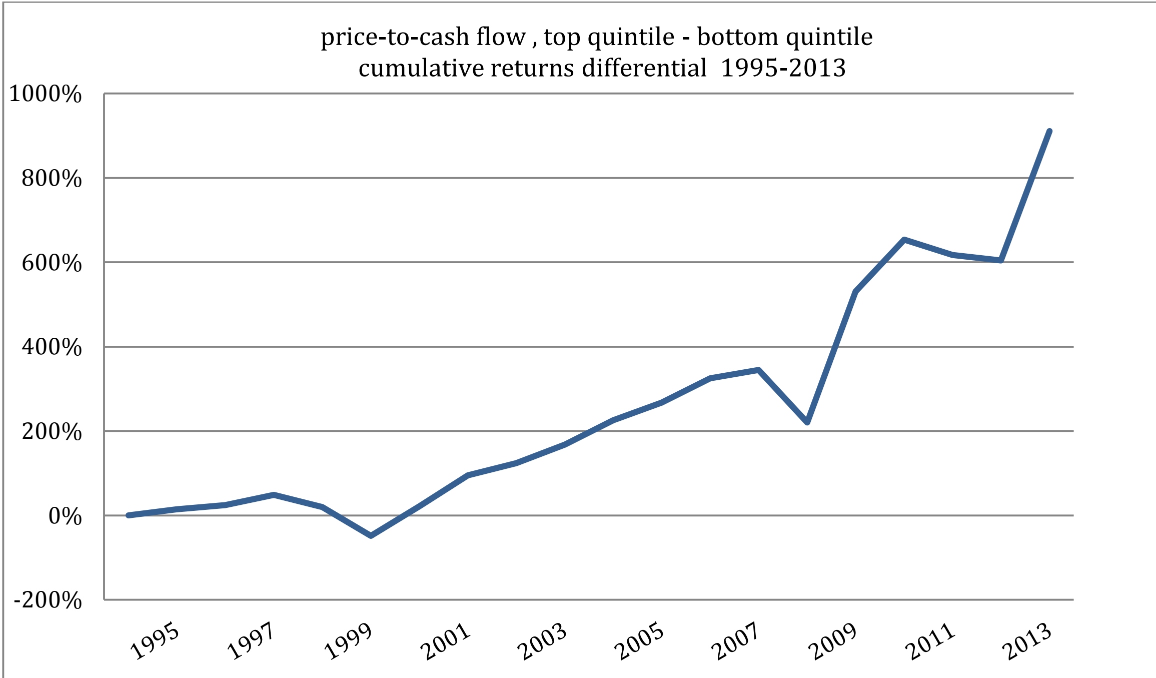

price-to-book ratio, decile returns
1995-2013
1600%
1400%
1200%
1000%
800%
600%
400%
200%
0%
low px-book
high px-book


price-to-book , top quintile - bottom quintile
cumulative returns differential 1995-2013
1200%
1000%
800%
600%
400%
200%
0%
-200%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

