# SCREENING FOR STOCKS USING THE JOHN TEMPLETON VALUE APPROACH

By Kenneth J. Michal

Templeton was the constant comparison shopper—whether it was clothes, furniture, a home, or stocks, he always looked for the best-priced bargains.

With the long-running bull market a distant memory, many once comfortable investors are suddenly wary; some are even beginning to panic. Others are beginning to look for new portfolio models and investment strategies that will secure their futures.

These investors might want to look at one of the investment game's old veterans for comfort and safety—value investing.

Value investing is the old stand-by. It is an investing approach that is strictly adhered to by many investors. Perhaps considered old-school by some, it is an ideology periodically reviewed in market environments such as now. Studies show that value strategies often fare better than growth strategies during bear markets and may even outperform growth strategies in the long run when risk is considered.

Value investing concentrates on unappreciated stocks trading at attractive prices—bargain stocks. Value investors search for stocks that are attractively priced relative to some measure of intrinsic worth. They most often look for solid companies whose stocks are trading at low multiples of price relative to book value, cash flow, earnings, dividends, or sales. This contrarian way of thinking looks for such stocks with the hopes that these low multiples are temporary, that the company will withstand Wall Street's wrath, and prices will eventually rise as Wall Street realizes the true worth of the firm.

## STICKING TO THE FAITH

This is the investment philosophy adhered to by John Templeton, one of the best-known investment advisors today. While in college, Templeton studied under one of the forefathers of value investing, Benjamin Graham. With that first security analysis course, Templeton caught the contrarian bug and continued to train in the art of value investing. He was always out bargain hunting. Templeton was the constant comparison shopper—whether it was clothes, furniture, a home, or stocks, he always looked for the best-priced bargains.

A benevolent and religious man, with his own foundation dedicated to religious and spiritual progress, Templeton puts his faith in the prospects of the companies he chooses and takes profits before any multiple can over-inflate the stock's value. Oftentimes he sells before the peak, but Templeton prefers to be on the safe side—especially when it is someone else's money. Founder of the Templeton Mutual Fund Organization, he considers managing money a sacred trust.

## STRICTLY CONTRARIAN

Templeton's long-standing strict contrarian nature was illustrated at a 1991 Templeton Mutual Fund annual shareholders meeting. Speaking at the podium, Templeton recommended a book to those in the audience who considered themselves serious investors. The selection was a sobering reality check to all in attendance: "Extraordinary Popular Delusions & the Madness of Crowds," by psychologist Charles MacKay.

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In his classic book, MacKay describes bubbles—periods of extreme speculation in stocks, bonds, real estate, collectibles, and other various types of investments. In a bubble, investors ignore company fundamentals and buy on the buzz—hot topic noise, wild rumors, and cocktail party tips—paying any price to become a player in the game. Eventually the collective buzz wears off and the real value of the investment is recognized. Investors panic and widespread selling causes the bubble to burst.

The book recommendation serves as a reminder that value investing with a contrarian mind can be a rather difficult discipline. Notes Templeton: "To buy when others are despondently selling and sell when others are avidly buying requires the greatest fortitude and pays the greatest potential reward."

## NEW INVESTMENT WORLDS

Templeton was given the moniker 'the Christopher Columbus of investing' because of his ability to discover new worlds. He was one of the first U.S. money managers to invest internationally, finding value in global markets and among emerging nations. An ardent contrarian and value investor, his focus was always domestic issues, but the scope of his searches was not limited to U.S. market boundaries. Sometimes bargains were found in Japan, other times Argentina. It did not matter. The goal was to seek out value, finding only the best bargains—regardless of country origins.

For this stock screen, we focus solely on domestic listed issues. We used AAII's fundamental stock screening software program *Stock Investor Pro*, which covers over 9,000 U.S. traded stocks. However, Templeton's philosophy on global investing and some guidelines for prospective investors are discussed in the sidebar on page 28.

Two books served as the basis for the creation of this article and stock screen. Both books feature sections devoted to Templeton's life and investing beliefs: "Lessons From the Legends of Wall Street," by Nikki Ross, CFP (Dearborn Financial Publishing Inc., $25); and "Money Masters of Our Time," by John Train (HarperCollins Publishers, Inc., $26).

