4 PROVEN APPROACHES TO PICKING

[MULTIBAGGER STOCKS]

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Preface

Not many in this part of the world would have heard of the famous value investing firm, Tweedy Browne Company LLC. However, this is not their only claim to fame.

Some years back, the firm conducted an extensive research in the field of equity investing. It was an attempt to find out a stock picking method or strategy that has given the highest returns over a long term period. Aptly titled, 'What has worked in investing', the findings of the study are likely to burn a big hole in the myths that people have about investing... especially the ones who do not believe in the concept of value investing.

The truth is finally out

So here we are. Finding the next market beating portfolio does not need sophisticated analysis nor does it involve losing sleep over which way interest rates are headed next or attempts at finding out whether India will run a trade deficit or a surplus in the next fiscal. It is entirely free of this so called mumbo-jumbo.

Instead, all it requires is finding out which stocks are trading the cheapest relative to their peers and sticking with them for a few years. Yes, that's all there is to successful investing. And we have the report for proof.

As per the report, a portfolio of stocks that are trading at the cheapest valuations when measured on conventional valuation parameters like price to book value and price to earnings have shown remarkable consistency in attaining market beating returns for a sufficiently long period of time.

But why look for cheap stocks? Will any good stock not suffice? Certainly not!

Buying stocks should not be different from buying things on sale in a supermarket or waiting for the car companies to offer special incentives. The time to buy stocks is when they are on sale i.e., selling cheap, and not when they are priced high because everyone wants to own them.

The objective of this report is to validate this very fact – stocks selling cheap tend to give better returns over a long period as compared to those selling at expensive valuations, all things remaining same.

As part of the analysis that went into preparing this report, we dug deeper into history and studied whether the approach of buying cheaply valued stocks has delivered good returns over the long run.

The year we have used as our base is 2010 as we believe that analysis going as far back as nearly a decade is a long enough time to prove the validity of our approach.

And what has been the conclusion of our study?

Less valued stocks have performed brilliantly over the long term. Whether one bought stocks trading at low P/E, or low P/BV, or even low Graham's Mutiples (we will explain this in a bit), the returns have been great.

Using this analysis as a backdrop, we have compiled some lists of stocks that pass these 'low priced' criterion as of now. You can treat this as a universe from which to find your next multi-bagger stocks.

Well, the good news does not end just yet. This exclusive 10 page report, which is otherwise worth Rs 495, is being presented absolutely free of cost to you.

But just a word of warning here – these lists present just the universe of stocks that pass these criterion. One still needs to analyse a company's past performance record, its management credibility, and future prospects before making the final buying decisions.

We hope this report is of some help to you in your search for some brilliant long-term investment opportunities.

Here's to your long term financial well-being.

