THE COMMON TRAITS OF SUCCESSFUL INVESTMENT STRATEGIES

By Maria Crawford Scott

Although there are many investment approaches, they share common traits, in particular seeking quality companies with good growth prospects that can be purchased at a reasonable price.

Over the past few years, the Stock Analysis Workshops have presented the investment approaches of well-known and successful investment professionals. These approaches run the spectrum, from those that are primarily value-based to those that focus primarily on growth, from those that focus on smaller firms to those that prefer the corporate giants.

Yet there are also many elements these approaches have in common. A look at these shared traits may give you some useful guidelines when developing your own investment approach.

Table 1 presents a summary of the approaches. [The date of the Stock Analysis Workshop that provided an in-depth discussion of the investment approach is indicated below each name; links to the articles can also be found on our Web site at www.aaii.com.]

PHILOSOPHIES & UNIVERSE

While the philosophies underlying the various approaches vary greatly, they share one obvious characteristic: They are well-articulated and define clear objectives. They do not simply state: "seek value" or "seek growth." For instance, Benjamin Graham and Geraldine Weiss are probably the closest to pure "value" investors. But their philosophies are slightly different. Benjamin Graham believes that investing in companies that are selling below their "intrinsic" value provides a margin of protection on the downside, because the risk of the stock dropping further is lower. Geraldine Weiss likes high-quality, dividend-paying companies because of their stability and the extra boost that dividends provide; buying them when they are undervalued provides added return in the form of capital gains once they become overvalued.

The philosophies that place more emphasis on value aim to buy cheap and sell dear, with the notion that investors do not always act rationally, and often assess information emotionally, creating price distortions that can be exploited. Most of the value-focused strategies favor the companies of larger firms: (Buffett, Graham, Weiss, Dreman, O'Shaughnessy Value).

The philosophies that place more emphasis on growth tend to focus on areas of the economy that are in the stage of rapid and expanding growth, with earnings momentum. Most of the growth-focused strategies tend to favor smaller-capitalization stocks (Wanger, Price, and O'Neil).

Very few of the strategies could be regarded as "pure value" or "pure growth." Instead, most use a combination—those that focus on value also seek some growth, while those that focus on growth will not pay any price.

QUANTITATIVE CRITERIA

Stock selection criteria, both qualitative and quantitative, stem from the investment philosophy.

Quantitative criteria use financial data to sort through and screen for stocks with appealing investment characteristics.

Valuations: Approaches that are concerned with value emphasize companies and industries whose share prices are low relative to share value measures

Maria Crawford Scott is editor of the AAII Journal.

TABLE 1. WELL-KNOWN INVESTMENT PROFESSIONALS: A SUMMARY OF APPROACHES In-depth discussions

Focus	Philosophy	Universe	Quantitative Criteria
Warren Buffett (Jan 1998)	Invest in "excellent" companies based on their intrinsic value, where value is measured by their ability to generate earnings and dividends over the long term.	No limitation on stock size, but analysis requires that the company has been in existence for a considerable period of time.	***Valuations:*** Attractive relative to bonds (EPS for based on 10-year price projection using estimate ***Earnings:*** Strong and consistent upward trend. ***Financial Position:*** High level of retained earning ***Performance:*** Consistently high ROE, strong ope
David Dreman (July 1997)	Psychological biases can affect investment decisions, but investors can profit from others' over- and under-reactions.	Large and medium-sized companies.	***Valuations:*** Low P/Es—(bottom 40%); P/Es below ***Earnings:*** Higher rate of earnings growth than th ***Financial Position:*** High current assets/current lia ***Profitability:*** High ROE, high pretax profit margin
Philip Fisher (Sept 1996)	Invest in outstanding companies that over the years can grow in sales and profits more than the market as a whole.	No restrictions.	***Valuations:*** Low P/E relative to expected growth. ***Financial Position:*** Sufficient capital to take care ***Profitability:*** Above average profit margins; stron
Benjamin Graham (May 1996)	Investment in companies whose share prices are below their intrinsic value, which provides a margin of "protection" that can help absorb unfavorable developments.	"Defensive": High-grade dividend-paying stocks. "Enterprising": Unpopular large companies and secondary companies. For both types: Exclude small firms.	***Valuations:*** Low P/Es; low P/Books; adjust valuat ***Earnings:*** Positive and stable earnings for the 5 y ***Dividends:*** Dividends for 20 years; "enterprising ***Financial Position:*** Current assets 1½ to 2 times current assets.
Peter Lynch (Jan 1997)	Invest in companies in which there is a well-grounded expectation concerning the firm's growth prospects, and in which stock can be purchased at reasonable price.	All listed stocks—no restrictions.	***Valuations:*** Low P/E relative to firm's growth rate to its historical average. ***Dividends:*** For dividend investors: low payout ra ***Earnings:*** Year-by-year earnings consistency and ***Financial Position:*** Low levels of debt/equity; b relative to share price. ***Wall St. Coverage:*** Low institutional ownership
William O'Neil (CANSLIM) (July 1996)	Invest in companies whose stock prices are poised to rise due to favorable fundamental factors within the firm and industry, as well as favorable technical factors.	No restrictions, but stocks of smaller firms are favored.	***Earnings:*** High and accelerating quarterly earnin ***Technical Indicators:*** Share price reaching new h shares outstanding. ***Financial Position:*** Low amount of long-term deb ***Wall St. Coverage:*** Some, but not excessive, ins
James O'Shaughnessy (Nov 1997)	There is no single strategy that always works best, but any strategy must be disciplined and use rules proven successful (risk-adjusted) over long time periods.	For value-based strategies: Large market-capitalization companies. For growth-based strategies: All stocks greater than $150 million (adjusted for inflation).	***Value Approach:*** Market leaders; above average higher-than-average cash flows per share; high c ***Growth Approach:*** Market capitalization of $150 growth for five years; low P/S; high relative price