## LOW PRICE-EARNINGS RATIOS

When implementing a value investing strategy, there are a number of ways to create the screen. When screening for value in the form of attractively priced stocks, however, the foundation is often low price-earnings ratios. This Templeton screen is no different, incorporating a low price-earnings requirement as its base.

In some cases, stock screens with low price-earnings ratios are supported by solid estimated earnings and sales growth. Other times the above combination of criteria includes a strong dividend yield. The dividend-adjusted price-earnings relative to growth ratio, or PEG ratio, is also frequently used in value screens.

## FUTURE PROBABLE EARNINGS

One difficulty in implementing a low price-earnings ratio approach is separating the "good" companies—those that are simply misunderstood by the market—from the ones that the market has accurately pegged as being "losers." Many low price-earnings ratio stocks are in the bargain basement because their industry, products, or earnings and growth prospects do not excite investors.

Separating the good firms requires some additional, supportive filtering factors. For Templeton, such support and confirmation comes from what he calls future probable earnings, or

### Definitions of Screens and Terms

**P/E Ratio—Current**: Market price per share divided by the most recent 12 months' earnings per share. A measure of how the market currently values the firm's earnings growth and risk prospects. **5-Year Average**: Average annual P/E Ratio over the last five years.

**Earnings per Share—5-Year Growth**: Annual percentage growth in earnings per share over the last five fiscal years. A measure of how successful the company has been in generating the bottom line, net profit.

**EPS Growth Estimate—Firm**: A firm's mean expected growth rate in earnings per share from continuing operations over the next three to five years that is being forecasted by analysts as reported by I/B/E/S. Provides an indication of analyst expectations for a company's growth potential. **Industry**: An indication of the consensus in earnings growth expectations for the company's industry.

**12-Month Operation Margin—Firm**: Calculated by dividing the operating income of a stock by its total revenue for the last 12 months. Measures the percentage of revenues remaining after paying all operating expenses. **Industry**: Median operating margin for the last 12 months for the company's industry. Reflects the general profitability levels within the industry.

**Total Liabilities/Total Assets Q1—Firm:** Short-term and long-term liability divided by total assets of the firm for the most recent quarter. A measure of financial risk that indicates how much of the assets have been financed by liabilities. **Industry:** An indication of the general debt levels within the company's industry.

forecasted earnings growth. From Templeton's viewpoint, for any stock selection to be considered worthy, future probable earnings need to be strongly favorable.

Several other key components to judging the quality of the company, such as increasing earnings growth and operating margins, are discussed below.

## INDUSTRY GENERALIZATIONS

In some instances, investors make unfair generalizations about industries, and as a result, about individual stocks within the segment. Quite often investors look at struggling industries and swear off the entire group.

This suffering for the problems of the group is best portrayed by the retail industry's dominant presence in the screen results. Of the 27 passing companies presented in Table 1, nine are stocks from or closely linked to the retail industry. Our list features a broad sampling of retailers, including the upscale furniture store Ethan Allen Interiors (ETH), the housewares supplier for your bathroom, bedroom, and kitchen; Linens 'n Things (LIN); and discount department store Wal-Mart (WMT). The sub-group of retailers also features two very similar retail apparel stores geared toward the teenage demographic: the suburban mall staple stores Abercrombie & Fitch Co. (ANF) and Pacific Sunwear of CA (PSUN).

Retail stocks have become a favorite target of the market's wrath as of late, some for very good reasons. With poor results during the important holiday season, continued struggles in the first quarter of 2001 and the bearish outlook for the economy reflected in the low levels of consumer spending, many investors have avoided this group. Value investors, however, may see opportunities.

