SPECULATING VS. INVESTING IN THE CURRENT MARKET ENVIRONMENT

By Donald Cassidy

It takes discipline to leave the game while it's still so much fun—doing so exposes you to afterthoughts of how much more you might have made. But if you are able to do so, you can find a surprising array of growth opportunities while assuming greatly reduced risk.

Investing is a financial commitment of capital in which one anticipates returns from the underlying business. By contrast, speculating is committing capital in reliance upon cash payoffs coming from other "investors."

If the latter sounds uncomfortably like a Ponzi scheme, celebrate your own wise perception! Yet in the spring of 2000, we have been facing a stock market unlike any other. Even with the recent market corrections, hundreds of stocks command dizzying prices with no basis in proven fundamentals, while at the same time thousands of others are shunned despite offering historic bargain valuations.

But history says this cannot "never end," as so many now expect. And the significant plunge in the tech sector recently has exposed some of the extreme risk that exists in this area of the market.

It takes discipline to leave the game while it's still so much fun—doing so exposes you to afterthoughts of how much more profit you might have made if only you'd (over)stayed a bit longer. But if you are able to do so, you can find a surprising array of choices to grow capital in common stocks while assuming greatly reduced risk. A conservative investor does not need to retreat 100% to money-market funds' low or negative aftertax, after-inflation returns.

Many investors rely on mathematical screens; a wealth of available data tempts one to hope for a scientific solution in the selecting process. But I've found that markets refuse to fit into our perfectly square little boxes. Great companies with wonderful stock potential can fail a screen by 0.1 on yield, earnings per share growth or price-earnings ratios. I prefer to start conceptually and seek reasonable (although imprecisely defined) valuation measures as confirmation.

Requiring that each stock meet all of several strict mathematical criteria produces conveniently short lists. I prefer thinking about future prospects that past data cannot quantify or guarantee—there must be some sort of attractive story that will unfold. For instance:

- Does this company produce clearly needed products/services and hold a defensible market position?
- Does it pass the reasonable test of not being a deep industrial cyclical in case we hit a recession?
- Is there a recent disappointment that has caused institutional holders to drive down the price to attractive valuation levels?

As an example, I conducted an eclectic search for values recently, beginning not with a database screen, but merely with an A-to-Z eyeball scan of the Sunday stock tables in early March, when Nasdaq was around its highs. The question I asked, "Was *anything* reasonably valued?"

The admittedly unscientific process of looking down the price-earnings ratio column in the NYSE tables revealed more than a few figures under 10—easy to spot as single digits. That valuation level seems fairly justifiable, since stocks have returned roughly 11% annually over the long term. While not every company must pay a dividend, having many to choose from with yields

Donald Cassidy is based in Denver and is a frequent AAII Chapter and SIG speaker. The latest of his four books on personal investing is "When the Dow Breaks." He can be reached by E-mail at donald_cassidy@hotmail.com.

