

Strategy Research

# Mind Matters

Cyclicals, value traps, margins of safety and earnings power

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Several clients have raised similar questions after my recent value screenings. They point out that some of the names I find are commodity related/ industrial cyclicals made to look cheap by cyclically high earnings (something we ourselves have warned of many times this year). Ben Graham was aware of just this kind of problem, arguing that stocks should be evaluated on average earnings (based on “five, seven or preferably ten years”) rather than on current earnings. When we incorporate this into our deep value screen, we find 9 S&P500 stocks and 31 European stocks.

■ My screens are throwing up stocks that are perhaps what we might call ‘illusory value’ – that is stocks which appear cheap simply because they have cyclically high earnings which are about to crater. To some extent I don’t worry overly about such situations. The very essence of the risk management practice embodied within the margin of safety concept provides us with a cushion against the worst effects of earnings disappointment.

■ For instance, on average over 1985-2007, those value stocks that have delivered the worst earnings growth have still generated a return around the level of the average stock. Their low price effectively provided some protection against poor outcomes. In contrast, the glamour stocks that deliver the worst earnings growth end up showing an average return of just 2% p.a.

■ However, whilst the margin of safety is a useful protection it should be possible to improve returns by avoiding stocks which are likely to witness troubling earnings developments. Indeed, Ben Graham was mindful of the risks that value investors ran when it came to cyclicals. He urged that stocks should be valued against average earnings, not current earnings.

■ We have tested Graham’s suggestion by constructing PE’s based on average earnings rather than just one-year earnings. The results show that this simple adjustment has significant merit. For instance, a simple PE strategy based on one-year trailing earnings has beaten the market by around 2-3% p.a. since 1985. However, a strategy using a 10-year Graham and Dodd PE shows a 5% p.a. outperformance on average.

■ One of the other observations that our tests reveal is the indiscriminate nature of the market declines so far this year. All stocks are being sold to pretty much the same extent. Unusually, value isn’t offering any protection in this market.

■ Graham argued that an investor should never pay more than 16x average earnings for any stock. We use this as an additional factor in our deep value screens to help weed out those stocks whose apparent ‘value’ is really a function of cyclically high earnings. We have updated our value screens from last week. They show that a week is a long time in these markets! Last week just two stocks in the S&P500 passed our deep value criteria, this week nine do (and all pass the new Graham and Dodd PE filter as well). In Europe, the number of stocks passing our criteria has soared from 34 to 52! Some 31 pass the new average earnings filter. Full lists can be found inside.

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## Cyclicals, value traps, margins of safety and earnings power

A number of my recent value screens (see Mind Matters, [16 September](#), [22 September](#) and [6 October](#) for example ) have featured stocks that are generally considered cyclicals (often with an industrial- or commodity-related bent). This has raised numerous eyebrows given our generally gloomy prognostications and our expressed caution on cyclicals and commodities in particular.

There are two reasons why such stocks might show up on our value screens. Firstly, they are nothing more than stocks at the peak of their profits cycle whose earnings are about to crater (effectively a form of value trap). Alternatively, they are companies (arguably like some of the integrated oils) that have not celebrated the rise of the underlying asset price.

To some extent we are protected against truly disastrous consequences stemming from the former situation by the margin of safety embedded within the process of buying cheap assets. This is the one form of risk management that makes sense! By buying stocks whose prices have already fallen we are reducing risk and increasing the likelihood of return.

The table below shows how value offers us protection against negative outcomes. It shows the performance of stocks based on their valuation and assuming perfect foresight on the earnings front. This allows us to examine the performance across value stocks depending upon the earnings environment they end up facing.

By tracking across the first row of the row we can see how value stocks' returns change depending upon their earnings performance. Strangely enough the cheapest stocks that deliver the highest earnings growth generate the best returns. However, the protection of the margin of safety becomes clear as we move to the value stocks with the worst earnings growth – they still manage to generate pretty much a market level return.

In marked contrast, the glamour stocks (last line of the table) show the lack of protection inherent in buying stocks with high growth expectations embodied within their prices. The most expensive stocks that deliver the best earnings growth only manage to generate a return of around 8% p.a. on average (noticeably below the market return of 12% p.a.) However, this unimpressive performance pales into insignificance when compared to those high priced stocks that then go on to deliver the worst earnings growth, these stocks generate a return of 2% p.a. on average.

