6 Strategies for Investment (I)

Introduction

Over the past decade, global capital markets have experienced one of the most volatile periods in their entire history. For example, since the millennium, the index of Britain's highest valued companies, the FT-SE 100 (Footsie) has often moved up and down by more than 100 points in a single day, driven by the extreme price fluctuation of risky internet or technology shares, the changing value of blue-chip companies, a global banking and Euro financial crisis, rising oil and commodity prices, all underpinned by increasing geo-political instability.

Leading up to the millennium during the dot.com boom, many I.T. firms never turned a profit, let alone a dividend. Yet, even without yield, cover, or P/E ratios to compare one company with another and its peer group, their share prices soared, fuelled by speculation. Many traditional companies suffered from this tyranny of fashion. Despite creditable financial performance, their values plummeted as investors moved sectors. In March 2000 a radical shakeout of the FT-SE 100 occurred.

FT-SE 100 Adjustments: March 2000

Out of the Index	Into the Index
Allied Domecq	Baltimore Technology
Associated British Foods	Cable and Wireless Communications
Hanson	Capita
Imperial Tobacco	Celltech
Powergen	Emap
Scottish and Newcastle	Freeserve
Thames Water	Nycomed Amersham
Whitbread	Psion
Wolseley	Thus

As the table reveals, out went many UK household names that still provided essential goods, services and utilities to millions of consumers at home and abroad. In came little known firms, valued on hope rather than rational expectation. In terms of trading fundamentals, the nine new entrants only made a total profit of £500 million compared with the £3.73 *billion* earned by the companies they replaced. The new entrants also employed far fewer people. For example, Baltimore's staffing was only 500, compared with Whitbread's 98,000.

However, by 2001 the techno-bubble burst. Five years into the new millennium, Britain's blue-chip companies were also back in favour, as evidenced below by a reversal of fortune for the majority of companies who still survived from the previous table.

The FT-SE 100 Position: August 2005

Out of the Index	Into the Index
Baltimore Technology	Associated British Foods
Celltech	Hanson
Emap	Imperial Tobacco
Freeserve	Scottish and Newcastle
Nycomed Amersham	Whitbread
Psion	Wolseley
Thus	

Throughout 2006, UK plc like other economies appeared to be in good shape, with companies reporting increased sales, profits and dividends (a continuation of the strong results delivered in 2004 and 2005). The Footsie (like the American Dow Jones) was also extremely buoyant, well above the new psychologically important 6,000 barrier, up more than 80 per cent since its low of 3,287 in March 2003.

Yet, history tells us that "bull" markets (like "bear" markets) do not go on forever and sure enough, equity prices were rising for a fall. In 2007 the American sub-prime mortgage scandal fuelled by cheap money and credit facilities became public knowledge and quickly reverberated throughout global stock markets.

You will recall from Chapter One that the classic text by Charles P. Kindleberger on behavioural theory, now in its sixth edition (2011) offers a plausible explanation for what happened next.

At some stage after insiders sold their mortgage books to move into cash, markets generally began to panic and sell, resulting in what Kindleberger terms "revulsion". A period of several months ensued where disillusioned investors refused to participate in the market until prices were low enough to tempt them back.

Since then, governments, banking and financial institutions have all sought to put their house in order with tighter regulation. Many companies world-wide have also undergone a period of introspection. Management has sought to prune unnecessary costs and provide an increasing share of corporate efficiency gains in dividends. Thus, investors, technical, fundamental, or speculative, have received more money to reinvest, which has revived stock markets and particularly, takeover activity. However, with increasing political tension and the Greek Euro crisis, it remains to be seen whether markets can maintain their momentum. Much of the cost cutting is now implemented and future gains will be limited if consumer demand tails off and rising inflation, interest rates, oil and commodity prices squeeze profit margins.

So, without access to insider information what does this mean for investors?

The purpose of this Chapter is to suggest various strategies for buying, selling, or holding shares, when markets are buoyant, even in a climate of geo-political, economic, business and financial uncertainty. To keep the analysis simple, we shall focus on the data contained in share price listings, price, yield, cover and the P/E ratio. In Chapter Six we shall then move on to other sources of information from the press, media, internet and analyst reports to support these trading decisions.

6.1 Dividends as Income

In Part Two we explained why a theoretical share valuation model based on the present value (PV) of a *constant* future dividend stream in perpetuity (using the latest reported dividend per share capitalised by the current dividend yield as a discount rate) underpins stock exchange listings. We then explained how investors focus on the current yield, a company's annual dividend per share expressed as a percentage of its current share price, to compare its own return over time with that of its peers, or the market and establish whether its shares are over or undervalued. So, if a firm pays a 10 pence dividend in one year and its shares are currently trading at £1.00 (100 pence) the yield is 10 percent. If price rises, the yield falls and *vice versa*.