TABLE 1. CONSERVATIVE GROWTH INVESTING: A STARTING EXAMPLE

Ticker	Company	P/E (X)	Div Yld (%)	Source of Attraction
FOOD AND RELATED				
ABS	Albertson's	11	3.0	Down 2/3 on EPS plateau after acquisitions
CCK	Crown Cork & Seal	10	7.3	Price is 0.7 times book value
DF	Dean Foods	12	3.6	Smashed on temporary EPS flattening
IMKTA	Ingles Markets	11	6.7	Industry consolidating
SLE	Sara Lee	11	3.7	Consistent 11%–12% growth
SJM.B	J.M. Smucker "B"	11	4.4	Debt-free, steady grower
SVU	Supervalu	8	3.7	Growing grocer selling at 0.1 times revenues
USC	U.S. Can	8	0.0	Consolidating business
CLOTHING AND TEXTILES				
BCF	Burlington Coat Ftry	11	0.02	Buybacks; mgmt owns 57%
JCP	J.C. Penney	12	8.3	Sells at 0.08 times revs, ½ book value, 5 times cash flow
SMI	Springs Inds	10	3.5	EPS re-accelerating
WAC	Warnaco	6	3.2	Trades at over 20 times earnings most years
WXS	WestPoint Stevens	9	0.5	P/E half five-year EPS growth rate
SHELTER AND RELATED				
AIV	Apt. Invt. Mgmt	NM	7.5	Consistent cash flow and dividend grower
CPJ	Chateau Comm	NM	8.3	10% growth and 8% yield
EIX	Edison Intl	8	7.1	Low payout; smashed by institutions
ENGL	Engle Homes	4	2.4	Non-cyclical locations; dividend up 50%
HPG	Heritage Prop Part	NM	12.5	Consolidating industry
MYG	Maytag	8	2.6	P/E about 1/3 EPS growth rate
PGL	Peoples Energy	10	7.3	Consolidating industry; Chicago location
PIR	Pier One	12	1.4	Good grower punished for qrly flux
PNW	Pinnacle West	7	5.3	AZ location; very low payout; rapid div growth
SUS	Storage U.S.A.	NM	9.2	Low debt; rising dividend; 10% EPS growth
SPH	Suburban Propane	NM	10.9	EPS, dividends up despite two warm winters
TXU	Texas Utilities	8	9.0	Price smashed on minor UK setback
TRANSPORTATION				
AVI	Avis	6	0.0	EPS up eight-fold in four years
CTB	Cooper Tire	6	6.1	Replacement market great if recession
DAP	Disct Auto Pts	5	0.0	Industry consolidator
FRNT	Frontier Airlines	5	0.0	Debt-free; Denver hub attractive; mg'd for profit over growth
GPC	Genuine Parts	10	5.3	EPS reaccelerating; low P/E—often trades at P/E of 15
HRZ	Hertz	9	0.7	EPS have tripled since 1995
FINANCIAL				
ALL	Allstate	5	3.8	Low debt; huge share buybacks
BAC	Bank of America	10	4.7	Leader in out-of-favor industry
ONE	Bank One	8	6.8	Strong franchise; trashed by institutions
BBX	BankAtlantic Bcp	7	2.0	Well located; consolidating industry
BSC	Bear Stearns	7	1.5	Selling at 0.9 times book; consolidating industry
CNC	Conseco	4	1.5	Strong cash flow; to shed bad acquisition
KEY	KeyCorp	7	7.0	High yield on 50% payout; 1.2 times book
LNC	Lincoln National	8	4.6	Shareholder-value focused; high ROE
JNC	John Nuveen Co.	13	3.3	Aging boomers = natural mkt for munis
RJF	Raymond James Fincl	10	1.6	Southeast location; consolidating industry
PERSONAL CARE AND SERVICES				
ACV	Alberto-Culver	12	1.5	New ethnic mkt; P/E low vs historical
DL	Dial Corp	9	3.0	Smashed after missed quarterly EPS consensus estimate
HCN	Health Care REIT	7	15.2	EPS and dividends just keep growing
SRV	Service Cp Intl	4	0.0	Cheap on cash flow; trashed 90% by institutions

(continued on next page)

well above the puny 1%+ now afforded by the S&P 500 provides downside protection. I avoided recent start-ups (the price-earnings ratio criterion automatically eliminates many anyway) but not recent initial public offerings or spin-offs of established companies, which database searches of five-year records will miss.

Starting a search for companies with price-earnings ratios under 10 uncovered other possibilities by being flexible with the initial criterion. For instance, the discovery of one company with a price-earnings ratio of nine prompted a look at comparable companies with ratios only modestly above 10 that should not be arbitrarily excluded. Impeccable growth rates predictably produce inflated valuations; sometimes a temporary miss creates wonderful buying opportunities at price-earnings ratios not quite under 10. Public