### Returns split by earnings performance (Developed mkts 1985-2007) % p.a.

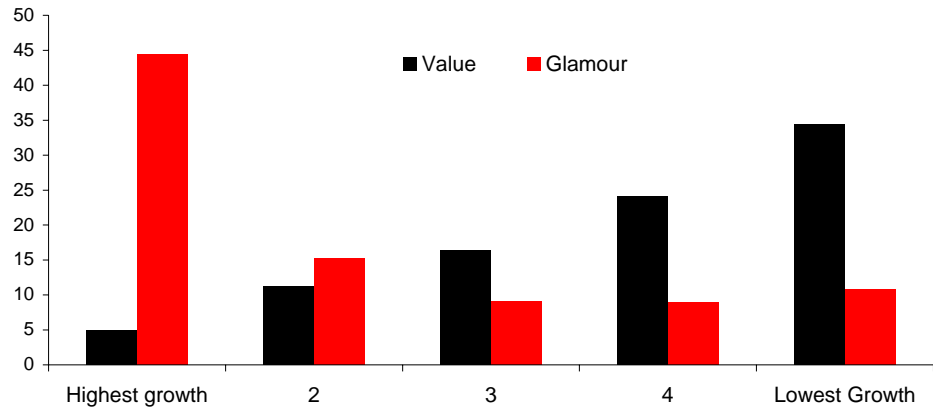
	Highest Growth	2	3	4	Lowest Growth
Value	19.8	21.6	17.7	15.9	11.9
2	20.6	18.0	13.7	11.0	10.9
3	17.8	14.0	11.6	9.87	8.10
4	15.7	10.5	8.55	6.67	6.12
Glamour	7.90	5.04	4.42	2.77	2.18

Source: SG Equity Research

Just in case you were wondering, the chart below shows the percentage of value and glamour stocks appearing within each of the earnings quintiles. The market does a surprisingly good job at getting the general direction of growth right! A far higher percentage of glamour stocks

end up in the highest growth quintile (44%) than corresponding value stocks (5%). However, given the mediocre returns such stocks achieve, it is clear that investors consistently overpay for growth.

**Distribution of stocks across earnings quintiles (%)**



Source: SG Global Strategy Research

Whilst the margin of safety may offer us some protection against the earnings outturns, we obviously could try and enhance performance by avoiding those stocks that might just face the worst earnings outcomes.

This obviously raises the question of how we might go about trying to weed out the value traps which are about to witness an earnings implosion. As is ever the case, when trying to think about investment problems it usually pays to revisit the words of Ben Graham. He noted:

The market level of common stocks is governed more by their current earnings than by their long-term average. This fact accounts in good part for the wide fluctuations in common-stock prices, which largely (though by no means invariably) parallel the changes in their earnings between good years and bad. Obviously the stock market is quite irrational in thus varying its valuation of a company proportionately with the temporary changes in its reported profits.

A private business might easily earn twice as much in a boom year as in poor times, but its owner would never think of correspondingly marking up or down the value of his capital investment. This is one of the most important lines of cleavage between Wall Street practice and the canons of ordinary business. Because the speculative public is clearly wrong in its attitude on this point, it would seem that its errors should afford profitable opportunities to the more logically minded to buy common stocks at the low prices occasioned by temporarily reduced earnings and to sell them at inflated levels created by abnormal prosperity.

Obviously it requires strength of character in order to think and to act in opposite fashion from the crowd and also patience to wait for opportunities that may be spaced years apart.

Rather than rely upon current earnings Graham had a simple yet powerful alternative – earnings power. As Graham opined:

The concept of earning power has a definite and important place in investment theory. It combines a statement of actual earnings, shown over a period of years, with a reasonable expectation that these will be approximated in the future, unless extraordinary conditions supervene. The record must cover a number of years, first because a continued or repeated performance is always more impressive than a single occurrence and secondly because the average of a fairly long period will tend to absorb and equalize the distorting influences of the business cycle.

Graham suggested earnings power (or average earnings) should cover a period of “Not less than five years, preferably seven or ten years”. Of course, many object to the notion of simple moving averages of past earnings since they obviously ignore growth. However, as growth forecasts are notoriously unreliable this might not be such a bad idea. Graham argued that analysts should base “The projection of future earnings and dividends ... (on) some past average as the best measure of the future”. Note that this statement is in terms of levels not growth rates!