If a stock's yield is low compared with its competitors, it could indicate the company is overvalued, which could be a good time to sell and buy back when share price falls to a more equitable level. On the other hand, there may be sound economic reasons why a share is highly valued that could dictate a policy of "hold and buy". Because the yield is a *ratio* with a numerator and a denominator, falling yields could also indicate that payouts are being cut, suggesting the firm is in difficulties and share price will fall. Investors need to decide whether the cut is a temporary measure, perhaps to finance profitable investment through retention, or is indicative of a fundamental problem.

If one company exhibits a higher yield than its competitors, it could signal that the stock is undervalued, suggesting a "buy" decision. Conversely, it could indicate that the firm is struggling, which has dented share price. Many shares exhibit high yields because their prices have fallen dramatically with little hope of recovery. This is why part of stock market law states that the "higher the yield the higher the risk" and investors seeking regular income assiduously avoid them. Yet high yielding shares can be good value.

Suppose two companies pay a dividend per share of 10 pence that are both valued at £1.00 yielding 10 per cent. The share price of one company then falls to 50 pence, so its yield rises to 20 percent. A speculative investor might buy this "undervalued" share with the higher yield on the chance that its price will rise again. This strategy, termed *value investing* (as opposed to *income investing*) is psychologically difficult for extremely risk-averse investors because the price fall may be the consequence of bad news, which is why you are paying half the price for the same dividend per share.

However, you will also recall that another part of stock market law is "buy low and sell high". Investors who bought into the Footsie at its all time peak of 6,930 in September 1999 (prior to the dot.com. crash) and held on till March 2003 when it plunged to 3,287 suffered 40 per cent losses. But this was the time when value investors pounced, expecting to "beat the market" by benefiting from any upswing, which they did. Naturally, it is a high-risk strategy. So, one way to hedge your bets is to analyse whether a company is sufficiently profitable to continue paying the current level of dividend in the short term.

A convenient measure of dividend risk (published in the Financial Times on Mondays) that we introduced in Chapter Two is the dividend cover. This defines how many times a company can afford to pay its current dividend out of current post-tax earnings. Conventional wisdom dictates twice earnings (cover of two). But again a word of caution: cover can rise if dividends are cut, indicating that profits and price are also about to take a turn for the worse.

Of course, not all shares exhibit low cover or high yields because profits and prices are low in a high-risk sector. Historically, the highest UK dividends tend to be paid on *defensive* stocks, such as food drink, tobacco and utilities. These consistently outperformed the FT-SE-All Share 20 year average yield of 3.3 percent and also the 4 percent high when the market plunged in March 2003. According to research conducted by *motley fool. com* who are regularly reported in the financial press like other financial websites, (see this Chapter's Selected References) buying the five shares with the highest dividend yield drawn from the FTSE-30 index every year and repeating the strategy annually, would produce a higher return, compared with a FTSE-30 average. For example, over the twenty year period from the millennium back through the 1980s (despite the 1987 global crash, Euro and Tiger economy crises of the Nineties) you would have made an average annual return of 26.15 percent, compared with the FT-SE 30's 20.38 percent.

Today, investors are enjoying a boom in dividends. Thus, one game plan to make short-term gains in a climate of financial and geo-political instability is to select shares with the highest yield, perhaps covered twice by earnings. If regular income is your motivating factor, share trading must be timed speedily, so as not to miss out on interim dividend payments, particularly if the political situation deteriorates. Most companies distribute dividends every three or six months. But remember, if you buy a share *ex-div* you are not entitled to the next dividend payment. If you sell *ex-div* you are entitled to the next dividend, but not any subsequently.

6.2 Dividends for Growth

If a company regularly pays a decent dividend, investors don't always expect future capital growth to underpin share price. However, some market participants are much more interested in growth than current income, particularly if their marginal income tax rate exceeds the rate of capital gains tax. They focus on a company's *free cash flow* (yield plus potential dividend growth) associated with a high payout on undervalued stocks, particularly when profits are expected to rise. If dividends move in sympathy with earnings per share (EPS) they represent the bulk of returns. Potential dividend growth is also a key component of the total return from shares when inflation and interest rates are low because their benefits feed into distributable profits.

