A COMBINATION APPROACH: SCREENS FOR VALUE ON THE MOVE

By John Bajkowski

Screening just for stocks with low P/Es may leave you with a list of firms with no growth prospects. Adding growth screens can help you identify reasonably priced stocks with some momentum.

Investors are constantly engaged in the battle of buying low and selling high. Strategy and tactics are critical elements in this struggle, and current indications point to successful investing results by following a disciplined contrarian, value-driven strategy. Value investors argue that while the market may be efficient in the long term, emotions often dominate in the short run. These emotions can overtake rational analysis, pushing a stock's price above its intrinsic value during periods of euphoria and below its true worth when reacting to bad news. The market also ignores many companies, leading to mispricings.

Value screens, such as the price-earnings ratio screen, typically look for low prices relative to actual measures of company performance. The price-earnings ratio, or multiple, is computed by dividing a stock's price by its most recent 12 months' earnings per share. The price-earnings ratio is followed closely because it embodies the market's expectations of future company performance through the price component of the ratio and relates it to historical company performance as measured by earnings per share.

A simple search for low price-earnings ratios, however, can be misleading as a screen for undervalued stocks. Typically, firms with high growth potential trade with correspondingly high price-earnings ratios, while those with low price-earnings ratios are expected to have low growth. Screening just for stocks with a low price-earnings ratio may leave you with a list of companies with little or no growth prospects. This article will explore some of the basic techniques used to combine value and growth measures to identify companies experiencing growth.

P/E TO EARNINGS GROWTH: THE PEG RATIO

One of the most popular techniques used to seek both value and growth involves finding stocks with low price-earnings relative to earnings growth. The P/E to growth ratio (PEG ratio) is computed by dividing the price-earnings ratio by the earnings growth rate. Ratios below one indicate that a stock may be undervalued, while stocks with ratios above one may be overvalued. The idea is to purchase a stock with some demonstrated earnings growth before the market recognizes the company's potential and bids up the price-earnings ratio.

Price-earnings ratios tend to adjust to expectations of future earnings performance. A stock that exceeds expectations could get a large price boost from an expansion of the price-earnings ratio coupled with the actual earnings increase.

AAII's *Stock Investor Professional* screening and research program was used to perform our screens. Table 1 presents the results of all of the filters with the AAII Shadow Stocks separated from the rest of the stock universe to help highlight a cross section of companies [see box at end of article for a description of Shadow Stocks]. Our first screen looked for companies with a P/E to growth ratio below one. This filter reduced the Shadow Stock universe to 142 from a starting point of 323, while the number of non-Shadow Stock firms

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dropped to 1,533 from a starting point of 8,587 companies.

The median P/E to earnings growth ratio for all companies currently in the database turns out to be one, while the median is 0.4 for passing Shadow Stocks and 0.8 for passing non-Shadow Stock companies.

The lower PEG ratio for the Shadow Stock group reflects both the lower median price-earnings ratio and higher median earnings per share growth of the group compared to the passing non-Shadow Stock companies.

The median price-earnings ratio of 20.2 for the passing Shadow Stocks is roughly equal to the 20.3 median price-earnings ratio of all the stocks in *Stock Investor Professional.* In contrast, the passing non-Shadow Stock firms have a median price-earnings ratio of 28.8, which exceeds the price-earnings ratio of 26.4 for the S&P 500 index.

Investment analysis is forward-looking. While historical earnings are easy to view, expectations are more difficult to judge. Services such as I/B/E/S collect and report analyst expectations of earnings, but many small-cap companies will have only a small number of analysts tracking earnings, if any at all. SL Industries, a manufacturer of electric power equipment, aviation spark plugs and lubrication components, has the lowest price-earnings ratio of both groups with a ratio of 9.9 times trailing 12-months' earnings of $1.35 per share. Looking forward, only one analyst provides an earnings estimate for this firm for 1998 and that figure is $0.90 per share. SL Industries' forward price-earnings ratio (price divided by estimated 1998 earnings per share) is 14.9 times 1998 estimated earnings. The median forward price-earnings ratio is 18.8 for the companies in AAII's *Stock Investor* program.

What moves a stock is not only the level of earnings, but how they compare to expectations. Your analysis should focus on whether or not the market consensus of future earnings growth is realistic.