Price to Cash Flow

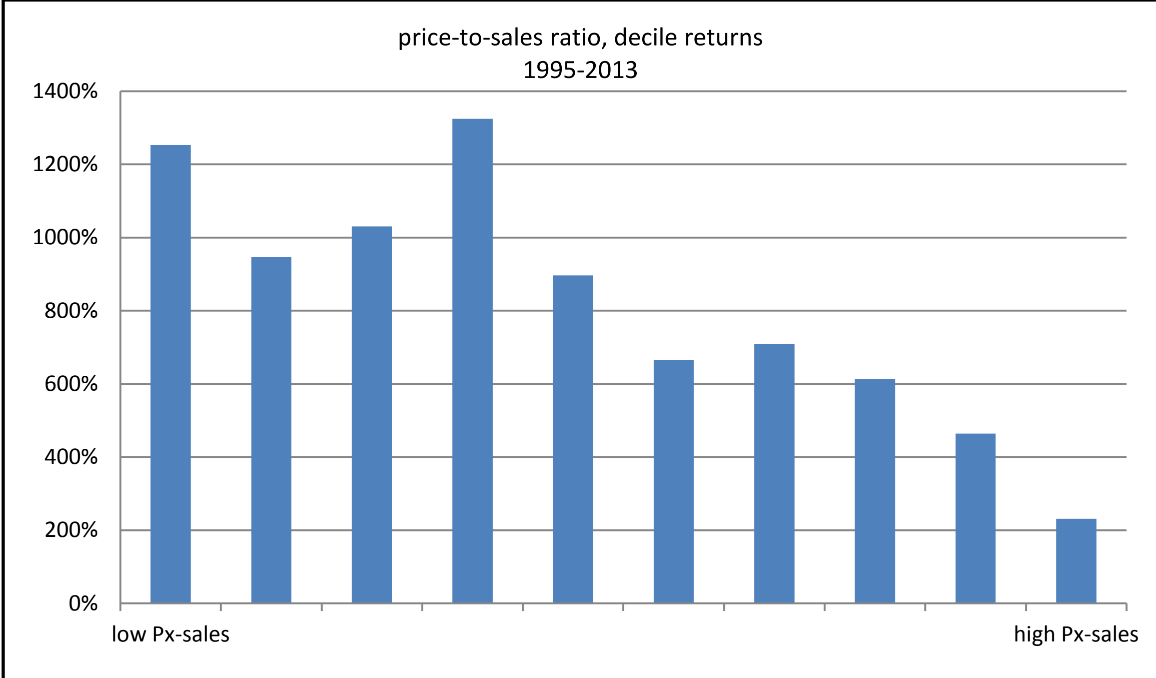
Buying stocks on a low price-to-cash-flow basis showed more of the same. Over the 19-year period studied, owning the cheapest quintile every year would have produced cumulative returns 900 percent higher than the richly-priced quintile.

price-to-cash flow ratio, decile returns
1995-2013
1400%
1200%
1000%
800%
600%
400%
200%
0%
low Px-CF
high Px-CF


price-to-cash flow , top quintile - bottom quintile
cumulative returns differential 1995-2013
1000%
800%
600%
400%
200%
0%
-200%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

Price to Sales

Buying stocks on a low price-to-sales basis was the 'least best' of the string of successful valuation measures. Over the 19-year period studied, owning the cheapest quintile every year would have produced cumulative returns more than 700 percent higher than the richly-priced quintile.


price-to-sales ratio, decile returns
1995-2013
1400%
1200%
1000%
800%
600%
400%
200%
0%
low Px-sales
high Px-sales

price-to-sales , top quintile - bottom quintile
cumulative returns differential 1995-2013
1000%
800%
600%
400%
200%
0%
-200%
1995
1997
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2011
2013