based on factors such as earnings, dividends, and assets.

Among these investment professionals, the price-earnings ratio (current price divided by earnings per share for the most recent 12 months) is the most widely used valuation measure.

Price-earnings ratios are usually used in a variety of ways: Stocks are sought with low absolute P/Es, low P/Es relative to the market or industry, and low P/Es relative to a firm's historical average. Among the professionals who also emphasize growth, PEG ratios (P/E divided by EPS growth, with ratios lower than 1.0 indicating value) are used, since they relate P/Es to growth rates, allowing firms that are rapidly growing higher price-earnings ratios.

Geraldine Weiss and James O'Shaughnessy's value approach favor dividend yields as a valuation s appeared in the *AAII Journal* issue indicated below each name.

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the year ÷ the long-term gov't bond rate). Attractive ed earnings growth and sustainable growth models. gs; low level of spending to maintain operations. erating and profit margins.	Buy consumer monopolies. Buy businesses easy to understand and analyze. Buy quality management.	Hold for long term. Sell if company no longer retains features that made it attractive.
w S&P 500. Also: high dividend yields. he S&P 500 recently and projected. abilities; low debt/equity; low payout ratios. ns.	To assess earnings growth, make sure to understand a company's main line of business, its components, and which components add the most to earnings.	Hold for long term; sell when P/Es approach overall market's P/E, unless solely due to an earnings decline. Use a 2-year rule if stock is not moving.
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tions to interest rates. yrs ("enterprising") and 10 yrs ("defensive"). " investors, some current dividend. current liabilities, LT debt less than 110%	Skeptical of subjective judgments—good management indicated by a good long-term track record.	Buy and hold for the long term. Sell if issues rise "excessively" above their intrinsic value and can be replaced by issues much more reasonably priced.
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gs; high and consistent annual earnings growth. highs, high relative price strength. Limited number of bt/equity. titutional ownership.	Look for firms with new products or services, or with new managements offering innovation. Also look for firms that are in growing industries, and focus on the top few. The general direction of the market should be positive.	Monitor stocks quarterly. Sell worst-performing stocks and let the better performers "run." Sell if a stock's price drops 8% below the purchase price; take gains when a stock has a 20% gain, unless outlook is particularly favorable.
common shares outstanding; above average sales; dividend yields. million or greater; consistent year-to-year earnings e strength.	——	Do not trade frequently. Sell stocks that no longer meet the criteria.

measure because of problems they see with the use of earnings to measure value. The dividend yield relates dividends per share to share price. Dividend payments, in contrast to earnings, tend to be more predictable and not subject to differing accounting interpretations, and are therefore a more stable measure to relate to share price. Prices, on the other hand, go to extremes, causing dividend yields to fluctuate. Of course, a dividend yield approach requires that dividends be paid, which tends to limit the investment universe to larger firms.

Weiss does use price-earnings ratios as a secondary measure of value, and in fact many of the approaches use several different valuation measures as a double-check.

Earnings and Dividends: Consistent year-to-year growth is the most

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Focus	Philosophy	Universe	Quantitative Criteria
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Ralph Wanger (May 1997)	Invest in companies that show evidence of growth potential, financial strength, and fundamental value.	Smaller-capitalization companies that are seasoned; no start-ups or initial public offerings.	***Valuations:*** Share price low relative to growth p (depending on the type of company). Also price value is not a useful measure. ***Financial Position:*** Low debt relative to its indus practices. ***Wall St. Coverage:*** Low institutional ownership.
Geraldine Weiss (Nov 1996)	Invest in high-quality, dividend-paying companies when they are undervalued.	High-quality stocks: DPS and EPS increases five of last 12 years; large no. shares outstanding, large instit'l ownership; no div interruptions past 25 years; S&P quality no lower than A–.	***Valuations:*** Buy when dividend yields are withir historically low P/Es and P/Book close to 1.0. ***Dividends and Earnings:*** Consistent earnings an ***Financial Position:*** Current assets/current liabiliti ***Dividend Protection:*** Be wary of payout ratios ap

common requirement for earnings and dividends among all of the investment professionals. Even the value-focused professionals do not find firms attractive if they are undervalued but have no ability to grow and prosper in the future.

