Stock Analysis WORKSHOP

A Blue-Chip Value Investor: Seeking High-Quality, Out-of-Favor Stocks

By Maria Crawford Scott

"A bird in the hand is worth two in the bush."

It's an old saying, but it's a sentiment felt by many conservative stock investors who prefer the stocks of stable and established companies that provide part of their return sooner, in the form of dividends, rather than later, in the form of capital gains.

How does one choose among these kinds of stocks?

One approach is followed by Geraldine Weiss, editor of the highly regarded Investment Quality Trends, a La Jolla, California-based newsletter that tracks and recommends stocks based on her approach.

Weiss melds a conservative, blue-chip investment style with a value approach, using dividend yield as a guide to value. A high dividend yield signals out-of-favor stocks, but many such stocks are out-of-favor for good reason—they are financially troubled. Weiss' strategy attempts to weed out truly financially troubled firms by seeking out-of-favor stocks within a relatively safe sector of high-quality stocks.

Weiss has outlined her approach in two books, "Dividends Don't Lie," with Janet Lowe (Longman Publishing, 1988, out of print), and her more recent "The Dividend Connection," written with son Gregory Weiss (Dearborn Financial Publishing, 1995, $24.95, 800/245-2665). These writings are the primary source for this article.

The Philosophy

Weiss can best be described as a blue-chip value investor—buying quality stocks at a good value.

Quality is Weiss' first concern—investing in companies that have withstood the test of time by surviving numerous economic cycles without lowering or canceling a dividend. These stocks tend to be more stable and are usually the last to fall when the economy is declining, making them less risky than lower-quality or unproved stocks.

Weiss also notes that quality companies provide, through their dividend payments, a reliable source for steady and increasing income. These payments significantly contribute to an investor's bottom line return, and in particular provide support during bear markets by supplying a source of income.

Of course, significant profits come from price appreciation. Weiss maintains that all stocks go through cycles of undervaluation and overvaluation, and that investor profits can be achieved by taking advantage of these cycles—buying stocks when they are undervalued and subsequently selling them when they are overvalued.

But dividends are the star players in the approach. In Weiss' view, dividends offer the best indication of both quality and value, besides providing a source of return.

The quality of corporate management can be judged by examining a firm's dividend payments and policies. Companies that provide steady dividend payments over the long term are generating sufficient earnings to first cover all expenses and debt payments; companies that increase cash dividends year-after-year are able to do so through increased earnings and thus are particularly well-managed.

For Weiss, the most important measure of investment value is the dividend yield—a company's current annual dividend per share divided by share price.

Why? In the long run, the underlying value of the stream of dividend payments determines the price of a stock. As Weiss points out, the impact of dividends on price is reflected when changes occur—if a dividend is increased, the stock becomes more valuable and more highly rated; if a dividend is decreased, stock values decrease.

The dividend yield ratio relates dividends per share to share price, similar to other popular valuation measures such as price-earnings ratios (price divided by earnings per share) and price-to-book-value ratios (price divided by book value per share). Weiss does not discount these other ratios, but notes

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that distortions in reported earnings and book value more easily arise with them. Dividend payments, in contrast, tend to be more predictable and not subject to differing accounting interpretations; they are real, measurable dollars paid out to shareholders, and offer a more stable measure to relate to share price.

On the other hand, Weiss believes that over the short term, prices go to extremes. This causes a company's dividend yield to fluctuate within a range that is unique to each company. When dividend yields are relatively high, the share price is low relative to dividends per share paid out, indicating that the stock may be undervalued; when dividend yields are relatively low, the share price is high relative to dividends per share, indicating that the stock may be overvalued. Weiss suggests buying and selling blue-chip stocks when they reach the extremes of their historical dividend yield range.

The philosophy combines a high-quality strategy with a value approach, and has a goal of minimizing downside risk, maximizing the potential for capital gains, and maximizing the growth of dividend income.

The Blue-Chip Universe

Because the safety of dividend payments and their ability to rise are central to her approach, Weiss suggests that investors begin their selection process by narrowing their initial list down to a universe of blue-chip stocks. In this sense, the pre-selection of the "universe" of stocks is particularly important.

Weiss seeks companies that are well-known, with good managers, good research and development efforts, good marketing skills, well-known products and services, and that are reluctant to cut a dividend even in times of cyclical stress. In particular, she lays out six criteria:

1) Dividend increases in five of the last 12 years: A measure of good long-term performance of the company's ability to increase net earnings, reflected by a trend of increasing dividends. Weiss terms this the most reliable measure of good management.
2) A minimum of five million shares outstanding: An assurance of liquidity, which in turn prevents manipulation of share price. Firms smaller than this may have trouble attracting institutional investors, which leads to illiquidity.
3) Shares must be held by at least 80 institutions: Another assurance of liquidity, but Weiss views this rule as the least rigid of her criteria.
4) Improved earnings in at least seven of the last 12 years: Another indication of a well-managed company, indicating that a company can survive the tough years and prosper in the good ones. Weiss notes that she also looks for sales increases, and profit margins that are under control.
5) It must have paid dividends, with no interruptions, for roughly the past 25 years: Consistent dividend payments are a sign of a profitable, well-managed company; a long record also provides the historical data necessary to evaluate the range of dividend yields indicating valuation extremes. Weiss suggests that if an investor wants to relax the number of years, dividends should have been paid long enough for several cycles of overvaluation and undervaluation to be established.
6) The stock must carry a Standard & Poor's quality ranking no lower than A–. S&P ranks the quality of stocks on a scale of A+ to C (a D indicates reorganization) based on past growth and stability of earnings and dividends; Weiss finds the rankings a useful guide to investment quality. Although stocks must have a quality ranking of A– to make the initial list, Weiss allows stocks to drop to B+ once on the list; however, if they drop to B, the stock is deleted from her blue-chip list.

How many should be included in the universe? Weiss herself follows 350, a number she says is somewhat arbitrary but is a manageable size, while including a wide variety of industry groups.

Dividend Yield Criteria

Once a pre-selected list of blue-chip stocks is developed, Weiss suggests the purchase of these stocks based on a value approach, using historical dividend yields as a guide.

Specifically, Weiss charts a firm's dividend yield and its price over a decade or more, and looks for historical high and low dividend yield "turning points," when stock prices change direction. Weiss maintains that most stocks turn at roughly the same dividend yield each cycle; averaging these dividend yields defines the boundaries.

"If a major rising price trend has ended in a 2% yield area many times, and a major declining price trend repeatedly has ended in a 5% yield area, a profile of value has been established for that stock—a 2% dividend yield identifies a historically overvalued price where the stock should be sold to preserve capital and protect profits. Conversely, when that stock is priced to yield 5%, it is historically undervalued and a good buying opportunity is at hand."

Weiss suggests that investors buy from their blue-chip stock list when the prices cause dividend yields to be within 10% of their historical high dividend yield.

On the other hand, she does not suggest investors purchase an undervalued stock without first examining the reasons why a stock's price has fallen—in particular, checking for the possibility of a dividend decrease, which would eliminate it from consideration.

Other Factors

Weiss does not discount the use of other value measures when analyzing stocks, and in fact suggests several that are useful in confirming valuations derived in the dividend yield approach. In addition, these valuations can help an investor more fully understand how the market perceives a stock.

In particular, she suggests:

1) A price-earnings ratio that is historically low for that particular stock and other similar stocks, and that is below the market multiple. A low price-earnings ratio reflects the market's low

The Geraldine Weiss Approach in Brief

Universe of stocks

High-quality 'blue-chip' stocks. To get on this initial list, stocks should have the following characteristics:

- The dividend must have increased a minimum of five times in the past 12 years.
- Shares outstanding should number at least five million.
- Shares must be held by at least 80 institutions.
- In at least seven of the last 12 years, corporate earnings should have improved.
- It must have paid dividends, with no interruptions, for the past 25 years.
- The stock must carry an S&P quality ranking no lower than A–.

Criteria for initial consideration

Buy from the blue-chip stock list when the prices cause dividend yields to be within 10% of their historical levels of high dividend yield, indicating it is historically undervalued.

Other factors

- A price-earnings ratio that is historically low for that particular stock and other similar stocks, and that is below the market multiple.

- A price-to-book-value ratio that is no higher than 1.3, and the closer to 1.0, the better.

- A ratio of current assets to current liabilities of at least 2.0, and a debt-to-equity ratio of no more than 50% debt to equity (utility stocks are excluded because of their unique regulatory status). Conservative investors should look for a debt-to-equity ratio or no more than 20%.

- Also be wary of other signs that dividend payments may be in jeopardy: Payout ratios approaching 100%, although a rising earnings trend can support rising dividends; and an indicated dividend higher than reported annual earnings, although strong cash flow can help cover a dividend payment when earnings temporarily drop.

- In general, when evaluating a stock for potential purchase, examine:
  – The company's financial performance, including its record of earnings, dividends, debt-to-equity ratio, dividend payout ratio, book value, and cash flow.
  – The company's product performance, whether it is manufacturing goods or services that are in demand, its research and development efforts, and its ability to market its products or services.
  – The company's investment performance in the form of capital gains and dividend growth.

Stock monitoring and when to sell

Aim for a portfolio of about 20 stocks selected from a variety of industry groups.

Continually monitor the portfolio to weed out stocks that no longer satisfy the requirements of good value or quality.

Sell stocks when they are within 10% of their historical low dividend yield, indicating overvaluation. If you tend to be reluctant to sell when prices are rising, consider placing a stop-loss order 12% to 15% below the overvalued price.

If dividend yields rise among stocks you own, make sure you understand why, but in general view it as an opportunity to buy more. However, if rise occurs because a company omits a dividend, wait temporarily for prices to shore up, and then sell, since it no longer meets the blue-chip criteria.

growth-in-earnings outlook for the firm.