Take for example, the aforemen-

**TABLE 1. COMPANIES PASSING THE TEMPLETON VALUE SCREEN**

| | P/E Ratio | | 5-Yr. | EPS Growth Est. | | 12-Month Operating Margin | | Total Liabilities/ Total Assets Q1 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Company Name (Exchange: Ticker) | Current (x) | 5-Yr. Avg. (x) | EPS Growth (%) | Firm (%) | Industry (%) | Firm (%) | Industry (%) | Firm (%) | Industry (%) | Description |
| Cutter & Buck Inc. (M: CBUK) | 6.3 | 24.3 | 64.4 | 31.7 | 15.0 | 10.7 | 4.6 | 24.3 | 54.4 | Sport & outerwear |
| Pre-Paid Legal Services (N: PPD) | 8.2 | 42.4 | 43.3 | 20.0 | 15.0 | 30.3 | 4.3 | 38.2 | 45.0 | Legal service plans |
| Midland Company (M: MLAN) | 8.8 | 12.7 | 29.3 | 11.6 | 11.4 | 9.5 | 7.0 | 71.5 | 73.1 | Physical damage ins |
| Strattec Security Corp. (M: STRT) | 8.9 | 11.6 | 29.5 | 10.0 | 10.0 | 12.3 | 4.6 | 36.4 | 66.9 | Locks for autos |
| Dycom Industries, Inc. (N: DY) | 9.1 | 22.3 | 48.0 | 22.1 | 14.0 | 13.3 | 3.9 | 20.3 | 61.9 | Servs for telecomm |
| PMI Group, Inc. (N: PMI) | 9.4 | 10.2 | 17.5 | 12.1 | 11.4 | 49.0 | 7.0 | 37.3 | 73.1 | Mortgage & title ins |
| Radian Group, Inc. (N: RDN) | 9.5 | 12.2 | 24.5 | 13.8 | 11.4 | 57.3 | 7.0 | 38.3 | 73.1 | Mortgage ins |
| Mohawk Industries, Inc. (N: MHK) | 10.0 | 12.8 | 87.7 | 14.5 | 11.7 | 9.5 | 3.1 | 57.9 | 63.0 | Carpet manufacturer |
| Fossil, Inc. (M: FOSL) | 10.2 | 13.6 | 33.8 | 18.7 | 18.7 | 18.6 | 4.5 | 28.3 | 47.7 | Fashion watches |
| Dataram Corp. (M: DRAM) | 11.1 | 19.5 | 61.5 | 33.0 | 27.5 | 11.4 | –11.3 | 17.7 | 38.2 | Computer add-in memory |
| Blyth, Inc. (N: BTH) | 11.3 | 28.1 | 42.1 | 15.3 | 12.6 | 14.8 | 5.2 | 48.0 | 65.3 | Home fragrance prods |
| MGIC Investment Corp. (N: MTG) | 11.5 | 13.8 | 23.3 | 12.3 | 11.4 | 71.0 | 7.0 | 36.1 | 73.1 | Mortgage ins holding co |
| Triad Guaranty Inc. (M: TGIC) | 11.8 | 13.5 | 34.8 | 12.0 | 11.4 | 59.2 | 7.0 | 39.1 | 73.1 | Mortgage ins holding co |
| Ethan Allen Interiors Inc. (N: ETH) | 15.0 | 16.7 | 35.1 | 13.0 | 13.0 | 16.3 | 8.2 | 25.5 | 51.8 | Home furnishings |
| Orthodontic Centers of Am (N: OCA) | 17.5 | 40.2 | 54.2 | 28.0 | 20.7 | 35.1 | 0.0 | 22.6 | 63.3 | Servs for ortho cntrs |
| SkyWest, Inc. (M: SKYW) | 18.2 | 23.7 | 30.2 | 17.7 | 13.0 | 17.0 | 6.1 | 28.1 | 74.2 | Airlines |
| Abercrombie & Fitch Co. (N: ANF) | 18.5 | 42.6 | 70.7 | 22.1 | 17.7 | 21.7 | 5.7 | 34.9 | 48.1 | Casual apparel |
| Sonic Corp. (M: SONC) | 18.9 | 19.0 | 20.8 | 19.5 | 18.0 | 20.6 | 2.6 | 41.5 | 53.3 | Drive-in restaurants |
| Linens 'n Things (N: LIN) | 22.0 | 24.6 | 177.6 | 23.8 | 18.3 | 6.8 | 2.7 | 44.1 | 62.5 | Housewares |
| Schering-Plough Corp. (N: SGP) | 23.0 | 34.2 | 19.1 | 13.9 | 12.8 | 31.9 | 24.7 | 43.2 | 52.6 | Pharm & health care prods |
| Performance Technologies (M: PTIX) | 24.5 | 31.3 | 9.1 | 26.0 | 20.0 | 22.9 | 4.7 | 11.8 | 46.9 | Telecomm prods |
| Pacific Sunwear of CA (M: PSUN) | 24.8 | 35.5 | 52.1 | 22.6 | 17.7 | 11.1 | 5.7 | 23.3 | 48.1 | Casual apparel |
| Cost Plus, Inc. (M: CPWM) | 25.7 | 31.9 | 49.5 | 24.1 | 18.3 | 7.5 | 2.7 | 36.8 | 62.5 | Home living prods |
| Safeway, Inc. (N: SWY) | 26.0 | 28.5 | 31.8 | 16.1 | 14.5 | 7.2 | 1.7 | 67.2 | 69.1 | Supermarkets |
| Cintas Corp. (M: CTAS) | 29.8 | 37.2 | 20.9 | 18.6 | 15.0 | 16.5 | 4.3 | 31.1 | 45.0 | Corp identity uniforms |
| Estee Lauder Co. (N: EL) | 30.3 | 37.7 | 23.8 | 14.7 | 12.6 | 12.2 | 5.2 | 48.0 | 65.3 | Cosmetics & fragrances |
| Wal-Mart Stores, Inc. (N: WMT) | 34.7 | 36.3 | 15.8 | 14.6 | 14.0 | 5.4 | 3.0 | 63.0 | 66.3 | Discount dept stores |
| **Median of Passing Companies** | **15.0** | **24.3** | **33.8** | **17.7** | **—** | **16.3** | **—** | **36.8** | **—** | |
| **Median of All Companies** | **14.3** | **18.4** | **7.2** | **17.5** | **—** | **2.6** | **—** | **56.5** | **—** | |