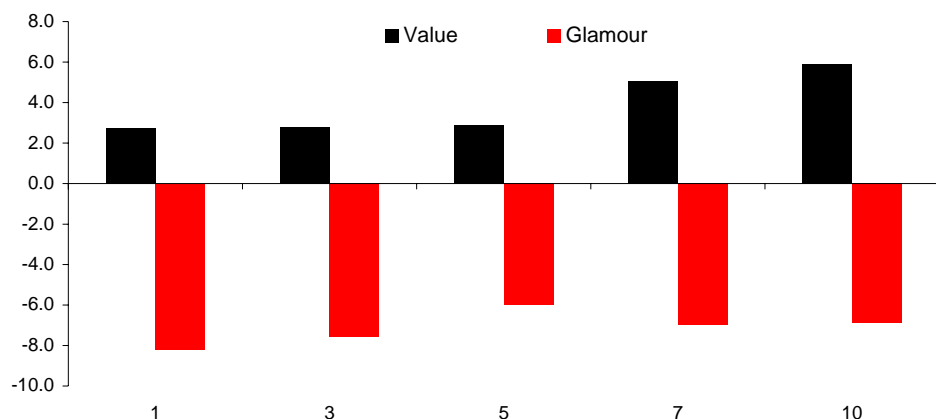
### The empirical evidence on the earnings power approach

Could such a deceptively simple idea improve the performance of a value strategy? To test this we used global developed market data since 1985. The answer we uncover is a resounding affirmative.

The chart below summarises our findings. It shows the excess returns (i.e. after removing the market) as we vary the period over which we calculate the earnings. For a simple, one-year trailing PE, the cheapest stocks beat the market by around 2-3% p.a. In contrast, the most expensive stocks underperform the market by 8% p.a. Thus a long short strategy generates a return around 11% p.a.

When we use a 10-year moving average of earnings to calculate the E in our PE, the cheapest stocks outperform the market by over 5% p.a. on average. The return on the expensive stocks is an underperformance of around 7%. Thus the long short return rises to 13% p.a. on average.

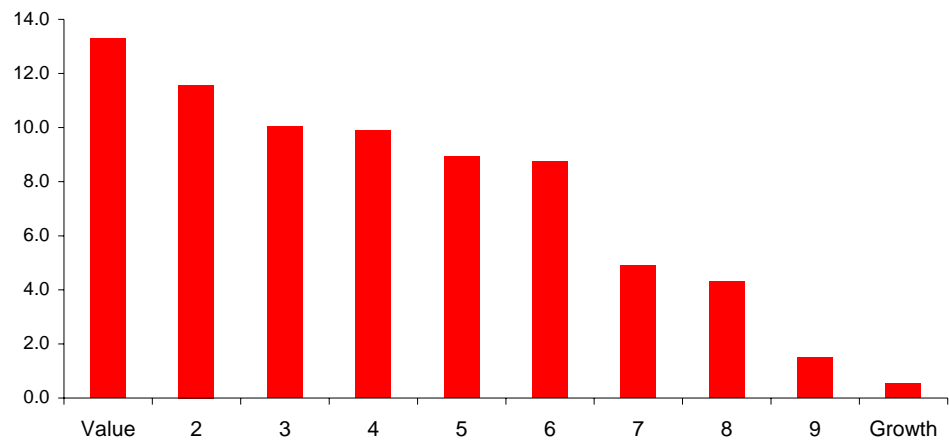
**Excess returns % p.a. 1985-2008 as function of earnings horizon**



Source: SG Global Strategy Research

The chart below shows the average annual performance across the deciles measured on 10-year earnings power. It is nearly monotonic. The chart reveals just what a bad investment stocks with a very high Graham and Dodd PE actually are. They essentially earn nothing! So you are paying for the pleasure of holding the stock.

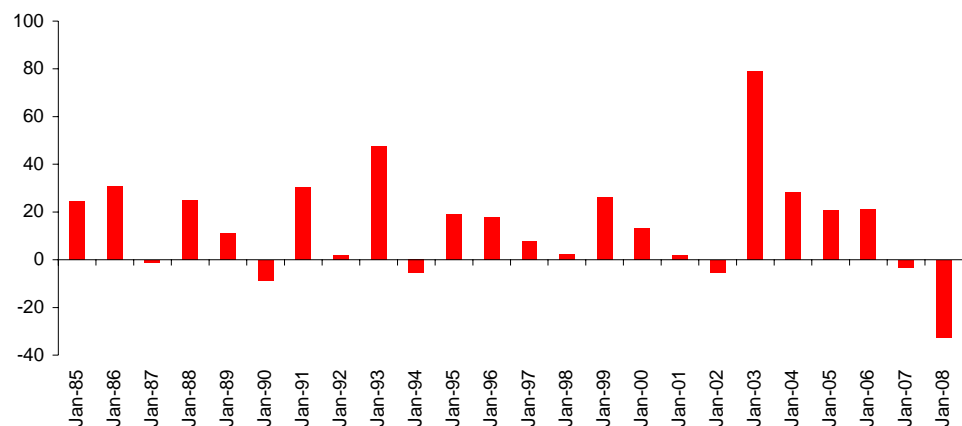
**Graham and Dodd 10-year PE deciles (1985-2008, % p.a.)**



Source: SG Global Strategy Research

One final observation before I move on to using the Graham and Dodd PE to improve our value screening. The chart below shows the performance of the long only 10-year Graham and Dodd PE strategy over our sample period. It clearly shows just how bad a time this has been for value investors.

