NEW SERIES

$how Me the MONEY

BOOK 2

The Science of Stock-Picking

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SMART INVESTOR | Teh Hooi Ling

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3 GUESS WHAT, BORING STOCKS PAY

Most investors tend to overvalue risk and undervalue safety in deciding on the kind of shares they want to buy

15 November 2008

In a recent report on Pan-United Corporation, OCBC Investment Research (OCBCIR) said the market has ignored the fact that the company has consistently been growing its underlying core businesses, namely the supply of ready-mixed concrete, shipping and port operations in China. "As management continues to pride itself on delivering strong and consistent dividend payouts, we are switching our valuation to the Dividend Discount Model," the report said.

OCBCIR used 7 per cent as the required rate of return to discount dividend. "As such, our fair value is now $0.59 (previous fair value was $1.03 using discounted cash flow model). Our forecasted dividend yield for the final payout is about 6.8 per cent or 2.5 cents per share," it said. "That translates to a FY08 return of 14.3 per cent at the current price."

I find it interesting that OCBCIR is using the dividend discount model (DDM) to value Pan-United. Perhaps it is a reflection of the very conservative and risk averse mood that everyone is in now.

The DDM basically values the worth of a stock to an investor based on the dividends the investor expects to receive from now to perpetuity. In January 2003, I used SMRT to illustrate the use of this method of valuation in this column. "Take, for example, SMRT," I wrote then. "The shares paid 2.15 cents after-tax dividend last year. Assume, also, that SMRT increases its dividend payment by 2 per cent a year in perpetuity.

"The 2 per cent growth is arrived at after taking into consideration the average growth of Singapore residents of 1.7 per cent in the last 10 years and allowing room for fare hikes.

"Since SMRT has a fairly stable income, you may decide that you need to have 6 per cent return in order to compensate you for taking on the risk of holding the stock. The stock's value is then: Next year's dividend/(your required rate of return – the growth rate in dividends forever).

"So, in the example above, next year's dividend is 2.237 cents, your required rate of return is 6 per cent and the constant growth rate is 2 per cent. Plug the numbers into the formula and you get $0.02237/0.04 or $0.559.

SAMPLE CONTENT

increasing gross margins.

Each item on the checklist with a "yes" answer has a score of one; "no" answer, zero. Companies with improving fundamentals will have higher F-scores (seven to nine), and those with deteriorating fundamentals will have low F-scores (below three).

The Piotroski screen

	Scoring Yes	Scoring No
Profitability		
Positive earnings	1	0
Positive cash flow from operations	1	0
Increasing Return on Assets (ROA)	1	0
Quality of earnings : Operating cashflow > Net income	1	0
Leverage, Liquidity and Sources of Funds		
Decreasing long-term debt as a proportion of total assets	1	0
Increasing current ratio (increasing ability to pay off short-term debts)	1	0
Decreasing or stable number of shares outstanding	1	0
Operating Efficiency		
Increasing asset turnover ratio, indicating increasing sales as a proportion of total assets	1	0
Increasing gross margins	1	0
Total	9	0

Piotroski's strategy calls for buying a company with the requisite low PTB ratio and an F-score of eight or nine. Piotroski's research shows that low PTB stocks with high rankings are less likely to go bankrupt or to fall drastically in price than those with low rankings. This provides a greater safety margin.

Mr Montier's final criterion is capital discipline. Companies that have grown their total assets by more than a double-digit percentage will pass through his short screen.

So let's say our "buy" criteria should be companies with price-to-sales of below 1.2 times, Piotroski F-score of more than seven and total asset growth of less than 20 per cent from a year ago.

The lone stock the screening process spits out is Singapore Petroleum Company (SPC). Its market cap is less than half of its sales, and its Piotroski F-score is seven. And it didn't have a big asset growth in the year just ended; in fact, its asset base shrank 22 per cent.

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12 PUNTING FOR QUICK PROFITS FROM BLUE CHIPS

Top candidates include Golden Agri, NOL, Nobel, Olam, Genting Singapore, City Developments and Sembcorp Marine

16 July 2011

Since November last year, the stock market has been trapped in a trading range of 3,000-3,300 points. Investors would see their stocks rise, then fall again a few weeks later. Except for those stocks which are yielding generous dividends, there is no profit for investors to pocket unless one resorts to short-term trading.

In my years of watching the market, I've come to the conclusion that, at least in Singapore, on average it doesn't quite pay to punt in the small cap stocks. Yes, the volatility may be there, and you may be making some good money if you are nimble enough. But the question is for how long. There is a rather high chance that you may find a newspaper headline of that stock you are holding screaming at you one morning . It could be that the cash that was supposed to be in the bank isn't there, or that the revenues and profits have been overstated, or that a fire has gutted the company's factory.

Small caps vulnerable

Such bad news will deal a big blow to the stock price of small cap stocks. It is not unusual for them to plunge 50-60 per cent in a day, which would mean all the accumulated profits that you had made previously might be wiped out. Worse still, you might even lose your capital.

So I've convinced myself that if one were to itch to trade in markets such as now, one should be trading the blue chips. At least, if there is some unexpected negative macro developments, or even certain unflattering news relating to the company, chances are that over time these blue chips would bounce back. One just has to ride through the rough patch.

The question then is which of the blue chips are good candidates for trading?

I downloaded the daily share price of the 30 component stocks of the Straits Times Index (STI) from 2000. I then calculated their price difference over three-trading-day periods. From there, I find out the standard deviation, or volatility, of this price movement. In addition, I also calculated the one month return of these 30 stocks.

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27 GROWTH AND GROWING PAINS

If a business grows too fast, investors should look at how much investments are required and the real cash generated

8 December 2012

When is growth desirable in a company? Much depends on the investments required to generate that growth.

A company that is making a return below its weighted cost of capital (WACC) is destroying value, even if its earnings per share are growing. The faster its earnings grow, the greater the value it destroys.

If a company is earning exactly its cost of capital, then earnings growth should have no effect on its price-earnings (PE) multiple. Its earnings can grow at 5, 50 or 500 per cent, but its PE multiple will remain the same.

As long as a company is earning returns greater than its cost of capital, any rise in its earnings growth or its return on invested capital (ROIC) will increase its PE. However if it is earning less than its cost of capital, the faster it grows, the more wealth it destroys and the lower its PE multiple.

Investors must be alert to how companies redeploy their capital, especially internally generated funds. "Returns (on the capital) should be the first order of consideration, and earnings growth should come second because earnings growth can be good, bad, or indifferent based on the economic returns," says Michael Mauboussin, chief investment strategist at Legg Mason Capital Management.

That a business should earn more than its WACC as a measure of its efficiency is the concept of Economic Value Added (EVA), which Temasek Holdings is a big fan of.

Now let's apply this to a sector that is under intense spotlight now – the global commodity supply-chain sector. The three major players in this sector in Singapore are Wilmar, Noble and Olam, whose business model has been attacked by Muddy Waters as unsustainable.

Charts 1, 2 and 3 show how the capital deployed in all three companies have climbed sharply over the past five years. However, their ROICs, as calculated by Bloomberg (net operating profit after tax divided by average invested capital) have declined. For Wilmar, it fell from 13 per cent in FY2006 to 3.6 per cent in FY2011.

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