

Value Investing Using the Fundamental Rule of Thumb

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Investing is all about trade-offs.

One of the trade-offs in investing is risk versus reward. Ideally, you are rewarded for incurring additional risk with higher returns. Another trade-off involves income versus growth. Typically, seeking stocks with high levels of current income means forgoing some growth potential.

The Fundamental Rule of Thumb screen, which combines earnings yield, dividend yield, and the ratio of earnings retained to book value, takes full advantage of the concept of trade-offs. Individually, all of these value factors are well-known and oft-used by value investors. By combining them, you can calculate a trade-off score that may help uncover stocks meriting further analysis.

The rationale for a screen that combines earnings yield, earnings retention, and dividend yield is simple: Every value investor should seek growth and dividends at a bargain price. Of course, growth and dividends in one company are often contradictory, and therefore trade-offs are necessary. Exceptional growth can offset a low or non-existent dividend yield and can be worthy of further analysis if the stock is attractively priced. On the other hand, a high dividend yield and a low price relative to earnings can compensate for lower growth.

A screen that follows the Fundamental Rule of Thumb approach is built into *Stock Investor Pro*, AAI's fundamental stock screening program and research database. The screening criteria used in the program are detailed in the box on page 6.

Evaluating the Screen

The companies passing the screen, along with a simple hypothetical portfolio, have been reported and tracked on



AAII.com for 11½ years (see Figure 1). The screen lagged the market in 1998 and 1999, a period in which the market favored growth strategies over value approaches. It also participated in the general market collapse in 2008, from which few long-only equity strategies escaped. In between, its performance has been strong on both an absolute and relative basis.

Year-to-date, the Fundamental Rule of Thumb approach is up 60.2%. Overall, the cumulative gain for the screen is 613.9%, compared to a 1.8% gain for the S&P 500.

Earnings Yield

The primary components of the screen are earnings yield, earnings retained to book value, and dividend yield. Earnings yield is simply earnings per share divided by share price.

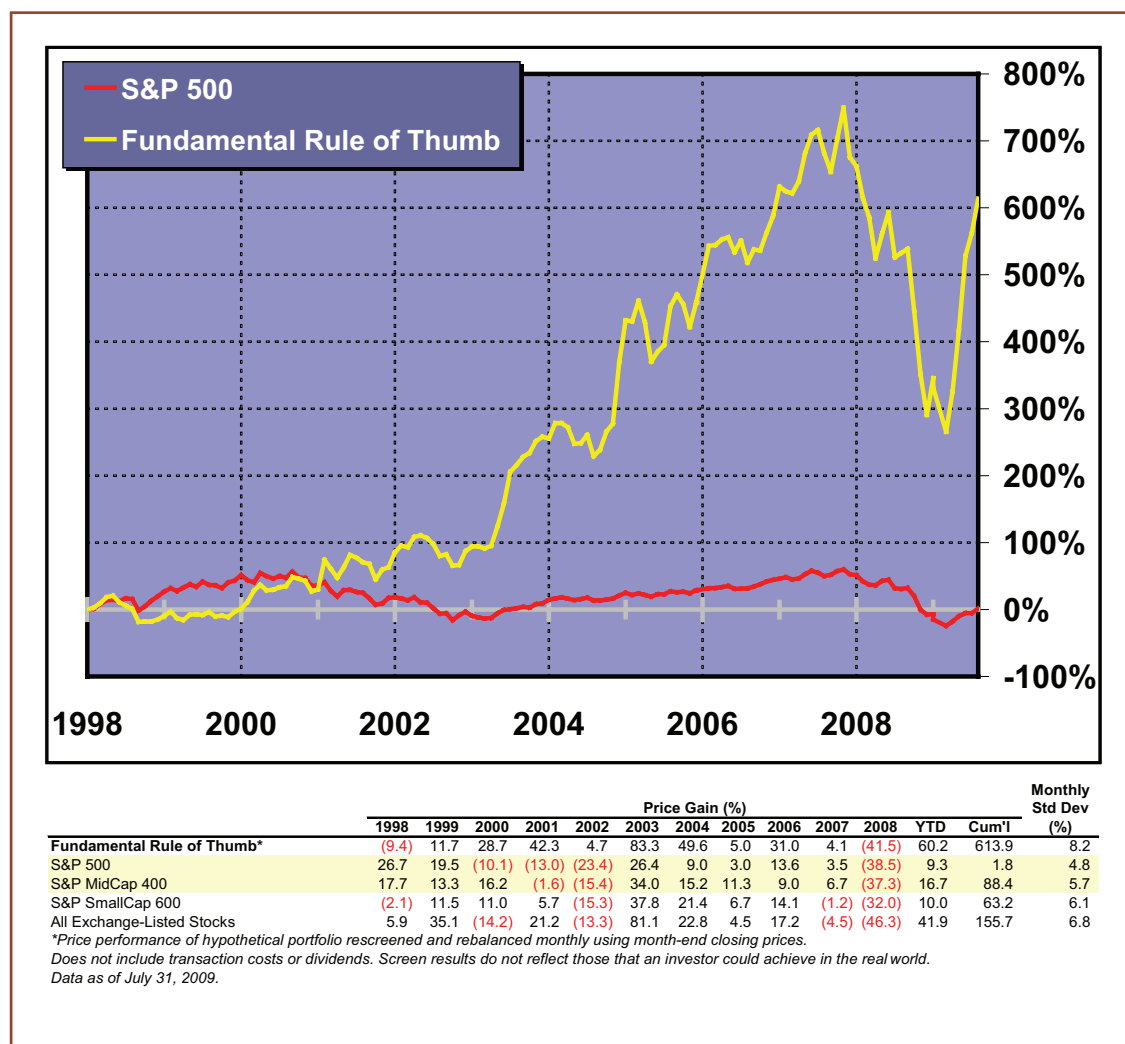
The earnings yield relates the generation of earnings to the stock price. A high earnings yield is desirable. Earnings per share and price are also the components of the price-earnings ratio (price per share divided by earnings per share); it is the reciprocal of the earnings yield.