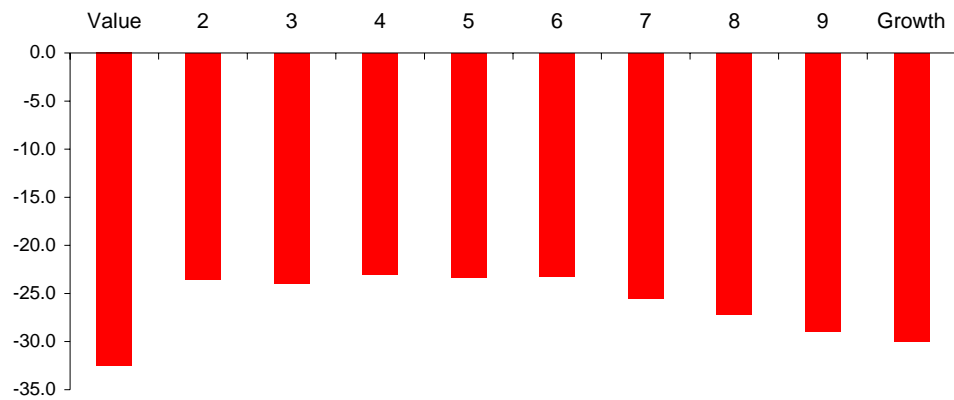
**Time series profile of long only Graham Dodd PE strategy, % return**



Source: SG Global Strategy Research

A complimentary perspective is shown in the chart below, which shows the year-to-date performance across deciles based on the 10-year Graham and Dodd PE. It highlights how indiscriminate the selling has been. Cheap stocks and expensive stocks (and everything in between) have been treated as equals.

**Year-to-date performance across 10-year PE deciles, %**



Source: SG Global Strategy Research

**Using Graham and Dodd PEs in our screening**

A simple cyclical adjustment seems to work well at improving the returns to basic value strategy especially on the long side of the equation. As such it could be a useful tool in weeding out those cyclicals that crop up in value screens simply because their historic earnings are high.

The table below updates the European and US stocks that pass the Graham deep value screen which we laid out last week (Mind Matters, 6 October). We have included an extra column which measures the Graham and Dodd PE. As Graham and Dodd noted:

It is the essence of our viewpoint that some moderate upper limit must in every case be placed on the multiplier in order to stay within the bounds of conservative valuation. We would suggest that about sixteen times average earnings is as high a price as can be paid in an investment purchase of a common stock.

Although this rule is of necessity arbitrary in its nature, it is not entirely so. Investment presupposes demonstrable value, and the typical common stock's value can be demonstrated only by means of an established, i.e., an average, earning power. But it is difficult to see how average earnings of less than 6% upon the market price could ever be considered as vindicating that price.

By overlaying our Graham and Dodd screen (based on an earnings yield of more than twice the AAA bond yield, a dividend yield of at least two-thirds of the AAA bond yield, and total debt less than two-thirds of tangible book value) with a long-term PE limit 16 times as suggested by Graham and Dodd we can see which stocks in our selection are potentially vulnerable to an earnings collapse.

The tables below are updated to reflect market movements until the close of play on Friday 10 October. When we last ran this screen a week ago, only two US stocks passed. Now 9 pass, and all of them have a Graham and Dodd PEs of less than 16x. This increase in stocks passing is due to the collapse in prices of the US energy sector.

**S&P500 stocks passing Graham and Dodd Screen (criteria 1, 3 and 6)**

Company Name	Earnings yield (%)	Dividend yield (%)	G&D 10-year PE	Market cap. (m)
Ashland Inc.	12.0	4.4	4.7	2,988.1
Carnival Corp.	10.5	4.9	13.8	35,013.6
Chevron Corp.	15.2	3.9	13.8	195,100.2
ConocoPhillips	15.0	3.9	10.9	142,502.2
Dow Chemical Co.	12.3	6.7	11.4	37,069.3
Ingersoll-Rand Co. Ltd.	12.3	3.6	10.1	15,350.7
Marathon Oil Corp.	22.2	3.6	10.1	43,210.6
Nucor Corp.	16.1	7.9	14.6	17,055.0
Tesoro Corp.	48.6	4.2	4.8	6,537.0

Source: SG Global Strategy Research

In Europe, the market move over the past week has increased the number of stocks passing our screen from 34 to 52! Of these 52, some 31 trade at Graham and Dodd PEs of less than 16 times. I've highlighted them in the table below.

