Shadow stocks and low P/E screens: How we did it

By John Markese

Pouring over thousands of stock reports, looking at key financial variables and reading investment newsletters as well as recommendations by analysts are all activities pointed toward the goal of reducing the universe of common stocks to a manageable group for indepth analysis and potential investment. If you don't stand back initially and construct some guidelines for screening common stocks, the task can be, at best, arduous.

This issue of the *Journal* marks the beginning of a new series on common stock selection techniques. Our goal is to provide a framework for screening common stocks based upon findings from academic research and past investor success. While techniques that have proven useful in the past do not necessarily guarantee future value, understanding them serves as a practical springboard to developing new effective approaches.

One of the broad areas of research that could be of practical help to the individual investor is stocks not widely followed by analysts, and thus glossed over by the major institutions. The individual investor has a comparative advantage in security analysis when evaluating these kinds of stocks. The stock categories that have not been of interest to analysts have been termed at various times as small stocks, neglected stocks and out-of-favor stocks. Our term is "shadow stocks", the name coined by AAII president James Cloonan.

In developing these screens, we looked at pertinent firm data that would be available to individual investors. The ready availability of home computers and the array of financial software and databases has greatly reduced the individual investor's required time commitment for screening stocks. The American Association of Individual Investor's research staff used Standard and Poor's Stockpak II System to perform screening routines on the information for 4,600 firms available on the Stockpak II monthly database. The primary screens used were firm size, industry classification, and recent earnings per share figures.

The size screen was employed as a primary screen in response to the large body of research that indicates that small stocks, after adjusting for risk differences, have outperformed large stocks over recent decades. Size was measured by equity capitalization—the number of common stock shares outstanding times the market price per share. The value of the screen was set at greater than $20 million but less than $100 million. Stocks with equity capitalization much below $20 million would have relatively thin stock trading and large transactions would move the stock price, a potential liquidity problem that should be avoided. In addition, requiring a $20 million minimum size generally avoids new issues and firms without an established record. This range still includes some of the smaller stocks listed on the New York Stock Exchange and the American Stock Exchange, but the stocks that predominately passed the screen are traded over-the-counter.

The earnings per share screen required positive earnings in the last two fiscal years. This screen is simple and tends to eliminate firms in distress that are potential turn-around situations. These firms require particular expertise usually not possesed by the individual investor. Finally, only industrial firms were included; financial firms were excluded. Financials, particularly banks and investment companies, have unique financial data reporting and require special analysis.

Having screened the universe of 4,600 stocks down to about 1,000 stocks, two additional screens were ap-

Continued on page 37

Continued from page 33
plied. One was a screen for low institutional interest, and the other a screen for low coverage by financial advisory services. The latter screen is somewhat subjective. The screen for institutional interest is the number of institutions holding the stock, a statistic available in Standard and Poor's monthly stock guide. These latter two screens were done by hand.

These primary screens yielded the "Shadow 440." They are listed in the table on pages 34 and 35.

Having identified the shadow stock investment sample, selection variables that have some research evidence as a foundation will be applied and reported in this issue and in future issues of the *Journal.*

The selection variable applied to the Shadow Stocks this issue is low price-earnings ratio. Market folklore and research studies have pointed to low price-earnings stocks as superior performers. Whether the low price-earnings ratio should be interpreted as a contrarian indicator of value, a second level screen for general investment community neglect and lack of institutional interest, an out-of-favor stock, or any or all of these, has not been resolved.

The 50 shadow stocks with the lowest price-earnings ratio are presented and listed in ascending order by price-earnings value (see table, opposite). The price-earnings ratio is calculated by dividing the month-end price—October in this instance—by the earnings per share for the latest 12 months. The price-earnings value was constrained as greater than zero, eliminating firms with recent negative earnings per share.

The low price-earnings ratio screen was also applied to non-shadow stocks and the results are reported for comparison purposes. Since the non-shadow stocks have been screened only on price-earnings ratio, the list may include bankrupt or near-bankrupt firms.

In future issues, other secondary screens will be explained and applied to the shadow stocks. Future screens will include debt-to-equity ratios, price-to-book-value ratios and five-year earnings per share growth rates. Finally, shadow stocks that meet two or more screens will be reported.

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