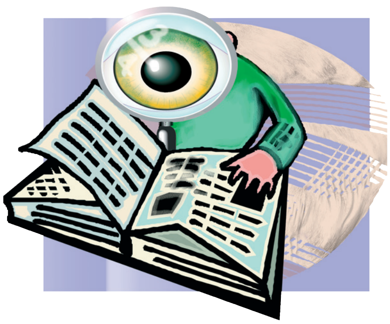
How I Find Lower Risk/Higher Reward Stocks

by Charles Rotblut, CFA

Article Highlights

- Four key attributes are an attractive valuation, good financials, a strong business model and diversification.
- The risk-reward ratio measures the probability that a stock will fall in price ("risk") versus the likelihood that it will rise in price ("reward").
- This screen scores stocks based on several criteria, rather than seeking precise characteristics.



There are four key attributes I look for in a stock: an attractive valuation, good financials, a strong business model and the ability to add diversification to my portfolio.

These traits are based on some of the great investment literature that has been written over the past 100 years. For example, Benjamin Graham and David Dodd emphasized the importance of book value in "Security Analysis" (1934). Philip Fisher stressed the importance of a good business model in "Common Stocks and Uncommon Profits" (1958). And Harry Markowitz revolutionized portfolio management by showing that diversification can increase returns and lower risk at the same time.

When you combine attractive valuations, strong financials, a good business model and the ability to add diversification, the result is a good risk-reward ratio for a stock.

What is the risk-reward ratio? It is a measure of the probability a stock will decrease in price ("risk") versus the probability that a stock will increase in price ("reward"). The lower the amount of risk and the greater the potential for reward, the higher the probability that the stock will turn into a profitable investment.

To measure a stock's risk-reward ratio, I developed a scorecard for my new book, "Better Good Than Lucky" (W&A Publishing and Traders Press Inc., 2010), based on these four key attributes. Since investing is messy as opposed to an exact science, I assigned a range of scores for each criterion instead of requiring that a stock meet specific characteristics. It is extremely difficult to find the perfect stock, but there are many stocks that are capable of helping you build wealth. Therefore, the goal is to find stocks whose potential rewards outweigh their potential risks.

The Criteria

Valuation

Price-to-Book Ratio (P/B): The current stock's price divided by book value per share, this ratio shows how many times net asset value a stock is trading at. I prefer a low price-to-book ratio because a well-managed company should not trade at a price near or less than its theoretical liquidation value, or book value. Several studies, as well as data from Ibbotson Associates, show that stocks with low price-to-book ratios outperform stocks with high price-to-book ratios. (Book value, total assets minus total liabilities, is also referred to as equity or shareholder's equity.)

Price-Earnings Ratio (P/E): The current stock price divided by earnings per share, this is a measure of how many times trailing 12-month (TTM) earnings a stock is trading at. A high price-earnings ratio can signal that many investors are optimistic about the future, increasing downside risk. (In other words, expectations are too great.) Conversely, a low price-earnings ratio can signal that investors are pessimistic or apathetic, increasing the potential reward should the company announce good news.

Strong Financials

Cash From Operating Activities: Located on the cash flow statement, this is a running scorecard of how much money is coming into and going out of the company based

Table 1. The Risk-Reward Scorecard

What is the price-to-book ratio?

Answer	Score
Below 2.0	1
Between 2.0 and 3.0	2
Between 3.0 and 4.0	4
Above 4.0	5

What is the price-earnings ratio?

Answer	Score
Below 12.0	1
Between 12.0 and 20.0	2
Between 20.0 and 25.0	4
Over 25.0	5

Is cash from operating activities positive?

Answer	Score
Yes for the last five years	1
Yes for at least three of the last five years (including the last reported fiscal year)	2
No for at least three of the last five years (including the last reported fiscal year)	4
No for most of the last five years	5

Are revenues, net income and earnings increasing?

Answer	Score
Yes for the last five years	1
Yes for at least three of last five years (including the last reported fiscal year)	2
No for at least three of the last five years (including the last reported fiscal year)	4
No for most of the last five years	5

What is the company's current ratio?

Answer	Score
Above 1.0, but below 2.0	1
Above 2.0	3
Below 1.0	5

What is the company's debt-to-equity ratio?

Answer	Score
0.5 or lower	1
0.5 to 0.75	3
0.75 to 1.0	4
1.0 or higher	5

How does the company's return on equity compare to its peers?

Answer	Score
Better than its peers	1
About the same as its peers	3
Worse than its peers	5

Have earnings estimates risen or fallen over the last 30 and 60 days?

Answer	Score
Earnings estimates for this year and the next year have risen	1
Earnings estimates for this year and the next year are basically unchanged	3
Earnings estimates for this year and the next year have fallen	5

Does the company sell products that fulfill needs, is it profitable and does it operate in a market with barriers to entry?

Answer	Score
Yes	1
Yes to two of the three characteristics	3
No	5

Does the stock add to your portfolio's diversification?

