Sunday, September 2, 2012

Why Do We Own Stocks?

A lot has been made of the lack of trading volume on the major stock exchanges. The conventional wisdom attributes this phenomena (or lack thereof) to general distrust and fear of the system of late. It is also well documented that high-frequency computer trades often account for over half of all shares traded in a single session.

So what? Too much emphasis is placed on daily market price swings of stocks, and not enough on why we should own shares in the first place. Shares in companies, be they private or publicly traded are merely units of ownership that measure one's claim to the company's assets and earnings. Buying and selling stocks and just wishing and hoping based on the "Greater Fool Theory", (Google it), is just that – a fools game that should be left to the algorithm number crunchers and their super computers.

It is amazing to hear the nonsensical responses to the question, why do you own a particular stock? You get things like, "they make cool products", or "it has split three times" and on and on. Instead the focus should be on:

1. Dividend yield and dividend growth
2. Dividend sustainability (cash flow coverage)
3. Barriers to entry (moats)
4. Financial leverage (use of debt)
5. Return on Invested Capital.
6. Tax Efficiency

The above is not a complete list but it is a good start. If one is not willing to address them then they should stick to mutual funds or ETF's. I will qualify this statement as an opinion and not necessarily a statement of fact. Absent from the above list are "share buybacks." More often than not, management has proven to be lousy market timers when it comes to buybacks. However, there are occasions when buybacks make sense, only when the stock becomes extremely undervalued. Buybacks then remove shares from the weak hands of panic sellers paving the way for to spread future dividend payments over fewer shares thereby increasing the per share yield.

There is little need to expand on points 1, 2 and 3 as they should be self-explanatory. However the complex relationship between points 4 and 5 warrant further discussion. First, there is too much weight placed on a company's price/earnings ratio as a yardstick of value. The P/E ratio completely ignores the long term debt on the balance sheet and considers only its common stock capitalization which is calculated by multiplying the current stock price by the shares outstanding divided by the earnings per share. If the common stock is a claim on the company's earnings and assets, then so is its debt. Therefore, a more appropriate yardstick of value is the Enterprise Value/Earnings ratio. Enterprise Value (EV) combines market cap and long term debt reduced by cash and then divided by the net income.

As an example, consider two companies with identical P/E ratios of 10. Company A has no debt while company B has long term debt equal to 50% of its market cap. Ignoring cash, Company A has an EV/E ratio of 10 while Company B's EV/E ratio is a much higher 15. Which company is more valuable?

This is not to say that debt is necessarily bad which brings us to point 5, "Return on Invested Capital (ROIC)." This may be the most important metric to consider when adding debt to the capital structure to finance growth. Simply put, if the return on capital is greater than the cost of capital, then debt is good.

And finally Tax Efficiency should be considered in structuring a portfolio. I refer to this in the context of what classes of investments belong in which accounts. For instance, conventional blue chip dividend paying stocks are most efficient in a tax deferred account such as an IRA or 401K. Taxable accounts should be overweight with tax deferred investments such as Master Limited Partnerships (MLP's) where distributions are essentially return of capital.

Also on the subject of tax efficiency Real Estate Investment Trusts (REITS) and Business Development Companies (BDC's) have inherent built-in tax efficiencies. They avoid the double taxation curse of traditional corporations as long as they distribute 90% of their income to their shareholders. Unlike MLP's though, the income to the shareholder is not tax deferred.

So, trade away, buy and hold, to each his own. But know why you are doing what you do.