ANNUAL EARNINGS GROWTH

Table 1 lists the annual growth in earnings per share over the last five years. The median growth rate was 47.1% for the passing Shadow Stocks and 36.6% for the passing non-Shadow Stocks. Both of these figures are significantly above the 13.0% median for all firms.

Coherent Communications, which manufactures voice enhancement products for wireless, satellite, and cable communications systems, leads the pack with a historical annual growth in earnings of 129.0%. Growth rates this high are typically due to special situations in which earnings for the base year of the growth rate calculation is near zero. The growth rate calculation for Coherent Communications is based upon earnings per share of $0.01. Normally growth rates above 20% per year cannot be sustained in the long-term. The consensus five-year annual earnings growth estimate for Coherent Communication is 30.0%. By comparison, the median growth rate estimate is 15.0% for all firms tracked by *Stock Investor Professional.*

It is important to remember that the historical growth rate is a raw growth figure that does not divulge any change in trend or indicate the variability of earnings. The easiest and most direct way to judge earnings is to examine the earnings directly year-by-year, looking for stability and accelerating growth.

Another basic screen used here required positive earnings per share from continuing operations for the most recent 12 months and each of the last five years. This filter reduced the number of passing Shadow Stock firms from 142 to 111, while reducing the number of non-Shadow Stock firms from 1,533 to 933. More stringent screens would require increases in each of the last five years or even an increase in the year-to-year growth rate for each of the last five years.

When examining a firm's earnings patterns, it is necessary to carefully read both quarterly and annual reports, which can clue you in to possible explanations for certain earnings growth patterns. Was a significant portion of the earnings growth achieved through acquisition or internal growth? Did earnings growth in a franchise come from increases in same-store sales or the opening of new stores? Did currency translations impact earnings? Are competitive conditions changing within the industry? Are margins increasing or decreasing? For example, without increasing sales and earnings from existing stores or steady or improving margins, earnings momentum may slow.

The sales growth rate is often used to confirm the strength of earnings growth. Sales are less susceptible than earnings to variability from accounting choices by management and often point to changes in company trends before it becomes apparent in earnings. Beyond examining the overall sales growth rate, it is important to look at the year-by-year sales figures to determine the consistency and trend of the growth. It is interesting to note that while the median five-year annual sales growth rate of 17.8% for the Shadow Stocks passing all the filters was higher than the median value of 11.4% for all firms, it trailed the 26.9% median for the passing non-Shadow Stock firms.

QUARTERLY EPS STRENGTH

Value screens such as low price-earnings filters are good at identifying neglected firms, but secondary screens for quarterly earnings growth are helpful in identifying stocks either poised or participating in an upturn. Quarterly earnings may indicate a change in the trend of earnings more quickly than just examining annual earnings figures. Quarterly earnings are closely