Warm regards,
Team Equitymaster

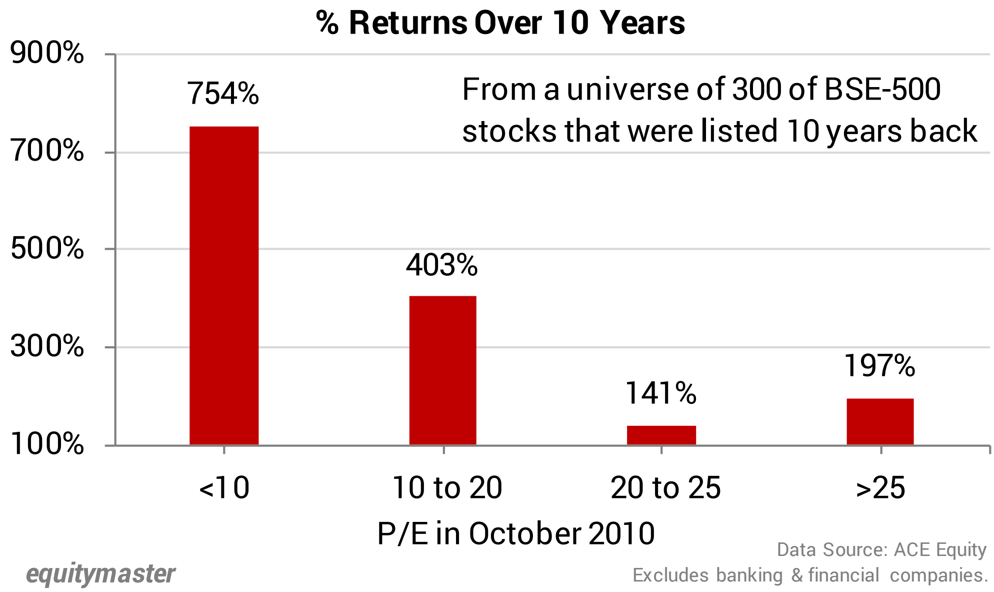
Approach I -

Buying Stocks With Low Price in Relation to Earnings

Stocks bought at low price/earnings (P/E) ratios offer higher earnings yields than stocks bought at higher P/E ratios. The earnings yield is the yield that shareholders would receive if all the earnings were paid out as a dividend.

Investing in stocks that are priced low in relation to earnings includes investments in companies whose earnings are expected to grow in the future. To paraphrase Warren Buffett, 'value' and 'growth' are joined at the hip. A company priced low in relation to earnings, whose earnings are expected to grow, is preferable to a similarly priced company whose earnings are not expected to grow.

Avg. return for stocks based on P/E



The fact that buying low P/E stocks can get you better returns than stocks trading at high P/E is validated by the under-mentioned chart. It shows the average returns of stocks over the past 10 years across different range of P/E multiples.

As the chart shows, stocks in the year 2010 with P/E multiples of less than 10 times have generated the biggest returns over the following ten years.

On the other hand, returns from the Sensex since then till date has been just around 95%, making it part of the category that has generated the least return as per the above chart.

Those who picked up stocks with P/E multiples of between 20 times and above have generated considerably lesser returns.

The analysis excludes stocks of banking and financial companies, as P/E is not the right metric to assess their valuations. Price to book value is, as we will study in the next chapter.

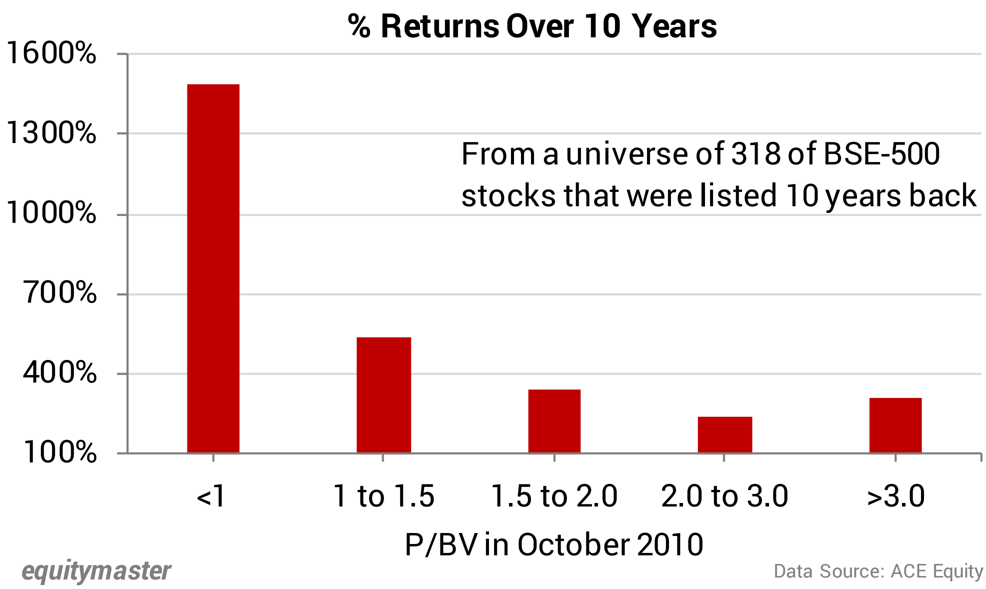
Approach II -

Buying Stocks With Low Price in Relation to Book Value

Apart from P/E, another ratio that is commonly used to value stocks is price to book value or P/BV. This is arrived at by dividing the market price of a share with the respective company's book value per share. Book value is equal to the shareholder's equity (share capital plus reserves and surplus). Book value can also be arrived at by subtracting current liabilities and debt from total assets.

