The Sell Decision

Profits in the stock market, of course, depend on buying low and selling high. While most of the focus is on the buy side, the decision to sell is equally important.

Once a stock is bought, you should sell for one of two reasons:

1) Sell if the stock price rises such that its valuation returns to the median of its historical range, or

2) Sell if the specific changes or improvements are not forthcoming during the management's projected time frame. Turnarounds take time, so don't sell out of boredom or just because the stock price continues to fall. Sell only when it is obvious your original thesis for recovery is unlikely.

A well-informed value investor may typically spend three to six months researching a stock and its industry before making a purchase decision. Once bought, the average holding period may typically be around two years. Patience is required—don't be too quick on the trigger for purchase or sale.

Pier 1: An Example

Pier 1 Imports (PIR-NYSE) is a good example of this approach. In September of 1994, ratio analysis indicated promise, when the stock was trading at about $8 per share.

Pier 1 did have excess discretionary cash flow and an estimate of the private market value was in the $15 to $18 per share range. At the end of September, all of the ratios were at the low end of their historical range, profit margins were below historical medians but improving, and the normalized price-earnings and price-cash flow ratios indicated a potential doubling of the stock price if the company returned to its median valuation. (See Table 1.)

A review of the fundamentals turned up a poor growth record, negative same-store sales comparisons and below-average profit margins as the reason for the laggard stock price.

Management did, however, have a reasonable turnaround plan, consisting of an extensive revamping of store locations and merchandise mix that was projected to improve margins and sales growth.

How has Pier 1 fared? Since that time, several of management's plans have been implemented. Margins are rising and same-store sales comparisons are positive. The stock has gained 20% (including a 5% stock dividend) but it still represents excellent value and additional gains seem probable.

Adopting the Approach

With its documented advantages, value investing should be attractive to individual investors. However, it is a difficult approach because of the psychological attraction of hot growth stocks over cheap, troubled value stocks. Developing your own value portfolio requires an inquisitive, analytical mind. You should be skeptical of popular opinion and media reports, and you must employ discipline to buy only low valuation stocks and to sell when prices rise above average. In essence, you will be buying a company's stock during periods of turmoil and selling when the outlook seems quite promising—actions that run contrary to your normal tendencies. Most of all, you must be patient because achieving improvements often takes a company longer than you expect.

Nonetheless, putting value-oriented investment strategies to work in your portfolio is a time-tested way to earn steady, above-average equity returns.

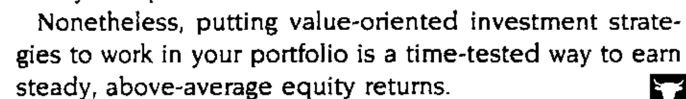

Table 1.
Pier 1 Imports Ratio Analysis

	As of 9/30/94	10-Year Range	10-Year Median
Price/Revenue (x)	0.43	0.2 - 1.4	0.9
Price/Book Value (x)	1.35	0.8 - 4.6	2.1
Price/Cash Flow (x)	6.65	4.5 - 19.2	11.5
Net Profit Margin (%)	3.9	1.1 - 5.3	4.5
Normalized Price/Cash Flow (x)	6.15		
Normalized Price/Earnings (x)	9.4		

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Value investing is not rocket science, but most investors find it difficult to distinguish a good company from a good investment, and to act contrary to popular opinion.

An Introduction to Value Investing: Guidelines for Developing a Strategy

By Michael Jones

The embodiment of the "buy low, sell high" mantra can be found in the "value" style of investing. Growth investors are happy to buy high-priced stocks in hopes of selling higher as the company continues to grow, while value investors always look at the price tag first.

In addition to the comforting logic of buying low, many studies have indicated that in the battle between value investing and growth investing, the value philosophy provides higher returns over time.

The techniques of value investing are not rocket science or wizardry—they can be successfully applied by anyone with sufficient financial knowledge, patience, and emotional discipline. The math is no more difficult than junior high arithmetic, and many of the most important tools are described within this short article.

Why then do the portfolios of typical investors reflect far more growth stock selections than low-priced and undervalued stocks? The answer lies in the difficulty most investors encounter in judging the difference between a good company and a good investment. In addition to mastering the analytic techniques, successful value investing requires a willingness to think and act contrary to public opinion.

Value vs. Quality

Finding companies with low valuations is not the problem. With a personal computer and a modem, anyone can access multiple databases to find stocks selling at low valuations on a variety of parameters. The problem is that companies sell at low valuations for a reason. Usually, that reason is a specific problem that has resulted in earnings shortfalls or doubts about long-term prospects. In many cases, investors focus on the short-term impact of these problems and sell these stocks so they can reinvest in other companies without such prominent blemishes. Indiscriminate and emotional selling often causes troubled companies to reach very low stock valuations.