Answer	Score
Yes	1
No	5

Source: "Better Good than Lucky: How Savvy Investors Create Wealth With the Risk-Reward Ratio," by Charles Rotblut, CFA (W&A Publishing and Trader's Press, 2010).

on business operations. (Long-term debt, dividends, stock buybacks and capital expenditures are accounted for elsewhere on the cash flow statement.) Cash flow is useful because there is a difference between earnings and cash. Earnings are an accounting figure, whereas cash flow shows how much a company spends and how much it brings in. A successful business generates cash, instead of burning through it.

Revenues, Net Income and Earnings per Share: A well-run business will have a history of sales and earnings growth. I look at both net income and earnings per share, because share repurchase programs can artificially inflate per share earnings growth.

Current Ratio: Current assets divided by current liabilities (both of which are located on the balance sheet), this is a measure of how liquid a company is. The current ratio calculates a company's ability to meet its current obligations. Companies should have adequate cash levels on their balance sheets, and this can be signaled by a current ratio in excess of 1.0.

Debt-to-Equity Ratio: Long-term liabilities divided by total shareholder's equity, this ratio reveals a company's leverage. The larger the number, the greater the claim debt holders can place on assets, among other risks. I prefer this ratio to be no larger than 0.5, though capital-intensive companies may have higher ratios.

Business Model

Return on Equity (ROE): Net income divided by equity, this is the return management is generating from shareholder's equity—a proxy for how well a company is run. Since return on equity is impacted by both a company's capital structure and its profit margins, it should be considered within the confines of an industry rather than across industries and sectors. I prefer companies whose return on equity is above that of their industry peers.

Earnings Estimates: Rising profit forecasts suggest business is going better than brokerage analysts previously thought. Conversely, falling earnings estimates suggest the company may be facing a slowdown or other difficulties.

Product Line, Profit and Competition: A good business model will produce products and services that fulfill needs, generate profits and operate in a market with barriers to entry. In other words, you want a company that caters to its customers' ongoing needs and does not face intense competition.

Diversification

Portfolio Overlap: Does the stock add to your portfolio's diversification? If the answer is no, the stock increases your personal risk level regardless of how strong the other characteristics are.

Scoring Stocks

A stock can have a score between 10 (very good) and 50 (very bad). Most stocks will fall somewhere between these two scores. I tend to favor stocks whose scores are in the teens, though in my book I give readers the leeway of going up to scores of 25. The scorecard is detailed in Table 1.

Companies that do not report data for any of the criteria are excluded from the screen. An investor wishing to look at stocks that are not tracked by analysts should eliminate the earnings estimate criterion from the screen and adjust the scoring system to a range of 9-45, instead of 10-50.

Implementing the Screen

Stock screens are merely filters designed to find stocks that match certain criteria. A screen does not tell whether a stock is good or bad, just that it meets the requirements specified by its creator. To get around this problem, I enlisted the help of AAII President John Bajkowski to create a screen that would evaluate stocks on each criterion and then limit the results to only those stocks with risk-reward scores below a certain level. I personally use a maximum score of 12.0.

Revenues and earnings per share are assigned half point scores in the screen since I suggest looking at them together when analyzing a stock. (This is a change from the First Cut column John wrote in the July *AAII Journal*, which screened for stocks based on earnings per share, but not revenues as well.) A company with a consistent rise in sales and earnings will be assigned a value of 1.0, whereas inconsistent growth in either line item can result in a fractional score, such as 2.5. I review the income statement manually before buying a stock to factor in the change in net income.

There are two criteria that cannot be screened for: one is product line, profit and competition; the other is portfolio overlap. Both of these require qualitative analysis that must be conducted outside the confines of the screen. Thus, the minimum score the screen will give a stock is 8.0, not 10.0. (Portfolio overlap can be limited by excluding specific industries from the screening results. Since many companies operate in multiple industries, additional analysis is still required.)

This may seem like an extra step, but stock screens are merely a method to reduce research time, not eliminate it. Since a screen does not show whether risks outside of the specified criteria exist, you should always do further research before buying a stock identified by my or any other screen.

The Results

The screen was applied using AAII's *Stock Investor Pro*, a fundamental stock screening and research database program, with data as of November 5, 2010. The results are displayed in Table 2. Due to space limitations, the table shows only those companies with a risk-reward score of 10.0 or lower, excluding the two omitted criteria. I also required that each company's return on equity be above its industry's average (using figures based on earnings for the trailing 12 months and equity for the most recently reported quarter). This is a second change from John's July First Cut column and helps restrict the list of passing companies to those that have consistently generated an above-average