TABLE 1 (CONT). CONSERVATIVE GROWTH INVESTING: A STARTING EXAMPLE

Ticker	Company	P/E (X)	Div Yld (%)	Source of Attraction
LEISURE AND AGING				
BLC	A.H. Belo	9	2.2	Assets in two consolidating fields
CASY	Casey's Gen Stores	11	0.7	Dip in gas margins; trashed by institutions
COA	Coachmen	7	1.6	One bad quarter EPS vs great boomer match
HMT	Host Marriott	10	9.4	Lease RE under, to a great franchise
LUB	Luby's	8	7.8	Debt-free; acquisiton digestion done
MLG	Musicland	4	0.0	EPS up while Web competitors folding
TEE	Nat Golf Properties	NM	8.4	Safe play on golf popularity; boomers
TOY	Toys R Us	10	0.0	Under book value; births booming
YUM	TRICON Glo Restau	7	0.0	KFC+Taco Bell+Pizza Hut at 0.3 times McDonalds' P/E
USV	U.S. Restuar Pptys	NM	14.2	Dividends keep rising but stock down 60%
VCAI	Vet Centers of Amer	11	0.0	Acquisition digestion done; consolidation in industry
OTHER				
BPL	Buckeye Partners	9	9.2	Pipeline down 10% since 9% dividend rise
ODP	Office Depot	15	0.0	Two down quarters spooked institutions
S	Sears, Roebuck	7	3.3	Selling at five times cash flow; EPS up each year since 1995
XRX	Xerox	12	0.3	Sells at 6 times cash flow; cut 70% on two down EPS qrtrs

NM – Not meaningful, because REITs are valued based on funds from operations (FFO), not earnings per share.

companies are not magical, smooth quarterly earnings per share growth machines, and paying as if they were is a mistake, as recent smashes in P&G and Motorola remind us. Analyst disappointment and impatience create bargain prices for those who are selective.

To the degree my list used price-earnings ratios as a criterion, I relied strictly on trailing 12-month earnings. These are real earnings, not the hopes of analysts all too often acting mainly as cheerleaders, and they are lower bases for the multiple. I also focused on basic and low-technology businesses, since these have higher survival and prospering prospects.

Table 1 is the result of my search to find value in the market. It is merely an example of a starting point for a conservative growth investor; obviously, considerable research must be conducted before any decision can be made. Your own differing criteria or exceptions—and certainly any mechanical screening—will unearth others of similar merit. The table includes the price-earnings ratio, dividend yield and the qualitative source of attraction for the stock. Included in my list are several (Engle, Frontier, Ingles, Casey's, U.S. Can) that are not widely followed by analysts. That can be a positive by reducing risk of overnight price collapses when earnings expectations are missed. I'd caution against owning more than one company in the narrower groupings (clothing and personal care as examples) or two in the broader "and related" clusters.

You can see from the table that there may indeed be value available in a wild market. Actually, it is really two markets: technology and the rest. History says extreme valuation dichotomies will not last. One cannot be sure what will trigger a return to favor for value-based growth stocks. My own short list of possible triggers includes recession, a market decline of some time duration, and a wild card: corporate takeovers.

A recession would hasten the demise of Internet companies that have weak business models; it would flatten corporate earnings, and compress price-earnings ratios. Investors would "get religion" and seek real current earnings, yields, and value. New bull markets are usually led from the ashes by solid values in major names.

A truly severe decline of the high flyers or a decline of several months' length (longer than in 1995–1999) would reverse the wealth effect that has accelerated consumer spending and no-worry thinking. Investors would re-think their approaches: what has recently burned us, we strongly avoid. Technology stocks, sinking IPOs, and similar leaders would be eschewed for solid names.

A third possible scenario causing a shift in leadership from high growth to value would be a new source of excitement—in particular, corporate takeovers and leveraged buyouts among downtrodden old-economy companies. Recent unsolicited tenders for Aetna and Nabisco might be first examples. Targets would, of course, be value stories, attracting much-shifted investor attention.

Some other trigger might emerge, if not one of those three. But as we've seen, even in a market widely considered to have gone mad, there are some reasonable equity bargains; conservative investors need not retreat 100% to money market funds or covertly speculate in the old game. True investors can afford to sleep well while holding stocks bought at bargain valuations. ◆