Overriding the desire to own cheap stocks is the competing desire to own good quality, successful companies. Most companies selling at low valuation levels do not fit the average investor's perception of a "quality" investment. Quality is typically defined as recognizable companies that have been and are currently doing well; for example Disney, Coca Cola, Merck, Microsoft, Hewlett Packard, Johnson and Johnson, General Electric. Rarely do "quality" companies such as these sell at low relative valuations. Low valuations are usually given to companies that are poorly understood or struggling through an obvious difficulty. Occasionally, blue chips fall from the ranks of "glamour" stocks due to well-publicized problems. After a half century of blue-chip status, GM, Ford, and Chrysler fell from grace in the 1979-1982 era due to high costs and poor product quality. IBM repeated that scenario in the early 1990s. Philip Morris was also considered a bona fide "blue chip" until recent years when legal attacks on the health liabilities of smoking removed it from that category. By the end of 1994 Philip Morris stock sold at half of an average stock's valuation. As a result of the typical investor's aversion to obvious problems, the concept of buying value is often at odds with the concept of buying quality.

Value Investing: Notable Studies

Why buy a "dog" when there are plenty of good quality companies available? Aren't you better off buying a portfolio of high-quality blue chips?

No. In the battle between quality and value, you are better off owning a portfolio of stocks with low valuations relative to the market averages.

An interesting article on this subject was published in the May-June 1987 edition of the Financial Analysts Journal. The

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article, "In Search of Excellence: The Investor's Viewpoint," by Michelle Clayman, reported on an Oklahoma State University study of the investment performance of "excellent" versus "unexcellent" companies. In 1982, the popular book, "In Search of Excellence," by Thomas J. Peters and Robert W. Waterman Jr., identified a number of "excellent" companies by screening for top performers on six historical financial measures of growth and profitability. Ms. Clayman used the same measures in reverse to identify a group of "unexcellent" companies by screening the S&P 500 for those falling in the bottom third of all companies ranked by each of the six measures. Predictably the difference in stock price valuation between the two groups was sizable. For example, the price-to-book-value ratio for the "excellent" companies was 2.11 versus 0.98 for the unexcellent group. The 29 "excellent" companies' and the 39 "unexcellent" companies' total investment returns were then calculated for the five-year period beginning 1981 through 1985. The "unexcellent" portfolio provided returns that beat the "excellent" portfolio by a remarkable 11% per year.

Many people would consider the "unexcellent" group a riskier investment portfolio because of the problems these companies were facing. However, the normal statistical measures of risk do not support this perception. In the Clayman study, both portfolios' level of risk (measured by both market risk and volatility) was nearly identical.

Studies such as this one show that risk levels are derived not only from what you buy, but also from what you pay (valuation). Buying stocks with low valuations inherently helps control risk in the portfolio.

Making Value Investing Work

Once you've decided to use a value strategy in your own portfolio, how do you decide which stocks to choose?

To start, you need a reliable source of historical data on public companies, such as the Value Line Investment Survey or one of the electronic databases available via CompuServe or America Online.

The first step for value investors is to identify cheap stocks. Use your database to find the needed fundamental information, and focus on trailing 12-month figures rather than future period estimates, which are notoriously inaccurate. The traditional valuation measures are ratios of the stock price relative to fundamental statistical measures from a company's income statement and balance sheet such as:

- Price/Revenue: Price per share divided by net sales per share;
- Price/Earnings: Price per share divided by earnings per share;
- Price/Cash Flow: Price per share divided by cash flow (earnings plus depreciation and other non-cash charges) per share;
- Price/Book Value: Price per share divided by book value (assets less liabilities) per share.

You should compare the recent data to prior periods. In particular, note trends in profit margins (earnings divided by revenues) in prior cycles; see if there is a "normal" profit margin range for the company and the industry.

This is helpful when a company's current results are temporarily depressed—a common occurrence with value companies. Profit margin problems can result in price-earnings and price-to-cash-flow ratios that are unattractive on the surface, even though a stock may be attractive based on price-to-revenue and price-to-book-value ratios. In these classic value opportunities, the prior year's "normal" profit margin can be multiplied by current revenues to produce "normalized" current earnings and, by adding depreciation and other non-cash charges, "normalized" current cash flow. Then you would use the normalized data to recalculate price-earnings and price-to-cash-flow ratios. In most cases, the normalized ratios will also look attractive compared to prior ranges.

These commonly used measures are further augmented by two estimated statistics that require some digging on the investor's part. The first is *stock price-to-discretionary cash flow*, which is the annual cash generated by the business in excess of required capital expenditures and working capital necessary to keep the business in a steady state. The investor must find out from management the amount of maintenance capital spending versus spending for purposes of growth. If this information is not disclosed in Management Discussion of Operations in the annual report, call the Investor Relations department of the company.

Discretionary cash flow varies from total cash flow depending upon the characteristics of the business. Certain industries, such as auto makers, airlines, and oil and gas producers, generally report large total cash flow but have small discretionary cash flow. The required capital investment in new plant and equipment, airplanes and exploration consumes a high percentage of internally generated funds. In contrast, at computer software, entertainment, and consumer product companies, discretionary cash flow is often a high percentage of the total cash flow because once a new program, game show, or breakfast cereal is created, little reinvestment is required to keep it salable. Discretionary cash flow is important to any business, but it is a particular tonic to companies in a turnaround mode.

