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## THE CONSERVATIVE INVESTOR

Although the Conservative Investor has performed well, I have struggled to add names to the portfolio. Simply put, I have found few stocks that I truly consider to be low risk. Over the past five years, I have suffered many hours of nail biting with the stocks in this portfolio. Even the best performers have had trouble of one kind or another. I also still worry, for example, about Sony's ability to complete its turnaround successfully and the risk in GE's finance business, including its derivatives exposure. Despite these ups and downs, the portfolio generated an average annual return of 16.8% in the three years ended December 31, 2005 and is up 16.5% so far this year.

From this point forward, market factors and economic conditions make it even more difficult to recommend a truly conservative portfolio. Since you can now earn about 5% on a 6-month T-bill, I believe that you should set a minimum return target of 7% on stock investments to compensate for the added risk.

With the average dividend yield on stocks now at 1.6%-1.9%, achieving that targeted minimum 7% total return requires realizing price appreciation of at least 5.1%-5.4%. In a bear market, it is much more difficult to achieve even a modest degree of price appreciation. To illustrate, assume that you own a stock that is trading at 17.4 times trailing earnings (equal to the current average for the S&P 500) and is expected to grow its earnings at 5% over the next 12 months. If the stock's P/E multiple remains at 17.4 at the end of the 12-month period, then your stock will rise 5%. On the other hand, if the multiple declines to 16 times, your stock will fall 3.5%. To compensate for the decline in the P/E multiple, earnings would have to grow by about 9% in order to achieve your 5% desired return! It is no wonder then why even the stocks of strong companies suffer during a bear market.

Given the headwinds caused by rising interest rates, it is surprising that the stock market is higher than it was when the Fed began tightening in the summer of 2004. Over the two year period ended December 31, 2005, the S&P 500 rose 12.3% (or at an average annual rate of about 6%). During the same period, the P/E multiple on "as-reported" trailing 12-month earnings for the S&P 500 declined from about 23 times to 18 times. The compensating factor was corporate earnings, which rose 43% (or at a 20% average annual rate), more than offsetting the negative impact of a lower P/E multiple. While many economists expect that earnings growth will stay strong for the balance of the year, the current period of earnings expansion is already one of the longest on record. At 10.5% of GDP, corporate profits are also at their highest level on record. Thus, we will almost certainly see a slowing in the rate of profit growth, if not an outright decline in the future, which will put further downward pressure on stocks.

As you know, I have been worrying about the potential for a decline in the stock market for some time now. This is reflected in the model portfolio's low equity weighting of about 40%. I too believe that it is tough to compete with a "guaranteed" return of about 5% on short-term T-bills.

Still, I recognize that my goal is to find stocks that will outperform the market and also provide a positive total return – above the return on short-term fixed income instruments – even in a declining market. So with that in mind, I offer the following guidelines for Conservative Investor stock selection going forward:

1. Solid business fundamentals – You can crunch all of the financial ratios and valuation multiples that you like, but the real key to determining whether a company's stock will outperform in a bear market is business performance. Ideally, I am looking for companies whose businesses: 1) offer products or services that are non- or countercyclical (i.e. those that can grow even in a weak economic environment); 2) have a strong and defensible market position; 3) have significant operations outside the U.S. (to benefit from a weaker dollar) and 4) can actually benefit from or at least keep pace with a pick-up in inflation (i.e. have pricing power that can result in margin expansion).

2. Price/earning multiple of 15 or less (below the market average) on 2006 earnings – This, of course, is a key focus of value investors. The trick, though, is finding stocks whose P/E ratios are low because the companies are underestimated or misunderstood, not those whose earnings are likely to decline.
3. Price/earnings/growth ratio of 2.0 times or less. – In order to ensure that the P/E multiple is not out of line with expected earnings growth, many investors seek to hold stocks whose P/E multiples are not more than 2.0 times the earnings growth rate. So if I am considering a stock with a P/E multiple of 15, I would ideally like it to have an earnings growth rate of 7.5% or greater.
4. Minimum 2.5% dividend yield/payout ratio below 50%/positive free cash flow - Dividends provide greater certainty of return, as long as the company is able to sustain them. A low dividend payout ratio (defined as total dividends divided by net profit) provides greater assurance of sustainability, since earnings would have more room to fall before the dividend has to be cut. Free cash flow (defined as net income plus depreciation minus capital expenditures) is a similar measure of dividend safety. The more that free cash flow exceeds total dividends, the greater the ability of the company to meet its dividend payment requirements.

