A Matter of Opinion

Qualitative approaches require investor judgment, and to make excess returns, your judgment needs to be more correct than that of the overall market.

A Review of the Qualitative Approaches to Stock Management

By James B. Cloonan

Over the past months I have been reviewing the various approaches to portfolio management in the hope that I could rescue some "mutual-fundaholics" and get them to manage their own stock portfolios.

In my July 1996 column, I discussed the rationale for doing it yourself, while admitting that some investors are better off using mutual funds. Since then, I have reviewed the various styles of management and ways of categorizing style beyond the simple value vs. growth division. I suggested that one useful way of dividing portfolio management methods was on the basis of the kinds of information necessary for the decision model. For this purpose, I divided portfolio management into quantitative and qualitative approaches.

My last two columns discussed quantitative approaches. While I believe that there are basic quantitative approaches that are simple, take little time, and will beat both the market and the vast majority of mutual funds by a meaningful amount, I pointed out in the article last November that to beat the market by a significant amount, it would require going beyond the numbers in a database.

If it is possible to outperform the market significantly, it can only be done based on qualitative approaches, by someone able to evaluate qualitative factors.

A qualitative factor is one that:

- Cannot be quantified,
- Can only be quantified on a subjective basis, or
- Can be quantified, but quantitative information is not generally available.

The ability of corporate management to cope with unforeseen adversity cannot be quantified. The value of residual customer goodwill toward a product or the value of patents and research can be quantified but only on a subjective basis. The true economic value of land or plant being carried at some accounting value can be quantified, but the information will be difficult to find.

All of these examples relate to qualitative values that might be used in stock selection. There is no limit to the possible factors that might influence the earnings and stock price of a given company.

The potential excess yields to come from correct analysis of qualitative factors depends not only on the analyst's ability to find the factors, but on the assumption that others don't consider the same things or they evaluate them differently.

While there are an almost infinite number of qualitative factors that might impact a stock, we can focus on a few approaches that qualitative analysts have used. Some of them may combine both qualitative and quantitative factors:

Price overreaction to news. Earnings disappointment is the most common source of bad news, but lawsuits, loss of contracts, labor problems, management problems, and a host of others occurs. The ability to interpret the ultimate impact of the news, particularly if the analysis disagrees with the general opinion, can be very rewarding.

Story Stocks. These are stocks where something dramatic is happening—new products, new applications, new markets, etc. You will not be the only one with knowledge of the story, but if you have a better interpretation of the results than the general market, you can win big. It might only be a better estimate of probabilities. For example, if a small pharmaceutical company has a drug in the testing phase, the current price is determined by the market's estimate of the potential profits if the drug succeeds and the probability of success. If your estimate of either factor is different and you are right, you will receive excess profits over the long run.

Quantitative values are inaccurate. One of the problems I mentioned with respect to quantitative approaches is that the data may be flawed. The most common problem is the difference between real economic value and accounting value. The latter is used in the price relative to book value evaluation. What is a manufacturing plant worth—its depreciated cost? Its replacement cost? Its market value? Maybe nothing if the product is outdated and the plant can't be effectively converted. The same kinds of questions can be asked about inventory, patents, real estate, research,

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etc. An interesting example is a magazine that carries unfulfilled subscriptions as a liability. In fact, if the company stopped publication, other magazines would be happy to do the fulfillment and pay a fee for each name.

Out-of-favor stocks. Because of their cyclical nature or because of changes in business conditions, the stocks of some companies go through periods of weakness. If the company is fundamentally sound, it is likely to come back. Buying such stocks can provide above-average returns for the long-term holder. A word of caution here. Some companies will get weaker and weaker and disappear. This approach is best for large companies—those that are "too big to fail" because someone will come along to save them. Actually, this approach is the basis of the "dogs of the Dow" strategy but can be expanded past the Dow 30 to the S&P 100 and beyond. This kind of opportunity might also be uncovered by some of the quantitative approaches discussed previously.

There are many more ways to find opportunities that the market has missed. There are, however, some problems for the qualitative analyst. Many of the judgments to be made are risky. Even the smartest analyst will miss often. It is not just a matter of good judgment, but of probabilities. If someone offered to let you flip a coin and gave you 3-to-1 odds, it would be good judgment to take the bet. But you could still lose. In the case of most qualitative analysis, diversification is particularly important.

Another major problem is where to get the information necessary for doing qualitative analysis. The primary research route is visiting the company, competitors, and customers and digging up information.

Most of us do not have the time for this, but sometimes it is possible because we come in contact with the company, its products, or its customers. The more plausible approach is to use secondary data. This can come from newspapers, TV, magazines, and advisory services. Remember that this information is for further sifting, not for blind action. Remember too that the larger the circulation of the source, the less likely that there will be an overlooked opportunity.

I have used this approach for some time and have found the most useful information on local TV, in the smaller advisory services, and from friends. These resources provide inputs for further analysis. I do not suggest acting on cocktail chatter, but a remark by someone who should know can provide the beginning of an analysis.

The qualitative approach is not for everyone. If you have time and want to try it, I suggest not only diversifying among several companies, but using this approach for only part of your portfolio.

In the next column, I'll summarize the approaches and discuss the practicalities of day-to-day portfolio management.