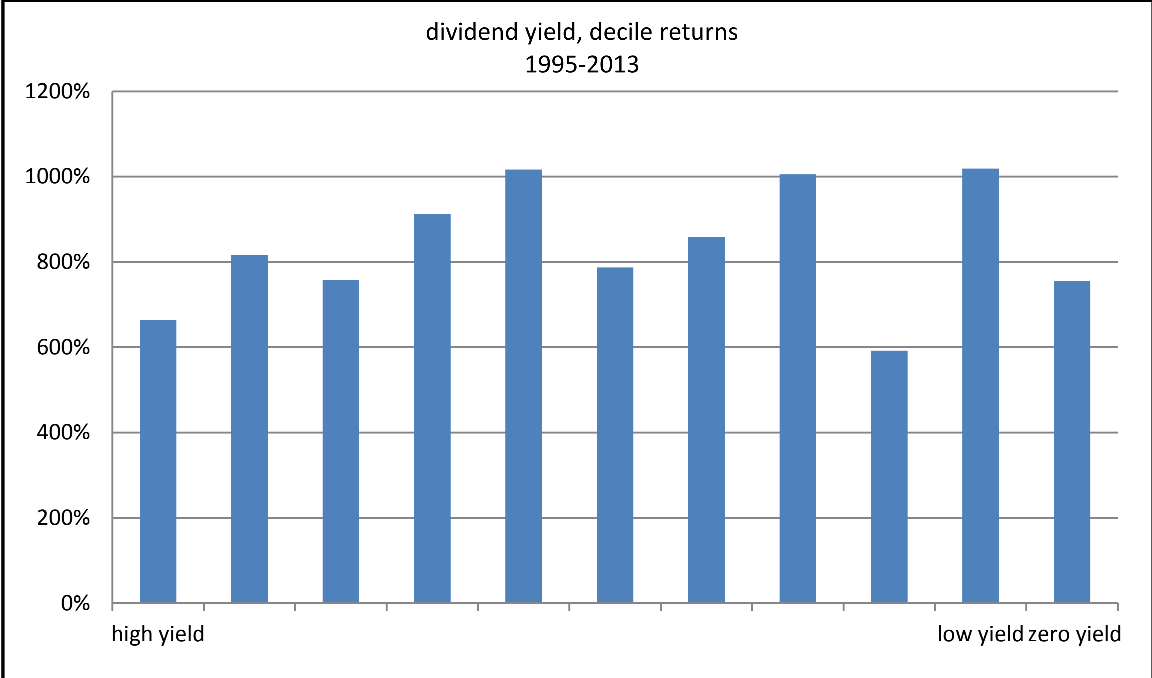
Dividend Yield

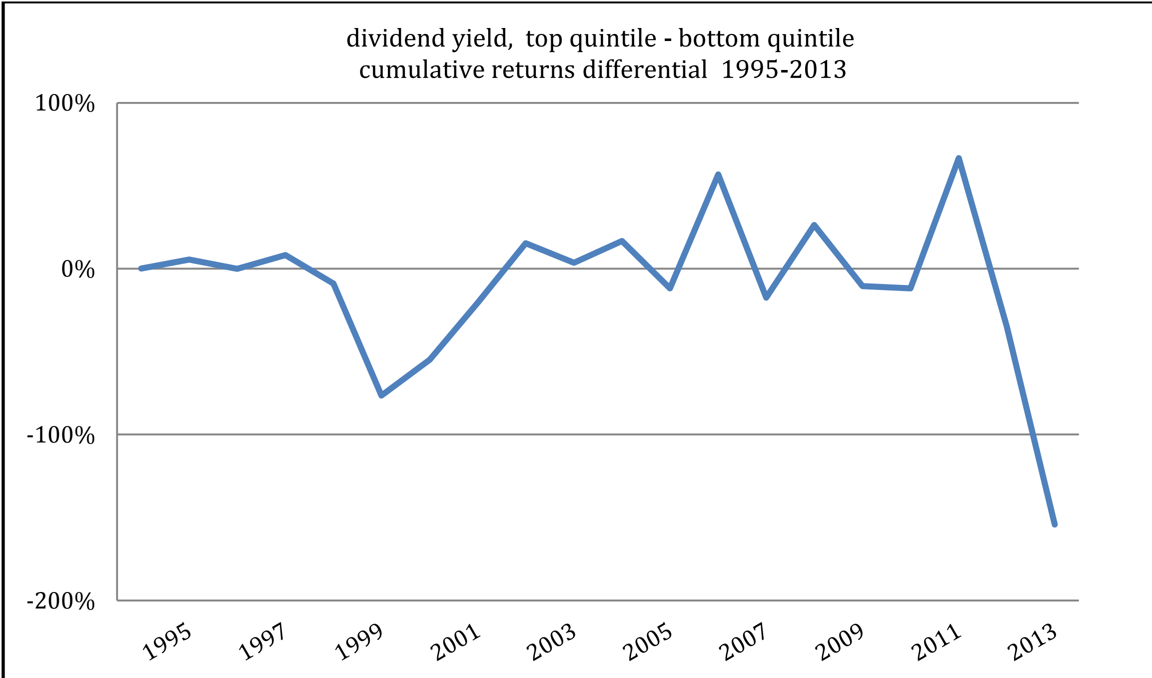
Finally, a break in the pattern.

The last valuation measure we examine is dividend yield, and here we can refute a common mis-perception, even among investment professionals: that stocks with high dividend yields are by definition cheap, or attractive.

The concept of owning high-yielding stocks is akin to the belief in a free lunch. It holds that investors can receive high levels of current income, in the form of dividend payments, while also generating growth of capital.