TABLE 1. SCREENING FOR VALUE STOCKS ON THE MOVE

Company (Exchange: Ticker)	Ratio of P/E to EPS Growth (X)	Price-Earnings Ratio (X)	EPS Latest 12 Mos. ($)	Annual 5-Year Growth Rates EPS (%)	Annual 5-Year Growth Rates Sales (%)	EPS Growth Q5 to Q1* (%)	26-Week Relative Strength Rank (%)	Price as a % of 52-Week High (%)	Business
Shadow Stocks									
Nobility Homes (M: NOBH)	0.3	22.5	0.69	86.7	33.9	64.3	98	91	Manufactured homes
General Employment (A: JOB)	0.6	25.0	0.71	40.8	23.5	90.9	93	85	Professional staffing services
RCM Technologies (M: RCMT)	0.8	25.0	0.78	90.9	33.5	50.0	85	99	Professional staffing services
Chase Corporation (A: CCF)	0.5	11.9	1.34	22.1	12.2	277.8	83	97	Prot've coatings & tape prods
Del Laboratories (A: DLI)	0.7	23.0	1.90	31.0	12.8	40.0	77	99	Cosmetics and pharmaceu'ls
SL Industries, Inc. (N: SL)	0.3	9.9	1.35	41.4	17.8	33.3	76	82	Engineered products
Barbers, Hairstyling (M: BBHF)	0.2	18.6	0.55	75.5	14.0	33.3	76	87	Hair salon franchises
Southwest Water (M: SWWC)	0.3	18.5	0.81	57.4	11.2	38.5	74	80	Water mgmt in Southwest
AmeriLink Corp. (M: ALNK)	0.4	20.2	1.14	47.1	24.1	150.0	70	63	Cable systems
Median for all Shadow Stocks	**0.4**	**20.2**	**—**	**47.1**	**17.8**	**50.0**	**77**	**87**	
Non-Shadow Stocks									
Lennar Corp. (N: LEN)	0.4	10.3	2.72	28.3	29.4	18.2	98	97	Home bldg & property mgmt
Safeskin Corp. (M: SFSK)	0.8	52.0	1.18	64.8	53.8	56.0	97	93	Disposable latex gloves
HEICO Corp. (A: HEI)	0.8	47.8	0.73	61.9	24.0	40.0	97	99	Aerospace prods & servs
Coherent Commun's (M: CCSC)	0.4	52.2	0.81	129.0	26.9	43.8	97	98	Voice-enhancement prods
Lowe's Companies (N: LOW)	0.3	29.8	1.96	112.7	23.0	13.6	95	97	Home-improvement stores
Capital One Financial (N: COF)	0.8	26.8	2.51	34.1	42.8	24.1	95	95	Bank holding co.
CIBER, Inc. (N: CBR)	0.9	63.6	1.05	73.2	53.4	86.7	94	100	Info technology consulting
Century Telephone Ent. (N: CTL)	0.9	19.6	3.11	22.2	21.6	13.3	94	99	Telecommunications
Pulitzer Publishing Co. (N: PTZ)	0.8	28.8	2.92	36.6	6.3	8.5	93	96	News publisher; radio & TV
Mohawk Industries (N: MHK)	0.9	22.4	1.17	25.1	45.1	42.9	92	92	Carpet design and manuf
Doral Financial Corp. (M: DORL)	0.9	16.6	1.63	18.8	22.3	14.6	92	97	Select financial services
Median for all non-Shadow Stocks	**0.8**	**28.8**	**—**	**36.6**	**26.9**	**24.1**	**95**	**97**	
Median for all companies	**1.0**	**20.3**	**—**	**13.0**	**11.4**	**15.4**	**50**	**81**	

** Growth rate in earnings per share for most recent quarter compared to same quarter one year ago.*

Statistics are based on figures as of February 28, 1998.
Source: AAII's Stock Investor/Market Guide Inc.

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

DEFINITIONS OF SCREENS AND TERMS

Ratio of P/E to EPS Growth: The price-earnings ratio of a stock divided by its annual growth rate in earnings per share over the last five years. Indication of valuation by the market relative to historical earnings growth. A ratio below one is reason for further analysis.

Price-Earnings Ratio: Market price per share divided by the most recent 12 months' earnings per share. A measure of the market's expectations regarding the firm's earnings growth and risk. Firms with very high price-earnings ratios are being valued by the market on the basis of high expected growth potential. A high ratio might indicate an overvalued situation; a low ratio might indicate an overlooked stock.

EPS Latest 12 Months ($): Net income after all expenses and taxes divided by number of shares outstanding.

Earnings per Share Growth Rate (%): The compound annual growth rate in earnings per share over the last five fiscal years. A measure of growth.

Sales Growth Rate (%): The compound annual growth rate in sales (revenue) over the last five fiscal years. Used here to compare with earnings growth rates; usually when earnings growth is higher than revenue growth, profit margins are expanding.

EPS Growth Q5 to Q1 (%): Growth in earnings per share from one quarter compared to the same quarter one year previous. Quarter 1 is the most recent quarter, while Quarter 5 is its counterpart one year ago. Provides an indication of true earnings momentum by taking seasonal changes into consideration.

26-Week Relative Strength Rank (%): Price performance of a stock compared to the price performance of all other stocks over the same period. Expressed as a percentile rank; the higher the rank, the better the performance relative to other stocks.

Price as a Percent of 52-Week High (%): Current price divided by the highest price over the past 52 weeks. A price momentum indicator that shows the range and movement of share price.

examined by the market and deviations from the expected norm are quickly rewarded or punished.