Stocks priced at less than book value are purchased on the assumption that, in time, their market price will reflect at least their stated book value, i.e., what the company itself has paid for its own assets. All things remaining constant, such stocks generate higher returns over the long run as compared to stocks that trade at higher P/BV ratios.

Avg. return for stocks based on P/BV



See for instance the chart above. Stocks trading at P/BV of less than 1 time have far outperformed those that traded at a higher valuation (1times and above).

Based on this analysis, it becomes clear that buying a basket of low P/BV stocks may get you outstanding returns over the long term. But you may do even better if you can determine which of the low P/BV stocks are worth purchasing and which are about to go bankrupt. Looking for companies with a good overall track record, and manageable to low debt among stocks trading at discount to their book value can present great investment opportunities.

Approach III -

Buying Stocks With Low Price in Relation to Liquidating Value

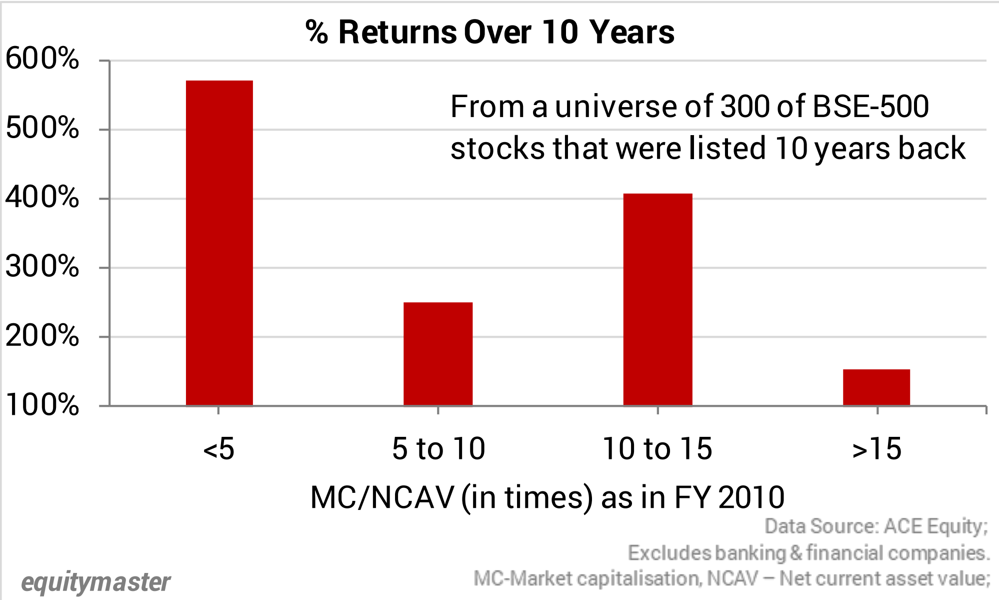
The idea here is to buy stocks at a cost less than their net current asset value (NCAV), and thereby giving no value to the fixed assets. But why just current assets? Because it includes items like cash and other assets that can be turned into cash within one year, such as accounts receivable and inventory, and is therefore a good measure of a company's worth if it were to be liquidated. This was a stock selection technique successfully employed by Benjamin Graham.

Graham believed that stocks selling below NCAV were worth more dead than alive. He stated if a stock was selling below liquidating value, either the price is too low or the company should be liquidated. He also states that stocks are 'real' bargains as per the NCAV method only if these companies are in no danger of squandering these assets, and have formerly shown a large earning power on the market price.

The fact that the NCAV rule works cannot be doubted. But it is difficult to find stocks that sell at a discount to NCAV in bull markets. It was the case in 2010 as well. While there were several stocks that were trading at low P/E and P/BV, but not many were trading at discount to their respective NCAV.