2) A price-to-book-value ratio that is no higher than 1.3, and the closer to 1.0, the better. This is a Benjamin Graham rule-of-thumb that seeks to buy stocks as close to the bare-bones worth of a company as possible.

Weiss' investment approach demands that the cash dividend be safe. A change in the dividend payment causes the dividend yield to change, so that a share price that was once regarded as undervalued may become fairly valued or overvalued, and vice versa.

How can investors judge the safety of dividend payments for both prospective stocks and stocks that they own? Of course, stocks on a blue-chip list should have relatively safe dividends. But Weiss also provides some guidelines:

- Seek stocks with a ratio of current assets to current liabilities of at least 2.0, and a debt-to-equity ratio of no more than 50% debt to equity (utility stocks are excluded because of their unique regulatory status); conservative investors should look for a debt-to-equity ratio of no more than 20%. Companies with high levels of debt can run into financial problems more quickly during a slowdown, putting the dividend in jeopardy.
- Payout ratios approaching 100% are a danger signal. Dividends are paid out of earnings, and are relatively safe and

can even be safely increased if the payout ratio (dividend as a percent of earnings) is 50% or less. The closer the payout ratio is to 100%, the more endangered the dividend and the less likely it is to be increased. A rising earnings trend, however, can support rising dividends.

- Similarly, an indicated dividend higher than reported annual earnings is a danger sign. Since firms pay dividends primarily from earnings, a company cannot sustain dividend payments above annual earnings. Although strong cash flow can help cover a dividend payment when earnings temporarily drop, an "unprotected dividend is in greater danger than a protected dividend."

Lastly, Weiss states that investors should examine all fundamental factors to fully understand the company before purchasing it, and when judging the merits of one prospective blue chip relative to another. She does not go into detail concerning what to look for, but she does provide a generalized guide of what to look at when judging the quality of a firm:

1) The company's financial performance, including its record of earnings, dividends, debt-to-equity ratio, dividend payout ratio, book value, and cash flow.
2) The company's product performance, whether it is manufacturing goods or services that are in demand, its research and development efforts, and its ability to market its products or services.
3) The company's investment performance in the form of capital gains and dividend growth.

Portfolio Monitoring and When to Sell

Weiss suggests that individuals aim for a portfolio of about 20 stocks, enough to assure that the portfolio is diversified but manageable. In addition, selected stocks should be in a variety of industry groups.

On the other hand, Weiss does not believe that an investor should always be fully invested—if, for example, few stocks are undervalued, or if the overall market appears to be overvalued (based on historical market dividend yields). Keeping money in cash during these times, she believes, allows an investor to take advantage when the opportunities eventually arise at the end of a bear market or during a major correction in a bull market. Weiss notes that these times offer investors the best opportunities to diversify their holdings because of the large selection of undervalued stocks.

Portfolios must be continually monitored to weed out stocks that no longer satisfy the requirements of good value or quality.

Within an investor's portfolio, Weiss believes stocks should be sold when prices cause them to be within 10% of their overvalued extreme range. She views historically low dividend yields as "alarm bells," and although the stock price may continue to rise, the upside potential is outweighed by the downside risk. Of course, dividend yields tend to fall when prices are rising—and Weiss notes that investors are often reluctant to sell these shares, particularly if they have held on to them for some time. Her suggestion: Place a stop-loss order 12% to 15% below the overvalued price; the market will then dictate the sale.

What happens when dividend yields rise—indicating undervaluation—for stocks held within a portfolio? Dividend yields will rise if the price drops, and Weiss notes that investors should try to determine the cause of the price drop. In general, however, she views this as a buying opportunity to add shares.

"When bad things happen to good companies, it must be viewed as a buying opportunity rather than a bailout. As long as a stock's dividend is maintained, even an extremely undervalued stock merits investment consideration."

Dividend yields may also rise, and prices drop, if the company omits a dividend. In this instance, she suggests that investors wait temporarily, since stock prices may move up shortly after, once the uncertainty has been eliminated. After the "rebound," however, the stock should be sold because it no longer meets the blue-chip criteria.

Conclusion

Weiss' strategy is an interesting derivative of a classic value approach that nonetheless reverses the process: Rather than finding undervalued companies first, and then analyzing for quality, Weiss first focuses on developing an initial list of quality companies in which you would be comfortable investing, and then purchasing them when they become undervalued.

The approach is particularly useful for investors who seek stocks that pay a steady dividend and are likely to continue paying a steady dividend; it is less useful for investors primarily seeking growth and who are trying to limit annual taxable income. The approach is also well-suited for those who want to take advantage of dividend reinvestment plans.

Weiss summarizes her own approach this way:

"Successful investing in the stock market is not brain surgery. Anyone can be a successful investor. The secret is no secret. It is simply that you confine your selections to blue-chip stocks, you buy them when they are undervalued, and you sell them when they become overvalued. This is the well-lit path of the enlightened investor."