**DJ Stoxx 600 stocks passing criteria 1, 3, 6**

Company	Earnings yield	Dividend yield	Graham and Dodd 10Y PE	Mkt Cap (US\$m)
Acerinox S.A.	12.3	3.6	11.7	6,367.8
Anglo American PLC	14.2	4.0	11.2	82,067.0
Antofagasta PLC	22.6	7.2	12.3	14,083.7
Bekaert S.A. N.V.	10.0	3.6	18.5	2,663.4
BHP Billiton PLC	14.3	3.8	18.3	212,730.6
Boliden AB	56.7	16.9	NA	3,437.4
BP PLC	14.4	6.0	10.9	230,903.4
Bulgari S.P.A.	10.2	6.5	15.4	4,179.8
Burberry Group PLC	10.1	3.9	NA	3,865.2
Carnival PLC	11.8	5.8	NA	34,394.8
Deutsche Lufthansa AG	23.1	11.5	11.9	12,160.4
ENI S.p.A.	19.8	9.4	8.1	133,727.6
Ericsson Sh B	15.2	5.6	15.4	37,334.5
Fortum Oyj	10.7	8.3	21.3	39,881.2
Galp Energia SGPS S/A	11.7	4.0	NA	22,262.6
GDF Suez S.A.	10.3	5.2	NA	57,362.9
Georg Fischer AG	23.2	10.0	8.7	2,472.2
Home Retail Group PLC	15.1	6.5	NA	4,513.2
Iberia Lineas Aereas de Espana S.A.	27.7	13.6	5.7	4,138.1
Kazakhmys PLC	45.3	6.1	NA	12,498.2
Kesa Electricals PLC	12.6	14.3	NA	2,511.4
Kesko Oyj	15.9	9.7	12.1	5,383.6
Konecranes Oyj	17.4	6.4	18.6	2,014.0
Koninklijke Philips Electronics N.V.	26.9	4.4	8.4	45,891.3
MAN AG	20.9	8.0	14.0	24,505.2
Neste Oil Oyj	19.0	8.4	NA	9,014.5
Nexans	16.2	4.4	NA	3,205.1
Nokia Corp.	15.9	4.5	14.3	148,896.8
Nokian Renkaat Oyj	10.4	3.8	25.3	4,342.9
Norddeutsche Affinerie AG	21.6	5.2	14.9	1,631.7
Norsk Hydro ASA	26.1	5.4	9.2	17,263.2
OMV AG	23.3	5.5	9.9	24,168.8
Orkla ASA	18.7	5.1	9.4	19,834.1
Outokumpu Oyj	44.1	15.0	5.7	5,576.6

**DJ Stoxx 600 stocks passing criteria 1, 3, 6 (cont'd)**

Company	Earnings yield	Dividend Yield	Graham and Dodd 10Y PE	Mkt Cap (US\$m)
Outotec Oyj	13.5	6.9	NA	2,305.4
Parmalat S.p.A.	28.0	11.6	NA	6,416.7
Persimmon PLC	37.4	13.9	4.7	4,809.1
Rautaruukki Oyj	28.0	16.9	8.4	6,004.3
Reed Elsevier N.V.	16.0	5.6	18.1	15,880.6
Repsol YPF S.A.	16.2	6.2	9.3	43,451.9
Royal Dutch Shell Class A	21.9	6.2	8.3	260,654.8
Salzgitter AG	31.7	6.0	7.5	8,409.9
Skanska AB	15.3	12.9	9.5	7,898.5
SKF AB	14.0	6.9	16.2	7,712.5
StatoilHydro ASA	12.5	7.7	12.5	99,064.4
Sulzer AG	10.9	3.7	26.6	4,935.2
Tomkins PLC	15.7	10.6	7.1	3,151.8
Total S.A.	17.6	6.2	10.3	186,178.8
Umicore S.A.	32.5	4.1	12.9	5,959.9
Vallourec S.A.	18.3	6.8	19.2	14,205.2
Wacker Chemie AG	11.9	4.2	15.3	14,219.5
Wartsila Oyj	12.3	19.1	11.6	7,297.9

Source: SG Global Strategy Research

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