In this form, it is apparent that a relatively high earnings yield is equivalent to a relatively low price-earnings ratio. Numerically, for example, if the earnings yield for a stock is 5%, its price-earnings ratio would be 20 ($1 \div 0.05$)—in other words, the price is 20 times earnings per share. The lower the earnings yield, the higher the equivalent price-earnings ratio.

The market tends to be forward-looking in its analysis. If it expects high future growth in earnings for a given stock with great certainty, it may be willing to accept a lower earnings yield (higher price-earnings ratio) today for that stock.

The characteristics of the 50 stocks passing the Fundamental Rule of Thumb screen are presented in Table 1, while Table 2 lists the top 25 companies currently meeting

Figure 1. Performance of the Fundamental Rule of Thumb Screen



book value measures change or growth in book value, but it is better thought of as an adjusted return on equity, or sustainable growth rate. The more commonly used return on equity figure is the ratio of earnings per share to book value. If no dividend is paid, return on equity equals earnings retained to book value. Sabine Royalty Trust (SBR) is an express trust with assets consisting primarily of the Royalty Properties, which has interests in production of oil, gas, and other minerals. The company passed the screen with a 1,164.3% ratio of earnings retained to book value. Sabine earned \$5.55 per share over the last four quarters, has an indicated annual dividend payout of

the criteria, as ranked by their rule of thumb score.

Georgia Power Company (GPW) has an earnings yield of 360.9%, which translates into a price-earnings ratio of 0.28 ($1 \div 3.609$)—an unusually low number that often points to a data anomaly. As it turns out, Georgia Power has a relatively low number of shares outstanding. For the latest quarter (ending March 31, 2009), the company averaged 9.3 million shares outstanding, placing it in the bottom 20% of the stock universe. As a result, the company's \$849.1 million in net income for the last 12 months translates into *per share* earnings of \$91.69 over the trailing 12 months.

The median price-earnings ratio of the Rule of Thumb stocks is less than one-fifth of the market level—3.1 vs. 16.7.

Earnings and Value

The second component of the Fundamental Rule of Thumb screen is the ratio of earnings retained to book value. Earnings retained are simply annual earnings after the annual dividends have been paid to preferred and common shareholders. Earnings retained are reinvested by the firm and determine the growth in book value.

Book value consists of all of the assets of the firm, less all debt and other obligations. When divided by the number of outstanding common shares, the figure becomes book value per share. The “book” in book value is an accounting determination rather than a market valuation. Book value is often termed equity, shareholder's equity or net worth.

The ratio of earnings retained to

\$2.29 per share and a book value per share of \$0.28. These figures lead to a stratospheric 1,164.3% ratio [$(\$5.55 - \$2.29) \div \$0.28$]. Such a high value is reason to perform additional analysis of the underlying numbers.