Historically, dividends account for the majority of a share's total return. For example, between 1950 and 2000, 80 per cent of investors' gains from global markets were represented by dividend distributions. Investors can also increase their wealth by creating "homemade" dividend growth. For example, if you had invested £100 in the Footsie at the start of 1993, held for a decade spending all the dividends and selling when the market fell to its all time low in March 2003, the investment was only worth £101. If you had reinvested the payouts every year, you would have realised £137.50.

Turning to a sectoral analysis, shares in British American Tobacco (BAT) between 2000 and 2010 rose by a massive 383 percent (equivalent to 17 percent per annum). However, with dividends reinvested, shareholders made an incredible 662 percent, or 22.5 percent a year. Over the same period, the FT-SE All-Share only returned 40 percent with dividends.

So today, if you want to invest for the long-term and reinvest dividends, which sector should you pick? There is no definitive answer. Who would have thought that in 2000 when techno-shares were the best-performing shares of the decade, an industry seriously impaired by smoking litigation would ever revive its fortunes so spectacularly?

Growth investors oblivious to the risks of rejecting a "bird in the hand" strategy outlined in Chapter Three can also be disappointed in the short-term. At a scholarly level, throughout the 1950s and 1960s the American academic Myron J. Gordon (*op cit.)* explained how a high dividend pay-out ratio supports current share price generally, particularly if investors express a strong preference for dividends now, rather than later. Conversely, if the payout is cut it could also indicate that a firm is struggling and also hit the share price. But there are flaws in Gordon's argument. Some companies do not pay dividends, or their payout may be erratic, yet their price will rise if the market believes the prospects for the company, however long term, are good.

You will also recall that when a share sells *ex-div*, its price falls by the amount of the dividend. In other words, a dividend received is equivalent to a capital gain lost. But what if the two are not *perfect economic substitutes*, meaning they are not valued equally, even if the rate of income tax equals capital gains tax? Rational investors might prefer the expectation of larger future dividends, rather than smaller ones today; if they believe that the firm can retain and reinvest earnings in projects whose future profitability more than compensates them for the delay. In the interim, investors who cannot afford to wait always have the option of creating *homemade* dividends by selling their shares to gain the wealth amassed by management on their behalf, (Fisher's Separation Theorem *op.cit*).

As we observed in Chapter Four, since the 1960s an impressive body of research initiated by the seminal work of Modigliani and Miller (MM) also suggests that dividends may actually be *irrelevant* to share valuation. All that matters is the "bottom line", based on the riskiness of a firm's profitable investment and not how its earnings are "packaged" for distribution. In the absence of worthwhile projects, according to MM's hypothesis, the sole purpose of a dividend pay-out is the return of capital to shareholders that is surplus to the firm's future investment plans. In otherwords, a high dividend pay-out ratio signals management's failure to satisfy shareholder's expectations and not their success. A high yield can then suggest that share price has fallen and is expected to fall further, as investors sell the stock.

6.3 The Price-Earnings Ratio: Past and Future

If dividends do not drive equity prices, or explain only part of their movement, an alternative strategy for analysing market forces is to focus on earnings.

The simplest selection criterion would be to identify companies that have experienced the largest increase in earnings per share (EPS) over the past year. However, performance is not an *absolute*. It must be related to some standard of comparison. Like dividend per share, EPS ignores *relative* movements in share price that establish whether a stock's EPS delivers an appropriate return commensurate with risk. The return individual investors earn also depends when they buy. If shares are cheap, long-run returns will be higher. But when they are expensive, they will be lower.

To identify these inter-relationships, you will also recall from Chapter Two that the most commonly used indicator is the price-earnings ratio (P/E). If a share costs £1.00 and the EPS is 10 pence, then the P/E ratio is 10 (the *reciprocal* of the earnings yield, which is 10 percent). Like the dividend yield, we then compare the P/E ratio of a company with itself over time, its competitors, or the market, to ascertain whether the stock is correctly priced.

For example, throughout 2004 analyst and press reports suggested that British Petroleum (BP) the highest ranked Footsie company in terms of market capitalisation with a P/E of around 20, was overvalued. The average for the oil sector hovered around 17.5, with Shell only on 13.5. By August 2005, the market responded to this information with a *price correction* and the P/E for BP fell to 17.4. But remember there may be sound economic reasons based on trading fundamentals that explain why a company deserves a higher rating than its peers.

Like dividend yield comparisons, when shares seem expensive it might not always be prudent to sell all of your holding, perhaps only a proportion, reinvesting when price and the P/E falls back to a more reasonable level. To complicate matters further, P/E ratios can rise because earnings fall and *vice versa*, without any compensatory price movement. This often occurs when shares are not actively traded or overlooked by market participants, particularly financial institutions (a phenomenon termed "institutional neglect").