Investors used to place more emphasis on dividends. From 1929 to 1959, the dividend yield on the average stock was higher than the yield on long-term Treasury securities. Following the 1929 stock market crash and during the Great Depression, investors required higher dividend yields because economic visibility was poor and corporate earnings could not be trusted. As the bull market roared in the last few decades of the 20<sup>th</sup> century, investors shifted their emphasis away from dividend yield to earnings growth. When the bear returns to Wall Street, investors may demand higher dividend yields, but there will probably be some differences this time, because inflation is on the horizon.

Under pre-1960 market norms, today's average dividend yield would be above 5%. Over the next five years or so, I believe that the market will focus more on yield, especially as interest rates rise. The transition to a yield-driven market will probably not be easy. If, for example, the required yield on a stock rises from 3% to 5% and the amount of the dividend stays fixed, the share price will fall 40%. Consequently, dividend growth potential should also be a key consideration in stock selection.

My selection of a 2.5% minimum yield requirement is somewhat arbitrary. It makes sense to seek an above-market yield on the portfolio to minimize the price appreciation necessary to achieve our desired 7% total return. Yet, many conservative stocks with good upside potential may have lower dividend yields. Understanding dividend policy is therefore important. If a company has a low dividend yield, a low payout ratio and ample free cash flow, then we should know why it has not raised its dividend. Likewise, we should try to ascertain whether a high yielding stock with a low payout ratio and a high level of capital spending will be able to sustain its dividend.

5. A share price-to-tangible book value ratio less than 2.0. P/E and cash flow multiples place a value on the current and future earnings potential of a business. If earnings begin to falter, however, then the value of the net assets of the company could provide back-up support for the value of the stock. A company's tangible book value is often used as a proxy for net assets. It is calculated by subtracting goodwill and other intangible assets from common shareholders' equity and dividing the resulting amount by the number of common shares outstanding. A low price-to-tangible book value ratio should provide greater back-up support for the stock price. Often, however, it may be a sign that the market is anticipating asset write-downs or future losses.

6. Decent balance sheet. Besides being cheap according to a number of valuation measures, conservative stocks should ideally have a reasonably strong balance sheet and generate sufficient cash flow to meet all debt service requirements comfortably.
7. Less emphasis on technical analysis. – Over the past ten years, technical analysis and its close relative, momentum-driven investing, have become the tail wagging the stock market dog. It is usually the case, however, that the key principles of technical analysis do not work well in a bear market. Although I believe that looking at the charts is still important, the value-driven approach that I have outlined here will hopefully allow us to identify stocks that are likely to outperform the market in good times and bad or at least give us a good shopping list, when the market bottoms.

The goal here is to find stocks that are relatively cheap, but still possess good growth potential. Less expensive stocks should have greater upside potential as they are “rediscovered” by the market. They also should fall less in a market decline. At the same time, good business fundamentals, financial strength and adequate earnings/cash flow flexibility should provide greater downside protection.

Nevertheless, these selection criteria are guidelines only and may not by themselves lead to the best performing stocks picks. Warren Buffett, in a 1992 letter to shareholders of Berkshire Hathaway, perhaps said it best:

“Whether appropriate or not, the term ‘value investing’ is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics – a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield – are in no way inconsistent with a ‘value’ purchase”

from Value Investing: from Graham to Buffett and Beyond  
by Greenwald, Kahn, Sonkin and van Biema; Wiley Finance, 2001

While there is no disputing Mr. Buffett’s admonition, its timing was a harbinger of the deterioration in investment principles that occurred during the balance of the 1990s and culminated in the collapse of technology stocks in 2001. Certainly, we should deviate from these fundamentally-oriented principles when warranted; but in the current situation, with an expected slowing in economic growth and consumer spending, high consumer debt levels, the twin trade and budget deficits and peaking corporate profits, it behooves us to consider carefully any deviation. In order to recognize value in a stock with a high price to book value ratio, high P/E ratio or low dividend yield, it seems to me that you have to possess an edge, such as superior insight into a company’s business potential. Although I usually strive to learn as much possible about the underlying business, there are practical limits to what I, as a generalist and sole practitioner, can accomplish. My job has also been made more difficult by the growing complexity of corporate business operations, the deterioration in the quality of financial reporting, accounting standards that permit a wide range of financial presentations, many of which can be misleading, and other financial practices, including the growth in the use of derivatives, which increase the risk of being blind-sided. Perhaps that 5% on T-bills looks even better to you now! Yet, with a set of logical investment criteria, a little diligence, some common sense and a dash of luck, this approach will hopefully produce the desired results.