*Data as of March 2, 2001.*

*Source: AAII Stock Investor Pro/Market Guide Inc.*

*Exchange Key: N = New York Stock Exchange*
*A = American Stock Exchange*
*M = Nasdaq*

tioned two retail apparel stores. Each possesses attractive, low price-earnings ratios and solid historical earnings growth. Each one has future probable earnings that are favorable relative to the retail apparel industry as a whole. These two stocks are solid prospects—especially the brand name of Abercrombie & Fitch—both with good growth numbers. Very likely, they are being overlooked simply because of their ties to the struggling retail industry.

## RUNNING THE SCREEN

Templeton likes to compare current price-earnings ratios to five-year average annual price-earnings figures when looking for the lowest multiple stocks. There are two hidden aspects of this first screening criterion: Not only does it require the current price-earnings ratio of the stock to be lower than its five-year average, but in addition any passing company must have been traded for at least five years and had positive annual earnings per share for each of the last five fiscal years.

Implementing this cornerstone criterion in the *Stock Investor Pro* program reduced the database of 9,541 stocks down to 1,703.

When screening against five-year averages, useless numbers can sometimes slip through the cracks in a screening technique. Beyond negative earnings, which lead to meaningless price-earnings ratios, unusually low earnings may also throw off standard price-earnings ratio screens. Short-term drops in earnings due to extraordinary events may lead to unusually high price-earnings ratios. As long as the market interprets the earnings decrease as temporary, the high price-earnings ratio will be supported. Because the average price-earnings ratio model relies on a normal situation, these "outlier" price-earnings ratios must be excluded.

To eliminate companies with these extreme price-earnings ratios, an additional filter was applied to the Templeton approach. Deploying criteria that excluded any stocks with ratios above 75 for any of the last five fiscal years reduced the total number to 1,436.

In this case, using a number like 75 will only eliminate the extreme values. If you want to be more conservative, you can set a lower threshold, perhaps excluding ratios above 50 or 40.

Templeton believes the income statement should show consistent earnings growth as well. Earnings per share growth is one of the primary benchmarks used to measure company performance. Screening for stocks with positive earnings growth over the last 12 months and over the last five-year period reduced the roster of passing companies to 868 stocks. The annual earnings growth rates over the last five-year period for the Templeton screen group ranges from 9.1% for telecommunications products developer Performance Technologies (PTIX) to 177.6% for Linens 'n Things. However, extremely high growth rates may not be meaningful—for example, high rates may occur because earnings in the base year used in the calculation were at an extremely low level or near zero. Linens 'n Things is a perfect example, since the firm's earnings per share figure in the base year of the calculation was –$0.01. Beyond an overall growth figure, individual investors should look at the year-to-year trends, since long-term growth rates can easily mask the variability and risk of the underlying figures.