When studying quarterly earnings, you typically cannot compare one quarter to the previous quarter in a meaningful manner. It is more useful to look at "quarter-on-quarter" earnings changes, where one quarter is compared to the same quarter last year. Many firms have annual seasonal cycles in either sales or production and the stronger the pattern, the more important it is to make quarter-on-quarter comparisons.

Our screen required that each of the last four quarters' earnings per share be higher than the same quarter one year earlier. This filter reduced the number of Shadow Stocks from 111 to 35, while dropping the number of non-Shadow Stock firms to 393 from 933.

As always, it is important to look at factors leading to the growth and determine if the growth is sustainable. Chase Corporation had a 277.8% increase in its November 1997 ending quarter compared to the same quarter in 1996. Chase Corporation is involved primarily in the manufacturing of protective coatings and tape products used in a wide range of applications from insulation for conductive wire and cable to highway bridge deck metal coatings. While its performance reflects higher sales of highway-related products, the company also benefited from a $1.7 million dollar gain from the sale of assets.

PRICE MOMENTUM

Price momentum is often used as a signal that the stock price is reacting to earnings performance that has occurred and is recognized by the market.

The relative strength rank indicates how a company's stock price has performed relative to all other stocks. A rank of 50% indicates that the stock's performance is better than 50% of all firms, while a rank of 90% indicates that a stock has outperformed 90% of all stocks. For the Shadow Stocks, we specified a minimum relative strength rank of 70% over the last 26 weeks. Looking at performance over the last half year helps to identify stocks that have had strong price performance that should still be relevant. This filter reduced the number of Shadow Stocks to the nine stocks listed in Table 1. The stocks are ranked by the 26-week relative strength rank. The same filter reduced the number of non-Shadow Stocks to 149 from 393. To avoid a small-cap overlap with the Shadow Stocks, we then specified a market capitalization [share price times number of shares outstanding] floor of $250 million that further reduced the number of passing stocks to 97. The top 11 stocks ranked by relative strength are presented in Table 1.

As an example, the Shadow Stock General Employment has a 26-week relative strength rank of 93%. General Employment provides job placement and temporary staffing in technology, engineering, and accounting fields. The stock has seen very strong price performance since 1992, increasing from a split-adjusted $0.54 to $17.75 at the end of February. Its 26-week relative strength rank of 93% is also strong. It outperformed the S&P 500 by 39% over the same time period. However, when looking at price momentum it is important to look for changes in trend.

You could complement a longer-term relative strength rank with a shorter-term ranking. General Employment's four-week relative strength rank at the end of February was 54%, which was roughly equal to the performance of the S&P 500, but significantly weaker than the 26-week relative strength rank. Optimally, the four-week relative strength rank would be higher than the 26-week relative strength rank.

The current market price as a percentage of the 52-week high price is another popular price momentum indicator. If a firm's stock price continues strong, it should be trading near its 52-week high. General Employment's current price of $17.75 is 85% of its 52-week high of $21.00. General Employment is a small-cap firm with only 8.7% of its shares owned by institutions and with only one analyst (as tracked by I/B/E/S) providing earnings estimates for the company. Recently the quarterly earnings estimate and annual earnings estimate was reduced by the analyst, but the long-term growth estimate is still a high 27%.

CONCLUSION

Value screens attempt to identify undervalued stocks. However, patience is required while waiting for the market to recognize the value of a stock. Combining value with price and earnings momentum screens should help to identify reasonably priced stocks on the move. But always keep in mind that the purpose of these screens is to illustrate with real firms a potential useful combination of value and momentum analysis. The screens are a mere first step in the stock selection process. ◆

The Shadow Stock series was started by AAII in January 1985. The list is updated each year and consists of non-financial stocks that are small, with low institutional interest, and that have had positive annual earnings for the two previous years. Shadow Stocks are presented to illustrate screening techniques that individual investors may find useful in their investment programs. They are presented as illustrations and are not recommendations. Further analysis of individual Shadow Stocks is necessary for any investment decision. A complete explanation of the Shadow Stock series, along with a list of all Shadow Stocks, appeared most recently in the February 1998 issue, new members receive explanations in the new member packet.