

Fallen Angels and Old Dogs

Value investing is attractive to investors because of its appealing rationale, and a long history of supporting evidence. The concept that assets sometimes trade below fair value, affording an opportunity for astute purchase, is straightforward. However there are important nuances in assessing value in practice. This newsletter explains the importance of being discriminating with value investing.

Relative and characteristic value

The table below looks at two stocks currently trading at around the same price to forward earnings ratio. Prime Television and Skilled Engineering are both small cyclical stocks, so a comparison between the two is immune from trends in small/large and cyclical/non-cyclical valuation. For Prime Television the cyclical exposure is via TV advertising, whereas for Skilled Engineering, blue-collar labour hire demand reflects strength in non-residential construction.

	Prime Television		Skilled Engineering	
	Feb 2003	Feb 2004	Feb 2003	Feb 2004
Price (\$)	2.05	2.45	1.80	2.54
Forward EPS (\$)	0.138	0.169	0.156	0.180
PE Ratio	14.9x	14.5x	11.5x	14.1x

Consensus earnings forecasts are from WestAM's survey of broking research

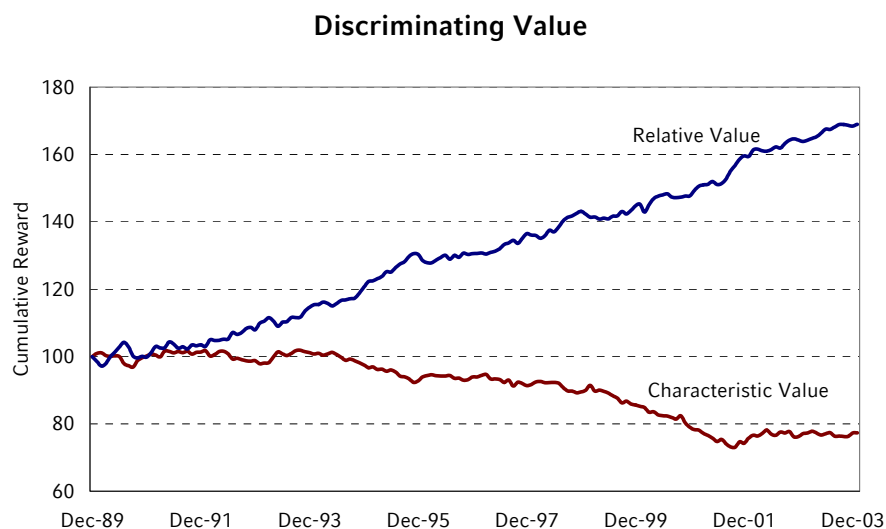
To put these numbers into perspective, the forward price earnings ratio for small cyclical stocks on average has moved from 10.1x to 11.9x over the past year, helped by the market's overall enthusiasm for small stocks over most of that time. The valuation for Prime Television has moved against that trend, whereas the valuation for Skilled Engineering has moved a little ahead of that trend.

A simplistic view of these numbers would suggest that Skilled Engineering is currently slightly cheaper with a price earnings ratio of 14.1x compared to 14.5x for Prime Television. However that observation ignores the characteristic valuation level of each stock. Prime Television is characteristically an expensive cyclical stock, due in part to the perennial speculation of deregulation of media ownership, and the strong leverage of that industry. Note forward EPS has expanded by 22% over the year. Conversely there is no clear characteristic valuation premium for Skilled Engineering. It actually traded at a discount to its peer group in 2002, before some good profit results in 2003. Characteristic value is analogous to the concept of fair value. What is interesting is whether a stock is cheap or expensive relative to characteristic value. This is what WestAM refers to as relative value. It could be argued that the relative valuation of Prime Television is on the cheap side of fair value, whereas the relative valuation of Skilled Engineering is marginally expensive. This comparison is for illustrative purposes only and other factors, aside from valuation, will typically influence investment decisions.

At the most naive level, simply buying stocks with low price earnings ratios will often lead to exaggerated sector or size biases in portfolio construction. The attendant risk will often overwhelm any value benefit. However even where sector and size biases are controlled, seeking the cheaper stocks within comparable peer groups may fail to discriminate between characteristic and relative value. An indiscriminate approach will deliver a mix of stocks that are cheap relative to their characteristic valuation level, and stocks that are simply characteristically cheap. It will also include some stocks that are moderately expensive compared to an extremely cheap level of characteristic value. In the next section we examine the differential rewards to these two valuation concepts.

What are the rewards to characteristic and relative value?

A good way of examining the rewards from each of these valuation concepts is to first analyse each stock's exposure to relative and characteristic valuation, then estimate the rewards to each of these factors, while isolating the influence of other important factors, such as momentum in stock prices, revisions to earnings forecasts, and sector constituency. The chart below shows the cumulative reward to these two valuation concepts over time.



As the chart shows, characteristic value is not attractive from an investment standpoint, whereas relative value is very attractive¹. Any value-based process that simply includes cheap stocks that are not necessarily cheap relative to their characteristic value will lead to inferior outcomes except for unusual periods like 2001/02. Recall the significant dispersion in valuation across the market that emerged through the growth bubble of 1998/99 severely affecting value managers, and the subsequent valuation compression which culminated in an exaggerated advantage to value investors in 2001/02. While this value/growth turbulence has now subsided, it exposed a weakness in indiscriminate value investing. The rewards to simply buying characteristically cheap stocks can be short-lived and moderate, with severe out-of-favour periods.

A related idea is addressed by Scott, Stumpp and Xu in a 1999 article². They define "Fallen Angels" as previously healthy companies with pessimistic outlooks, and "Old Dogs with New Tricks" as previously unhealthy companies with positive outlooks. They find Fallen Angels tend to do better in the US market

¹ The WestAM investment process has always focused on relative value and refinements on exposure to characteristic value have recently been introduced.

² Scott, J., M. Stumpp, and P. Xu. 1999. "Behavioral Bias, Valuation, and Active Management" *Financial Analysts Journal*, vol 55, no.4 (July/August)

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than Old Dogs with New Tricks, which tend to be dangerous investments. Stocks that are characteristically cheap, but relatively expensive will include some Old Dogs with New Tricks. Conversely stocks that are characteristically expensive, but relatively cheap will often include Fallen Angels.

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