Examining the expected five-year growth estimate captures Templeton's future probable earnings prerequisite. His desire for consistent growth in the future is portrayed by a positive earnings growth estimate filter, which chopped the number of passing companies down to 499.

Templeton also seeks companies with competitive advantages. This can be detected by comparing a stock's forecasted earnings growth figures to the forecasted growth of its industry; firms with earnings growth estimates greater than or equal to the industry median more than likely have a competitive advantage. Using this as a requirement, the total number of passing companies fell to 195.

## EARNINGS STABILITY

In addition to forecasted earnings growth rates, Templeton feels increasing earnings are important. In replicating the Templeton strategy here, only five years were required to remain consistent with the low price-earnings ratio provision.

The year-on-year positive earnings criteria served as the most restrictive portion of the Templeton screen. Independently implementing this set of criteria left us with only 558 stocks from the original 9,541 stock database. When the requirement of five successive years of earnings increases was added to the prior Templeton screens, the number of passing firms was reduced from 195 to 72.

## OPERATING MARGIN

The next set of criteria concerns operating margin. Operating margin, or gross profit margin, paints a picture of how efficiently the company's management is operating within the framework of the company's generated profits.

Templeton's emphasis here is recent stability and consistent increases—in this case, however, over a shorter period. A screen for positive operating margins over the last 12 months and for the latest fiscal year dropped the total to 54 passing companies.

Continuing the competitive advantage theme, further criteria for favorable operating margins were added. Requiring recent 12-month and current-year operating margins to be greater than or equal to industry medians for the respective periods narrowed the database down

to 49 stocks. Industry medians are particularly important in this area as benchmarks because operating margins tend to be very industry-specific.

Two numbers stand out in the industry 12-month operating margin column—the first is the negative median figure (–11.3%) for the computer storage devices industry. The associated passing company is memory chip manufacturer Dataram Corporation (DRAM). Clearly, the industry's degree of profitability has been poor over the last 12 months. Negative industry median operating margins have also been recorded over the last three years. Looking at Dataram's year-to-year numbers, however, shows a reasonable trend in their profitability ratios. In terms of profitability performance, Dataram is performing rather well.

Nevertheless, within such a commodity-based industry, this kind of profitability is questionable versus all firms and other industries. Although the median operating margin for all companies is just 2.6%, that figure includes many firms who have yet to turn a profit. There are several industries performing at much higher levels that serve for better comparison.

This brings us to the second interesting industry median—the strong figure posted by the pharmaceutical industry labeled major drugs. The major drugs industry registered a handsome 24.7% median operating margin. The passing company linked to this industry is pharmaceutical and health care product maker Schering-Plough (SGP). Schering-Plough's product lineup includes the antihistamine prescription drug Claritin and other brands like Nasonex, Dr. Scholl's, and Coppertone. In passing the screen, Schering-Plough's operating margin surpasses the already strong figure of its industry by posting an equally impressive 31.9% figure. Confirming this 12-month figure is a steady, continuous five-year period operating margin range (27.3% in 1995, 28.4% in 1996, 28.2% in 1997, 28.8% in 1998, and for 1999 30.5%).

Looking at these median numbers by comparison, in addition to year-to-year trends, it is clear that Schering-Plough as well as the entire major drug industry, far outperforms Dataram and the computer storage device industry when it comes to the profits from the sale of their products.

Templeton also compared current operating margins to previous margins. With the additional filter requiring current operating margin to be greater than the five-year historical average operating margin, the total went down from 49 to 38 stocks.

Screening for the most recent 12-month timeframe reduces the probability of ADR stocks passing the filter, as ADRs are not required by the Securities Exchange Commission (SEC) to post or file quarterly or monthly figures.