Table 2. Companies Passing the Risk-Reward Screen*

Company (Ticker)	Risk-Reward Score	P/B Ratio (X)	P/E Ratio (X)	5-Yr Growth Sales (%)	5-Yr Growth EPS (%)	Curr Ratio (X)	Debt-to-Eq Ratio (X)	Ret on Equity (%)	Erngs Est Rev (%)	Description
Raytheon Co. (RTN)	8.0	1.77	10.2	6.9	39.2	1.4	23.0	18.9	(4.8)	defense prods & servs
General Dynamics (GD)	8.5	1.94	10.7	11.1	15.1	1.3	17.9	19.4	0.4	defense prods & servs
HealthSpring, Inc. (HS)	8.5	1.47	8.7	34.8	42.1	1.3	13.9	18.3	14.7	managed care
Humana Inc. (HUM)	8.5	1.44	8.1	18.8	29.9	1.8	24.1	19.7	4.5	health benefits solns
Lincoln Educational (LINC)	8.5	1.51	5.9	16.2	25.5	1.0	14.8	29.9	(8.3)	higher education
Northrop Grumman (NOC)	8.5	1.45	10.1	3.1	11.9	1.2	26.0	16.3	2.2	security systems
VSE Corp. (VSEC)	8.5	1.48	7.3	36.3	43.5	1.5	25.5	21.8	(2.2)	central mgmt servs
Dynamics Research (DRCO)	9.0	1.11	10.1	(0.5)	(0.7)	1.5	15.3	12.2	0.4	defense sys & servs
Eni S.p.A. (ADR) (E)	9.0	1.13	10.5	7.4	(6.6)	1.0	34.5	11.6	(6.0)	oil & natural gas
Hess Corp. (HES)	9.0	1.45	9.5	11.5	(8.0)	1.3	35.2	16.9	1.5	oil & natural gas
Honda Motor (ADR) (HMC)	9.0	1.19	8.6	(0.2)	(10.6)	1.3	49.4	14.2	10.0	autos & motor prods
Insight Enterprises (NSIT)	9.0	1.16	9.0	8.1	(14.6)	1.5	32.0	13.9	0.0	IT prods & servs
AMERIGROUP Corp. (AGP)	9.5	2.01	9.5	23.3	10.8	1.2	22.2	22.4	12.0	managed healthcare
Ensign Group (ENSG)	9.5	2.03	11.9	17.3	24.0	1.7	48.9	18.6	2.6	nursing & rehab servs
Pearson PLC (ADR) (PSO)	9.5	1.81	18.8	8.1	18.7	1.4	45.6	19.9	2.2	publish & business info
SK Telecom (ADR) (SKM)	9.5	1.96	9.0	6.6	(2.4)	1.4	40.7	58.1	3.7	wireless telecom servs
Almost Family (AFAM)	10.0	1.86	10.8	35.5	61.1	3.3	0.7	18.9	3.4	home health servs
AmerisourceBergen (ABC)	10.0	2.99	14.3	7.4	29.1	1.1	45.5	22.2	0.7	pharmaceutical servs
Atwood Oceanics (ATW)	10.0	1.75	9.6	29.1	94.6	3.2	17.6	20.0	1.1	oil & gas drilling
Bridgestone (ADR) (BRDCY)	10.0	1.06	9.5	1.4	(61.2)	1.4	29.9	11.3	(3.5)	tires & divers prods
Brink's Co. (BCO)	10.0	2.32	7.9	6.6	13.7	1.3	46.4	30.7	0.8	bank security servs
Chemed Corp. (CHE)	10.0	2.59	18.2	10.1	23.6	1.8	29.5	15.3	2.0	hospice & plumbing
Walt Disney (DIS)	10.0	1.91	18.0	3.3	9.3	1.3	28.5	11.1	0.2	entertainment co.
McDermott Int'l (MDR)	10.0	1.88	10.7	26.5	40.4	1.3	2.5	19.0	0.3	oil & gas servs
Henry Schein (HSIC)	10.0	2.19	16.6	10.9	21.2	1.7	16.2	14.2	(0.2)	healthcare servs
TESSCO Tech (TESS)	10.0	1.57	12.5	0.3	14.5	1.5	4.1	13.8	1.3	mobile support

Ranked by risk-reward score.
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 11/5/10.*

return for their shareholders.

One of the companies with the best (lowest) score is General Dynamics (GD). The company, as many of you know, is one of the world's largest defense contractors. It is also the second-largest manufacturer of corporate jets. The large capital requirements and the need for U.S. government security clearances help to limit competition. General Dynamics has grown revenues and earnings throughout most of the past five years, has a low level of debt and generates free cash flow. The stock trades with a price-earnings multiple of 10.7, which is well below the S&P 500's price-earnings ratio of 17.6. Earnings estimates have recently been revised upward for both 2010 and 2011.

What the stock screen can't tell you, however, is that the company faces the risk of defense spending cuts by the U.S. government and, to a lesser extent, by foreign governments. Thus, an investor in this company would need to monitor the potential for budgetary changes that would impact future revenues.

Conclusion

The risk-reward strategy is designed to find stocks with attractive valuations, strong financials and good business models. However, like any screening strategy, it only reduces, not eliminates, research time. Because a screen cannot identify all risks, I use screening strategies merely to provide a list of stocks that I would be interested in researching further as opposed to a tool that tells me exactly what to buy at any given period of time. ▲

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