As we found out, the structure of the company leads to this “inflated” number. The “dividends” Sabine pays are monthly income distributions to unit (share) holders. These distributions are, in general, the excess of revenues from the trust properties over the expenses and payments of liabilities of the trust. Therefore, the company distributes excess income to unit holders, preventing it from retaining earnings in order to grow book value. For the quarter ended March 31, 2009, the company had total assets of \$5.4 million, which consisted

Table 1. Fundamental Rule of Thumb Screen Portfolio Characteristics

Portfolio Characteristics (Median)	Fundamental Rule of Thumb Stocks	Exchange-Listed Stocks
Price-earnings ratio (X)	3.1	16.7
Price-to-book-value ratio (X)	1.0	1.4
EPS 5-yr. historical growth rate (%)	23.3	2.1
EPS 3-5 yr. estimated growth rate (%)	14.6	12.0
Total liabilities to total assets (%)	41.7	53.3
Market cap. (\$ million)	141.6	326.6
Relative strength vs. S&P (S&P=0) (%)	(6)	(2)
Monthly Observations		
Average no. of passing stocks	50	
Highest no. of passing stocks	53	
Lowest no. of passing stocks	49	
Monthly turnover (%)	21.8	

Data as of August 7, 2009.

primarily of cash.

Also, in the case of Sabine, using the indicated dividend does not provide an accurate picture of the company's expected distributions for the year. For most firms, dividends are fairly constant from quarter to quarter. However, Sabine's distributions are driven by the income generated by Royal Properties. Therefore, the indicated annual dividend of \$2.29 per share could deviate significantly from what the company ultimately pays out. Over the last five years, Sabine has, on average, distributed over 99% of its income.

The ratio of earnings less dividends to book value is the most intricate and difficult to interpret, primarily because of the book value figure and the many factors that can impact earnings. Further

complicating matters are companies such as Sabine Royalty Trust. It is for this reason that the Rule of Thumb screen excludes REITs and closed-end funds. However, as we have shown, these filters still do not eliminate all special situations.

Dividend Yield

The third fundamental value ratio is the dividend yield, which relates the annual cash dividend on the common stock to the current market price of the common stock.

While the Fundamental Rule of Thumb screen seeks high dividend yields, it is important to remember the trade-off between the dividend yield and future growth rate. The more dividends that are paid, the higher the dividend yield but the less the company has in

cash to build for future growth.

Sabine Royalty Trust has a dividend yield of 6.0% based upon an indicated dividend of \$2.29 per share and recent price of \$38.19. However, as we said earlier, the dividend yield will likely fluctuate from quarter to quarter not only from the change in stock price, but because the company's dividend or distribution is tied directly to its quarterly income.

FreeSeas Inc. (FREE), an international dry bulk shipper based in Greece, has the highest dividend yield at 17.1%. This is based on its indicated annual dividend of \$0.30 provided by Thomson Reuters. However, the company suspended its dividend at the end of March 2009 to focus on debt reduction.

As these two instances show, it is important to do follow-up analysis of companies passing quantitative screens such as this. When focusing on dividend yield, it is a good idea to confirm the safety (or existence in the case of FreeSeas) of the dividend payment. Most companies do not start paying a cash dividend unless they are confident of their ability to continue to do so in the future. However, as the last year or so has shown us, economic conditions may sometimes cause companies to suspend their dividend payments. Also, when analyzing a company's dividend history, a longer track record is a desirable feature.

Fundamental Score

The Rule of Thumb screen totals earnings yield, earnings retained to book value, and dividend yield and looks for companies with a high value. The three

What It Takes: Fundamental Rule of Thumb Criteria

- Exclude companies that trade on the over-the-counter (OTC) market;
- Exclude companies that trade as American depositary receipts (ADRs);
- Exclude REITs and closed-end funds;
- The ratio of total liabilities to total assets must be below the industry median;
- Only those companies with the 50 highest Fundamental Rule of Thumb scores are included in the final results

The Fundamental Rule of Thumb score is calculated as:

$$\text{Earnings Yield 12m} + \text{Earnings Retained to Book Value} + \text{Dividend Yield}$$