As such, for our analysis, we have studied the premium on NCAV at which stocks from our universe were trading at then. And the result is that - stocks that were trading at the lowest premium to the NCAV (less than 5 times NCAV) in the year 2010 have returned the most in the subsequent ten years. As compared to this, stocks trading at multiples of more than 5 times NCAV have turned out relatively poor performance over these years.

Avg. return for stocks based on MC/NCAV



Approach IV

Buying Stocks Using Benjamin Graham's Magic Multiple

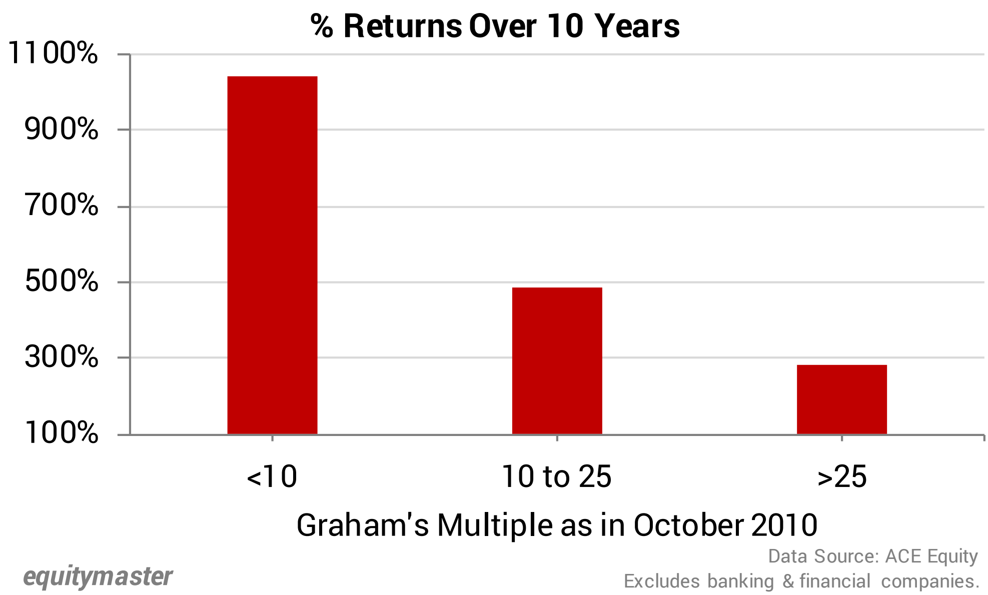
If you are confused which of the first two ratios - P/E or P/BV - to use to determine whether a stock is trading cheap, Benjamin Graham has a 'magic' formula to suggest!

It is the multiple of a stock's P/E and its P/BV.

Graham has put an upper limit to the output of this ratio - 22.5. This he derived using a maximum P/E of 15 times, and maximum P/BV of 1.5 times - the highest multiples he was ready to pay for stocks.

Our analysis shows that, on applying this multiple to our universe, stocks where the output of P/E multiplied by P/BV was significantly lower then 22.5 have generated more returns than those whose output was greater than 22.5.

Avg. return for stocks based on Graham's multiple



A Universe of Stocks 'On Sale'

After reading the above approaches to picking up cheap stocks, you must be wondering whether this can work in all environments. Quite certainly, we believe. Irrespective of the environment there will always be some stocks that would be trading cheap vis-a-vis their peers and also stocks that are expensive.

Thus, even now, you can still find cheap stocks using all these three approaches.

But don't worry, you won't have to do any hard work yourself! We will make your task easier... In fact, we will even zero in on the stocks for you...

You see, my colleague and I have jointly put in over 20 years of hard work to build systems and process to pick winning stocks by following these exact same ideas, and more.

If you are interested in getting access to our best views and investing ideas, then we recommend you start here...

Regards,
Tanushree Banerjee & Rahul Shah
Research Analysts & Co-Heads - Research, Equitymaster

P.S.: One segment of the stock market where one could make big returns is small caps. In fact, a select group of subscribers have seen several triple digit gains, and numerous double digit gains in the last few years alone! If you would like to explore this opportunity for yourself, please click here...

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