The other measure is *price-to-private market value*, which is the value a company might fetch in an acquisition. Developing a reasonable estimate of a company takeover value involves surveying recent mergers in the same industry and calculating the acquisition price relative to sales, earnings, cash flow, and book value of the acquired company. An investor can then use these ratios to estimate the potential price that the prospective company would be worth to a suitor.

Once these ratios are determined, an investor can make some judgments about the attractiveness of the stock valuation. The relative importance of each ratio in the value judgment depends upon the nature of the company. For certain businesses, a single valuation measure is key—for instance, *price-to-book value* for utility companies. In most cases, two or three of the measures will provide the best insight to value.

The relevant valuation measures should also be compared to the same ratios for the market averages, industry peers, and the company's own historical value range. When the company's ratios are low versus these benchmarks, you have a potentially cheap stock. As a rule of thumb, if the current ratios are in the lower third of the historical valuation range, you should proceed with your analysis.

Obviously, the steeper the discounts in these comparisons, the better.

Cheap or a Bargain? A Judgment Call

Unfortunately, simply identifying cheap stocks isn't enough. Cheap stocks aren't always bargains—they may deserve their low valuations. A bargain is a stock with both a low stock market valuation *and* a good probability of improving fundamentals.

To determine whether a cheap stock is attractive as an investment, you must determine if the company is poised for a "turnaround" or improvement in fundamentals.

Many of the indicators of change can be found in a company's annual and quarterly reports or news releases. Also, ask for the company's 10-K and 10-Q reports, which often have detailed descriptions of business fundamentals and management strategies.

At this stage, the process becomes one of judgment—there are no mathematical formulas to indicate that a company will improve its fundamentals. However, there are some signs you can look for. The following factors are generally positive indicators of improvement.

Management Change: When the board of directors of a troubled company boots the incumbent CEO and hires a new chief executive from outside the company, pay close attention. No indicator is more valuable in predicting improvement. New managers have no ties to past practices or people. They can and do move quickly in making difficult but necessary changes, including cutting costs, reducing overhead, selling unproductive assets or non-strategic product lines. Results aren't always immediate, but stock prices often move in anticipation of the change. Numerous examples of new management-led turnarounds exist, from Lee Iacocca at Chrysler in the early 1980s to the more recent rejuvenation of Eastman Kodak by George Fisher.

Mea Culpa: When something goes wrong, the first step toward improvement has to be a frank and thoughtful discussion by management of what happened, why it occurred and how the problem impacted the financials. If management is willing to fully describe the company's problems, you can bet that they have already decided on necessary changes.

Narrowing Down the Problem: The stock price of multi-product line companies are often hurt when one of the products or divisions runs into an unexpected problem while the other product lines continue to thrive. This circumstance indicates a high probability turnaround. The strength of the other product lines and the specificity of the problem allow management to quickly focus on the problems. It's easier for a management to fix or sell a problematic product line when they have a successful stable of product lines that have been obscured by the offender. The situation at Oracle Systems in 1991, with it's troubled applications software division, and at Policy Management Systems in 1993, with sudden losses in the healthcare insurance division, are good examples of the opportunity available under these circumstances.

Selling Assets: The sale of non-strategic or unproductive assets often portends future stock price improvement. Sometimes the benefit comes from immediately improving the balance sheet with the infusion of cash. In other cases, the sale allows management to focus on building the remaining businesses. A recent example was National Medical Enterprises' sale of its Psychiatric and Rehabilitation Hospital divisions in 1994. The improved balance sheet and renewed focus on its Acute Care Hospital division led to a significant stock price increase.

Traps for the Unwary

If the following factors are present, investors should be wary of a statistically cheap stock that is no bargain:

Low price-earnings ratios on cyclical stocks: A common trap for value investors is buying stocks of cyclical companies when their earnings are at or near cyclical peaks. For example, a strong value case can be made for the auto stocks right now because their stock prices have declined significantly in the past year, yet their earnings have been fine. However, in every post-war economic cycle, buying the stocks of Ford, Chrysler, and GM when they were earning above-average profit margins disappointed investors because the next recession was not far away and the subsequent decline in auto earnings led to declining stock prices. In general, you'll make more money in cyclical companies by *investing when they are losing money and selling after they return to profitability*, but well before profits peak.

Hear No Evil, See No Evil, Speak No Evil: Annual reports filled with pictures of new plants, smiling people and beautiful vistas don't help any investor, especially investors in companies with problems. If you read the section called "Management Discussion of Operations" and you still don't understand the specifics of the company's weakness, move on. Investing is tough enough without having to deal with this lack of candor.

Companies Making an Acquisition: Beware of the cheap stock of a company with acquisition plans, especially if the acquisition represents a new and exciting line of business. If the management isn't so hot at running the old business, why will they prove better at the new business? Also, paying a premium price to enter an exciting new business can damage the balance sheet and can dilute the earnings per share.