It is also important to note that P/E ratios published in the financial press are "trailing ratios" that divide a company's *current* share price by its *last* reported EPS. They only provide a "snapshot" of recent performance and also ignore future growth

If a company has a ratio that is low compared with its *long-term average*, competitors, or the market, stocks could be cheap. So, it may be a good time to buy. But if the P/E is relatively high it could be a signal to sell. Unfortunately, we have observed that investors do not always behave rationally. Think about 2000, with the tobacco sector trading on a P/E ratio of just seven and a dot.com bubble of sky-high ratios about to burst. If somebody suggested moving out of techno-shares into tobacco, there would have been few takers.

Today with hindsight, a popular valuation multiplier based on stock exchange listings that might have produced a rational decision is the *cyclically adjusted price-earnings ratio* (CAPE). It accounts for the effect of stock market cycles on profits by replacing the *latest* reported EPS in the conventional P/E ratio with an annual *simple average* EPS (say 10 years) adjusted for inflation. The rationale for the CAPE is that irrespective of market volatility and its causation, the market always *reverts* to its long-term average price (what statisticians term *mean-reversion*).The CAPE can also be compared over several years using a *moving average* to look at historical trends and identify the critical point before a current P/E ratio reverts to its mean after a spike or a dip.

So, if future investors were to look back over a decade to 2011-12, which market sector would be undervalued today but promises the best future returns?

To judge by current data, one obvious candidate is healthcare. Compared with an overall long-term average of 15, the global P/E forecast for 2012 is just 10.6. Turning to the American market leader, Johnson and Johnson, since 2000 the company's EPS surged by 186 percent but share price rose by only 13 percent. Its P/E for 2012 was also barely above 10, its lowest level for 20 years. However, analysts are reporting that healthcare in emerging markets, notably China and India, is expected to grow by 500 percent by 2020.

Still focussing on the future, we should also note that current P/E ratios are generally higher for companies with higher growth rates. So, comparisons with non-growth companies can make them appear overvalued. It is also difficult to compare companies with different growth rates.

To overcome these defects, another variant of the current P/E ratio based on stock exchange listings is the *price-earnings growth ratio* (PEG). It measures the trade-off between a stock's current price (P) the EPS generated (E) and analysts' forecast growth rate (G) by dividing the P/E ratio by G:

$$PEG = (P/E) / G$$

Proponents of the measure, such as Jim Slater (*op.cit.)* and Warren Buffett maintain that the P/E of a *fairly* priced stock should equal its growth. Thus, the PEG equals one. Based on the time honoured strategy of "buying low and selling high" investors should therefore:

Seek undervalued shares where: $P/E > G$ and $PEG > 1.0$
Avoid undervalued shares where: $P/E < G$ and $PEG < 1.0$

Summary and Conclusions

Based on the capitalisation of a perpetual annuity, markets have delivered an average annual dividend of six percent over the very long term. Historically, the average P/E for shares listed on western markets has ranged from 10 to 14. However, there is no *correct* dividend yield or P/E ratio. For example, shares in growth companies may trade on very low yields and a high P/E, but these will reflect investors' expectations that profits and hence dividends and price will all rise. Alternatively, a company may be a "castle built on sand" where profits fail to materialise, fail to cover dividends and share price collapses spectacularly, (think dot.com).

History also tells us that markets always revert to their long-term average price. So strategically, a long-run policy of "buy and hold" could limit your returns, even if you bought cheaply, unless you are prepared to sell fast when markets lose momentum (1987, 2000 and 2007). Tactically, you should also take advantage of short-term price movements. To recapitulate part of stock market law:

The higher the dividend yield, the lower the P/E ratio and the lower the dividend cover: then the higher the financial risk and lower the price of an investment (or *vice versa*).

Selected References

1. Kindleberger, C.P. and Aliber, R.Z., *Extraordinary Manias, Panics and Crashes: A History of Financial Crises,* Palgrave and MacMillan, 2011.
2. Gordon, M. J., *The Investment, Financing and Valuation of a Corporation,* Irwin, 1962.
3. Fisher, I., *The Theory of Interest*, Macmillan (New York), 1930.
4. Miller, M. H. and Modigliani, F., "Dividend policy, growth and the valuation of shares", *The Journal of Business of the University of Chicago*, Vol. XXXIV, No. 4 October 1961.
5. Slater, J., *Beyond the Zulu Principle,* Harriman Press (2011).

Selected Websites (www.)

bestinvest.com
citywire.com
digitallook.com
fool.co.uk
hemscott.com
reutors.com