There is no free lunch. Investors should expect that when they own high yielding stocks, the current income represented by the dividend is about all they will receive. What you see is what you get. And beware of dividend cuts! The market is flashing a warning signal when a stock carries a high yield. While total returns on high yielding stocks are not disastrous, an investor would have been better served owning stocks with the lowest yield or no yield at all. Better still, when picking stocks, investors should ignore dividend yields and focus on more useful measures.


dividend yield, decile returns
1995-2013
1200%
1000%
800%
600%
400%
200%
0%
high yield
low yield
zero yield


dividend yield, top quintile - bottom quintile
cumulative returns differential 1995-2013
100%
0%
-100%
-200%
1995
1997
1999
2001
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2005
2007
2009
2011
2013

Academic studies have long extolled the performance of value stocks over growth stocks, in a sense consistent with our study. The distinction here is the magnitude and uniformity of outperformance from lower valued stocks. The unexpected results of our study leave us stuck between two extremes. One extreme is a Eureka moment, where a great revelation strikes. The other extreme is a high degree of skepticism -- in the complex world of financial markets, nothing is this easy.

We have done our best to scrub the numbers and double-check our methodology. We made sure to avoid survivorship bias. A universe of 1000 stocks seems more than an adequate sample, as does a 19-year timeframe.

One plausible explanation is that from 1995 through 2013, value stock performance as a whole trounced growth stocks, and most any measure of value would show favorable results. To test this, we look at the returns for the Russell 1000 Value index, compared to the returns for the Russell 1000 Growth index, over the entire time period. Indeed the Value index did outperform the Growth index, but to a much smaller degree than our study indicates. From the start of 1995 through 2013, the Value index compounded returns at 10.2 percent per annum, while the Growth index compounded returns at 8.7 percent.

Another possibility is that one large stock market sector accounts for the out-sized gains of value stocks. Financial stocks are a logical place to look, as they typically sell at low valuations. Likewise, if an expensive sector, such as tech stocks, performed poorly for the study period, that too might explain the results. However, this did not occur. In fact, tech stocks outperformed financial stocks for the period in question.

We are left a bit perplexed by our own work. The results seem directionally valid, but the order of magnitude is excessive. Perhaps this was simply an anomalous period in the US equity market, unlikely to repeat. We have long believed that valuation is an important component in stock selection. Whether valuation trumps everything, and above all else “what goes up” are cheap stocks, is still open to debate.

Epic proprietary study, data source: Bloomberg

Tidbits source:
Bloomberg
Wall Street Journal

Tidbits..

Bank of Japan unexpectedly boosts asset purchase program.
European Central Bank cuts benchmark interest rate, launches asset purchase program.
Federal Reserve ends asset purchase program, Quantitate Easing, version 3.

Study shows Wall Street strategists serve as contrarian indicator on stock market direction.
High profile market chit-chat is more than a waste of time; it is expensive as well.

Regulators easing mortgage lending rules, to include three-percent down payments.
Former Fed Chairman Ben Bernanke tells audience his mortgage loan application was rejected.
Clueless in D.C.

Yahoo discloses it faced massive fines for withholding user information from US government.
'Online privacy' is an oxymoron.

Alibaba lists shares in largest Initial Public Offering in US history, attains market capitalization above Amazon.

eBay announces plans to spin off PayPal as independent payments company in 2015.
Hewlett-Packard to split into two companies, with printers and PCs thrown into "old tech, slow growth" pot.
Symantec to split into separate cyber security, and information management, companies.
Investor Starboard Value LP wins proxy fight for all 12 board seats at Darden Restaurants.
Shareholder activism on a winning streak.

Oil prices collapse to five-year low, under 80 dollars per barrel.
Rockefeller heirs to divest fossil fuel stocks from philanthropic fund in green energy push.
Easier to sell oil stocks than use public transportation.

Warren Buffett says Berkshire Hathaway pension plans hold no bonds in their portfolios.
Fair warning to bond bulls.

International Monetary Fund cuts 2015 global growth forecast to 3.8 percent, warns of possible equity price corrections from frothy levels.
Expect another cut in that growth forecast.

US economy expands above three percent rate for second consecutive quarter.
Unemployment, at 5.8 percent, drops to six year low.
Federal budget deficit shrinks to lowest level since 2007.
Long-term Treasury yields briefly plunge; mortgage rates dip below four percent.
For borrowers, one last chance, again.