That said, I am also on the lookout for “stealth” conservative investments (i.e. those that look risky, but in fact are not). I suspect that the best performing investments over the next several years will be those falling into this category. My first lesson in this regard came shortly after I took over publishing Income Builder with Bank One, which was added to the Conservative Investor portfolio by Patrick Keenan, the previous publisher of Income Builder. Although CEO Jamie Dimon had come on board, the bank had not yet completed its turnaround. While Bank One may have

been a good bet, it was not, in my view, a conservative investment; so I pulled it from the portfolio. Well, the stock was a solid performer for the next two-and-a-half years, right through the recession, helped by falling interest rates. In early 2004, Bank One was acquired by J.P. Morgan Chase at a decent premium. Hopefully, I will be able to recognize similar situations as opportunities in the future.

## **ACTION THIS WEEK:**

The Allstate Corporation (ALL) is a NEW BUY (200 shares) in the Conservative Investor portfolio. I am also transferring the positions in Verizon (VZ) and AT&T (T) from the Trend Trader to the Conservative Investor.

## **THE CONSERVATIVE INVESTOR**

	NO. OF SHARES	6/6/06 PRICE	EPS 2005	PE RATIO	EPS 2006F	PE RATIO	YTD YIELD	YTD RETURN
AT&T (T)	400	26.73	1.44	19	2.05	13	5.0%	NA
The Allstate Corp. (ALL)	200	54.21	2.64	21	5.75	9	2.5%	NA
Avery Dennison (AVY)	100	56.99	3.46	16	3.70	15	2.7%	3.1%
Campbell Soup (CPB)	1,000	36.12	1.71	21	1.80	20	2.0%	21.3%
General Electric (GE)	100	34.55	1.72	20	2.00	17	2.9%	-1.4%
Sony Corp. (SNE)	200	44.60	1.00	45	1.10	41	0.5%	9.3%
Verizon Comm. (VZ)	200	31.70	2.50	13	2.60	12	5.1%	NA

Previously, AT&T (T) and Verizon (VZ) were included in the Trend Trader portfolio, where year-to-date, they achieved returns of 6.7% and 0.7%, respectively, excluding dividends. They are not included in the Conservative Investor performance figures given on page 1 of this Bulletin.

## **The Allstate Corporation (ALL)**

Despite suffering \$5.7 billion in losses from the Gulf Coast hurricanes last fall, Allstate, a property and casualty insurer, is still in great shape. It is working diligently to minimize its exposure to catastrophes going forward, while also pursuing profitable growth in areas like auto insurance. The company has a strong balance sheet and has bought back \$3 billion of its shares in the past five quarters. The stock's valuation is low – just 9 times projected 2006 earnings and less than 1.9 times tangible book value (excluding unrealized gains on fixed income securities) – and it pays a decent dividend. Risks include higher than expected insurance claims and weaker investment performance, but management keeps a close eye on all aspects of its business and I believe the investment risk is manageable. I am adding 200 shares of Allstate to the Conservative Investor portfolio.

## **Campbell Soup Company (CPB)**

Campbell's stock has had a great run lately, even as the market has faltered. The company reported fiscal fourth quarter earnings of \$0.40, higher than last year's \$0.35 and well above the consensus estimate of \$0.35. It also raised earnings growth expectations from 5%-7% to 8%-9% for the full fiscal year. Despite the run-up, the company still possesses many of the characteristics that qualify it for this portfolio – including a non-cyclical core product line with pricing power and significant international operations. Consequently, I believe that Campbell's stock has excellent long-term performance potential.

Due to a scheduling conflict, I am postponing the previously planned Midyear Teleconference originally scheduled for June 21. Bulletin 1274 will be published on Wednesday, June 21. Portfolio changes will be available on the web site ([www.larkresearch.com](http://www.larkresearch.com)) after 3:00 PM on that date. As always, you can reach me at (732) 499-4300.

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