## FINANCIAL STRENGTH

Templeton also monitored the balance sheet, looking for companies showing good financial strength. Templeton believes a strong financial position enables any company to work through the difficult periods often experienced by overlooked, out-of-favor stocks. Acceptable levels of debt vary from industry to industry, and for that reason the last criterion screens for companies with total liabilities relative to assets in the current quarter that are below their industry norms. This particular ratio is used here because it considers both short-term and long-term liabilities.

Again, since ADR stocks are not required to provide quarterly results, screening for quarterly data limits the prospects from the international stock group. With this final filter, the number of passing companies is reduced to 27 stocks, which are presented in Table 1. The passing stocks are sorted by lowest price-earnings ratios. Medians for the passing stocks and medians for the complete database are provided for comparison.

## QUALITATIVE FACTORS

In addition to researching company reports, pouring over financial statements, and analyzing each stock's industry, Templeton also placed a great deal of importance on several qualitative factors: quality products; sound cost controls; and the intelligent use of earnings by management in order to grow the firm.

Templeton also looked for any potential catalyst that might change the perception of a stock and spark interest among star-gazing investors, which in turn would cause the stock's price to rise. Catalyst-type events include the creation of new markets and products and could also extend to announced potential mergers and acquisitions, as well as favorable changes within the company's industry.

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## CONCLUSION

During difficult financial times, many investors seek shelter under the sturdy umbrella of a value investing approach.

"Be prepared emotionally and financially for bear markets," warns Templeton. "If you are really a long-term investor, you will view a bear market as an opportunity to make money."

Remember that fundamental stock screening is only a starting-point, and the results of any screen are simply a list of companies that meet a set of objective criteria. Before any investment decisions are made about any passing stock, additional research and further analysis are necessary. ✥

### The Importance of Global Investing

In the investment world, the terms global and international are sometimes used interchangeably.

But to John Templeton, they have very different meanings: International investors buy stocks or bonds outside their home country; global investors have no geographic boundaries—they can invest anywhere.

Templeton considers himself a global investor. One important reason is based on his theory of the impact of global diversification: Templeton believes that foreign stocks are natural diversification instruments.

#### Global Diversification

Many investors question the need to own foreign stocks. Their rational is that many U.S. companies (Disney, McDonald's, and Microsoft, for example) rely on foreign operations for significant portions of their income, and therefore they only need to hold domestic stocks with solid market share numbers abroad. Templeton believes that these type of investors are limiting their potential to earn greater returns by excluding some of the world's top-producing companies.

Templeton theorizes that, although in the short term it appears as though world stock markets move in sync, over the longer term these global markets have performed differently. When one country's stock market may advance, another's declines.

#### Risk Factors

Owning well-selected stocks in different companies, industries, and countries can reduce many of the associated risk factors.

When investing internationally, a diversified portfolio of stocks from various countries can help mitigate the potential impact of negative changes in currency rates, differences in accounting standards and government policies, as well as other political and economic risks.

Potentially, the most significant of these risks are changing currency rates. Factors that play a role in the value of a country's currency rates include political and economic conditions, inflation, and interest rates.

#### Mutual Funds and/or ADRs

Templeton advises conservative investors to invest in global or international mutual funds. These funds offer a diversified portfolio of professionally managed stocks.

Moderate, or what Templeton specifically calls aggressive, investors can buy stocks directly on a foreign stock exchange, but the drawbacks include language barriers, trading restrictions, and low trading volume. Any investor buying foreign country stocks should have a concrete understanding of that nation's accounting methods. Templeton warns, however, that buying stocks on foreign exchanges is something only the most experienced investor should consider undertaking.

Alternatively, individual investors can also purchase foreign stocks in the form of ADRs (American depositary receipts). The advantages of ADRs include the ability to purchase shares through domestic brokers, the minimal transaction costs compared to setting up similar trade accounts internationally, and having company reports published in English. Some are listed on U.S. exchanges; however, most trade over-the-counter. Examples include popular companies like Bayer (BAYZY), Heineken (HINKY), and Sony (SNE).

Lastly, Templeton suggests that investors who purchase individual stocks can further reduce the risks involved with international investing by buying the ADRs of several different financially strong firms. These investors should consider additional diversification protection through the purchase of a small amount of international or global mutual funds.