Table 2. Companies Passing the Fundamental Rule of Thumb Screen

Company (Exchange: Ticker)	Earnings Yield (12 Mos) (%)	Earnings Retained to Book Value (%)	Div Yield (%)	Fund'l Rule of Thumb Score (%)	Total Liab to Total Assets (%)	Mkt Cap (\$ Mil)	Description
Sabine Royalty Trust (N: SBR)	14.5	1,164.3	6.0	1,184.8	22.2	556.8	oil & gas royalty trust
i2 Technologies (M: ITWO)	27.8	433.7	0.0	461.5	42.2	315.7	supply chain mgmt
Georgia Power Co. (N: GPW)	360.9	11.8	5.7	378.4	67.9	235.2	electric utility
New Concept Energy (A: GBR)	118.2	75.8	0.0	194.0	15.6	13.1	oil & gas wells
Insmed Inc. (M: INSM)	88.8	91.6	0.0	180.4	10.3	121.8	biopharmaceuticals
OceanFreight Inc. (M: OCNF)	143.2	15.5	0.0	158.7	58.9	125.6	shipping transport
BreitBurn Engy Ptnrs (M: BBEP)	108.9	37.9	0.0	146.9	37.3	460.7	oil & gas partnership
Mirant Corp. (N: MIR)	88.7	52.0	0.0	140.7	62.7	2,534.9	electric utility
Transcept Pharm (M: TSPT)	74.0	65.1	0.0	139.1	6.3	106.0	pharmaceuticals
Linn Energy, LLC (M: LINE)	64.4	54.6	11.1	130.1	42.0	2,742.2	oil & gas properties
Pre-Paid Legal Services (N: PPD)	11.7	116.7	0.0	128.4	69.6	511.9	legal expense plans
Chyron Corp. (M: CHYR)	73.3	53.8	0.0	127.1	21.7	21.2	graphics software
EV Energy Ptnrs (M: EVEP)	70.2	39.9	14.2	124.3	50.7	277.6	oil & gas properties
Innophos Holdings (M: IPHS)	46.3	60.3	3.7	110.3	55.3	392.6	specialty phosphates
VocalTec Commun's (M: VOCL)	55.8	45.3	0.0	101.1	40.4	8.3	Internet communications
TOP Ships Inc. (M: TOPS)	85.2	15.1	0.0	100.3	60.4	57.2	sea transport servs
FreeSeas Inc. (M: FREE)	65.7	14.2	17.1	97.0	57.1	37.0	dry bulk shipping
Star Bulk Carriers (M: SBLK)	68.3	22.4	5.8	96.5	34.3	202.7	dry bulk shipping
Great Northern Iron Ore (N: GNI)	14.6	71.7	7.9	94.3	27.2	137.5	mineral royalty trust
K-V Pharmaceutical Co. (N: KV.A)	72.6	17.5	0.0	90.0	46.7	112.9	pharmaceuticals
Paragon Shipping Inc. (M: PRGN)	59.3	20.5	4.4	84.2	56.2	122.3	shipping transport
Encore Energy Ptnrs (N: ENP)	35.4	34.8	13.5	83.7	42.7	693.0	oil & gas properties
Safeguard Scientifics (N: SFE)	43.6	38.7	0.0	82.3	27.7	229.4	corporate financing
OSI Pharmaceuticals (M: OSIP)	20.1	61.4	0.0	81.5	42.5	1,906.4	biotechnology
IEC Electronics Corp. (A: IEC)	20.7	58.2	0.0	78.9	43.7	54.2	electronic mfr servs

*Exchange Key: A = American Stock Exchange; M = NASDAQ; N = New York Stock Exchange.
Source: AAIL's Stock Investor Pro/Thomson Reuters. Data as of August 7, 2009.*

ratios are highly interrelated. A firm with an earnings yield of 5% that pays no dividend would need a ratio of earnings retained to book value of at least 20% to qualify with the desired score of 25%.

The 50 companies with the highest Fundamental Rule of Thumb score are tracked and presented on AAIL.com; the top 25 are displayed in Table 2.

As indicated in Table 2, FreeSeas passed the screen with a 97.0% Fundamental Rule of Thumb score. However, we know that the company has suspended its dividend payments, thereby changing the indicated dividend to zero. This would result in a higher earnings retained to book value (19.2% versus

14.2%), a lower dividend yield (0.0% versus 17.1%), and an overall score of 84.9% versus 97.0%.

If we were to assume that Sabine Royalty Trust was able to hold its 99.2% average payout ratio from the past five years, its numbers would look quite different as well. Given its current earnings of \$5.55 per share, its annual dividend (distribution) would be \$5.51 ($\5.55×0.992). This would result in a higher dividend yield (14.4% versus 6.0%). However, the greater impact would be on Sabine's earnings retained to book value, which would plummet from 1,164.3% to 14.3%. It would not have made the list of the top 50 companies.

Conclusion

The Fundamental Rule of Thumb screen has performed well, but it tends to uncover troubled and neglected small- to mid-sized companies that require careful, in-depth analysis. The results of any screen represent a starting point in the stock selection process, but screens that highlight deep-discount stocks require extra diligence to build profitable portfolios. Investors should steer clear of these stocks unless they fully understand the accounting, legal and industry factors impacting these companies. Of course, it is neglect that can lead to mispriced stocks and buying opportunities. ▲

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