Financial Position: Almost every investment professional requires a strong financial position, which enables a company to work through any periods of operating difficulty.

A common requirement is current assets twice current liabilities, and low debt-equity ratios (short-term and long-term debt divided by shareholder's equity, which indicates how much of the company has been financed by debt rather than equity).

Several approaches also require sufficient capital to cover current operating needs. And not surprisingly, approaches that are concerned with dividends require low payout ratios (dividends per share divided by earnings per share, indicating the amount of earnings that is paid out in the form of dividends).

Performance: Another common feature among the investment professionals concerns performance measures—how well the company is using its assets to generate revenues and earnings.

High returns on equity are required under several approaches. Return on equity (net income after all expenses and taxes divided by stockholder's equity) is an indication of how well the firm used reinvested earnings to generate additional earnings.

High profit margins and consistent sales growth are also required by a number of the professionals. Profit margin is net income divided by revenue, and measures the ability of a firm to generate earnings from revenue. Comparing profit margin to that of an industry average provides an indication of the competitive advantage a firm has against its peers. Favorable profit margins and increasing sales are an indication that a firm has found some kind of market niche or monopoly that it can exploit, a common theme among the growth-focused professionals.

Technical Indicators: Technical indicators are not popular among the value-focused approaches, but are used by two of the growth-focused approaches (James O'Shaughnessy's growth approach and William O'Neil). The technical indicators used are those that focus on price momentum, particularly relative strength. Relative strength measures the price performance of a stock relative to the price performance of the overall market; high relative strength indicates that the price is moving up more quickly than the market as a whole.

Wall Street Coverage: Among the investment professionals, there are two camps concerning Wall Street coverage: Those that favor institutional ownership for liquidity (Geraldine Weiss) and those that favor little institutional ownership and low analyst coverage for stocks because they are more likely to be undiscovered, and therefore possibly underpriced (Peter Lynch, Ralph Wanger). William O'Neil has a foot in both camps—he favors some institutional ownership for liquidity purposes, but prefers companies with a smaller number of shares outstanding in order to put demand pressure on the share price.

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erage. easing at peak of each succeeding business cycle. ined earnings; availability of additional financing. rgins.	Management owns substantial interest and plans intelligently. The company is in a growing industry; little gov't interference & absence of cut-throat competition. Good labor relations; total payroll not large relative to revenues.	Invest for the long term. Sell when company no longer fits definition of a growth company; trim when stocks reach excessively high relative price-earnings ratios.
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n 10% of their historical highs. Secondary valuations: nd dividend growth. es of at least 2; debt/equity less than 50%. pproaching 100%.	Examine product performance, research and development efforts, and ability to market products or services.	Sell stocks when they are within 10% of their historically low dividend yield, indicating overvaluation.

thing about a firm, and most of the investment professionals also rely on subjective judgments—qualitative criteria. (The exceptions—Benjamin Graham and James O'Shaughnessy).

A basic understanding of the individual company—its main product or service and market potential, its marketing efforts and ability to expand the business—is a common theme. For that reason, several of the investment professionals prefer to focus on companies and industries that are easier to understand.

Finding companies that operate in market niches, with little or no competition, is also mentioned by many of the investment professionals, both growth- and value-oriented.

Many of the growth-focused professionals tend to use some top-down analyses—identifying themes or economic sectors that are likely to expand in the future (Wanger, O'Neil, Price), and selecting firms that would likely benefit from these expansions.

WHEN TO SELL

The common trait among the investment professionals concerning when to sell is that a stock should be sold if it no longer meets the selection criteria, whether that is because the stock did what was expected or whether it is because there has been a fundamental change in outlook for the stock.

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Here's a summary of the common elements, which you can use to help develop your own stock-picking strategy:

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- Make sure you understand the firm you are investing in—its business and what drives its earnings and revenues, the market in which it is operating, and its prospects.
- Seek stocks with reasonable value: low price-earnings, price-to-sales, price-to-book, high yield if you are value-focused; low price-earnings relative to growth if you are growth-focused
- Seek stocks with consistent growth—that is, consistent growth in earnings, dividend, and sales.
- Invest in firms with strong financial positions: current assets twice current liabilities and low debt-equity ratios.
- Try to find firms that operate in a unique niche, with little competitive pressure.
- Small-capitalization stocks offer growth potential and may be overlooked—and undervalued—by Wall Street.
- Value investing is well-suited for reasonably sound, larger-capitalization stocks.
- Growth investing should be tempered with some value investing rules.
- Adopt a long-term outlook, ignore market "predictions," and concentrate on the fundamental condition of a firm rather than short-term temporary developments. ✦

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STOCK ANALYSIS WORKSHOP

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