Wednesday, January 4, 2012

So Much Data - So Little Time

As the universe of investment options continues to expand, so too have the metrics available to evaluate them. Hardly a week goes by without some new sure-fired silver bullet method surfacing that virtually guarantees a bulls-eye hit on the stock selection wheel. Navigating the treacherous waters of common stocks can be a harrowing experience indeed. Do we seek value, growth, income? Or should we just buy the shares of a company just because we think the stuff they make is cool?

So much for the metaphors – it's time to get real. Two of the traditional and most widely used stock data indicators are the Price/Earnings ratio (P/E) and Return on Equity (ROE). In their raw and unscrubbed form, both can be misleading when used as guideposts in stock selection and determining the optimum entry and exit points.

The ubiquitous Price Earnings ratio is arrived at by simply dividing the current stock price by the reported earnings per share. The P/E ratio can be expressed as either trailing or projected. For example, if a stock is trading at $50 per share and the reported or projected earnings per share is $5.00, the Price Earnings ratio is 10 ($50 ÷ $5 = 10). The problem with the P/E as a measure of earnings is that it only uses the market capitalization of the outstanding common stock and ignores Long Term Debt. The truth of the matter is that common stock and debt are both claims against a company's assets and should therefore both be considered in the valuation exercise.

For example, if company A and company B are both trading at $50 with earnings of $5 a share, then they will both sport a P/E ratio of 10. Since both companies have 10 Million shares outstanding they therefore have equal stock market capitalization of $500 Million. However, suppose that company A has no long term debt, but company B has $250 Million in LT debt. In this case, the total capitalization of company B (claims against its assets) is $750 Million compared to $500 Million for company A. So when we adjust the Price Earnings ratio of company B to reflect its debt level, it now becomes 15. The case can now be made that company B is 50% overpriced compared to company A based solely on their ratios of earnings against total capital.

The term that acknowledges the inclusion of long term debt in the capital structure is called Enterprise Value (EV). Enterprise Value is calculated by adding LT debt to market capitalization and deducting cash. There are several formulas that use EV to measure a stock's current market price, the most popular of which is the EV/EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) ratio. But to keep things closer to an apples to apples comparison with the P/E ratio, it is preferable to use the EV/E (Enterprise Value/Earnings) ratio instead. The EV/E, where the "E" represents net

income, is most useful when comparing alternative investment choices. It also serves as an effective scrubbing mechanism for the P/E ratio.

Return on Equity (ROE) is a widely used efficiency indicator that measures net income as a percentage of Stockholder's Equity. Stockholders Equity is tantamount to book value and is arrived at by deducting liabilities from net assets as listed on the company's balance sheet. With the possible exception of banks and pure financial institutions, book value has little to do with the earnings capacity of most businesses. For example, at this writing Google stock is trading at $665 a share, with a book value of $169 a share. Return on Equity for the trailing twelve months is reported at 20%. This suggests tremendous operating efficiency but it is almost entirely disconnected from the current share price.

To further illustrate the disconnect, consider The Clorox Company currently trading at $67.50 per share. Like Google, the Price/Earnings ratio is about 15. However, Clorox's book value (Stockholder's Equity) is a negative $.56 per share and its Return on Equity is a whopping 464%. Does this make Clorox 2.75 times more valuable than Google?

The point is that as average investors looking to buy a few shares of a publicly traded stock, we need to use sensible criteria to support our purchase decisions. We shouldn't be overly concerned with decades old book entries that create the distortions noted above. Our major concern should be -- does the current stock price support the earnings performance and potential of the company we wish to acquire and does its future bode well for providing an acceptable return on _**our**_ investment?