Chapter 11

Security Analysis for the Lay Investor: General Approach

The Responsibilities of Security Analyst

• Deals with the past, the present, and the future of any given security issue

• describes the business, summarizes its operating results and financial position

• sets forth its future earning power under various assumptions, or “best guess”.

• makes elaborate comparisons of various companies, or same company at various time

• expressed an opinion as to the safety of the issue – bond, preferred or common stock

• he may modify substantially the figures in the company’s annual statements, even though they bear the sacred imprimatur of the certified public accountant.

• it may be said that security analysts today find themselves compelled to become most mathematical and “scientific” in the very situations which lend themselves least auspiciously to exact treatment

•the national Federation of Financial Analysts is now the Association for Investment Management and Research, it publication is “Financial Analysts Journal”.

Two Basic Questions underlying the Selection of Investments

- What are the primary tests of safety of a corporate bond or preferred stock?

- What are the chief factors entering into the valuation of a common stock?

Bond and Investment-grade Preferred Stocks Analysis

1. Earning-coverage test

- The chief criterion used for corporate bonds is the number of times that total interest charges have been covered by available earnings for some years in the past.
- The chief criterion used for preferred stocks is the number of times that bond interest and preferred dividends combined have been covered.

  - For Investment-grade bonds: minimum coverage - before/after Income taxes; average of past 7 yrs, alternative measured by “poorest Year”; types of enterprise are Public-utility operating company, railroad, industrial and retail concern.

  - For Investment-grade Preferred Stocks: minimum coverage – the ratio of earnings before income taxes to the sum of fixed charges plus 2x preferred dividends

  - Other categories of bonds and Preferreds: the standards given above are not applicable to (1) public-utility holding companies; (2) financial companies; (3) real-estate companies.

Bond and Investment-grade Preferred Stocks Analysis – cont.

For Investment-grade bonds

TABLE 11-1 Recommended Minimum "Coverage" for Bonds and Preferred Stocks

A. For Investment-grade Bonds

Minimum Ratio of Earnings to Total Fixed Charges:

	Before Income Taxes		*After Income Taxes*	
Type of enterprise	Average of Past 7 Years	Alternative: Measured by "Poorest Year"	Average of Past 7 Years	Alternative: Measured by "Poorest Year"
Public-utility operating company	4 times	3 times	2.65 times	2.10 times
Railroad	5	4	3.20	2.65
Industrial	7	5	4.30	3.20
Retail concern	5	4	3.20	2.65

Bond and Investment-grade Preferred Stocks Analysis – cont.

1. Earning-coverage test – cont.

- Alternative requirements to meet the changed situation (when interest charges at 8% since 1961)

  the percent earned on the principal amount of the debt
  33% before taxes for an industrial company
  20% for a public utility
  25% for a railroad
  the "poorest year" requirement could be set at about 2/3 of the seven year requirement

Bear in mind that the rate actually paid by most companies on the total debt is considerably less than the current 8% figures, since they have the benefit of older issues bearing lower coupons.

Bond and Investment-grade Preferred Stocks Analysis – cont.

2. Size of Enterprise: minimum standard in terms of volume of business

3. Stock/Equity Ratio: the ratio of the market price of the junior stock issues to the total face amount of the debt, or the debt plus preferred stock

4. Property Value: The asset values, as shown on the balance sheet or as appraised, were formerly considered the chief security and protection for a bond issue

Conclusion

Investment history shows that bonds and preferred stocks that have met stringent tests of safety, based on the past, have in the great majority of cases been able to face the vicissitudes of the future successfully.

Common Stock Analysis

1. The valuation of common stock would ordinarily be found by estimating the average earnings over a period of years in the future and then multiplying that estimate by an appropriate "capitalization factor."

2. The now-standard procedure for estimating future earning power starts with average past data for physical volume, prices received, and operating margin.

3. The reader will note that quite a number of the individual forecasts were wide of the mark. This is an instance in support of our general view that composite or group estimates are likely to be a good deal more dependable than those for individual companies.

4. it is undoubtedly better to concentrate on one stock that you know is going to prove highly profitable, rather than dilute your results to a mediocre figure, merely for diversification's sake.

Factors Affecting the Capitalization Rate

Though **average future earnings** are supposed to be the chief determinant of value, the security analyst takes into account a number of other factors of a more or less definite nature. Most of these will enter into his **capitalization rate**, which can vary over a wide range, depending upon the “quality” of the stock issue.

1. General Long-Term Prospects: the views are reflected in the substantial differentials between the price/earnings ratios; EPS is also important

2. Management: It is fair to assume that an outstandingly successful company has unusually good management. The tendency to count it still another time as a separate bullish consideration can easily lead to expensive overvaluations.

3. Financial Strength and Capital Structure: Stock of a company with a lot of surplus cash and nothing ahead of the common is clearly a better purchase (at the same price). A modest amount of bonds or preferred stock however, is not necessarily a disadvantage to the common, nor is the moderate use of seasonal bank credit.

Factors Affecting the Capitalization Rate – cont.

4. Dividend Record: We think that a record of continuous dividend payments for the last 20 years or more is an important plus factor in the company's quality rating

5. Current Dividend Rate: the majority of companies have come to follow what may be called a standard dividend policy. This has meant the distribution of about two-thirds of their average earnings, except that in the recent period of high profits and inflationary demands for more capital the figure has tended to be lower.

   However, an increasing number of growth companies are departing from the once standard policy of paying out 60% or more of earnings in dividends.

   We have decided to defer our discussion of the vital question of proper dividend policy to a later section—Chapter 19—where we shall deal with it as a part of the general problem of management-shareholder relations.

Capitalization Rates for Growth Stocks

- The valuation of growth stocks

  Value = Current (Normal) Earnings × (8.5 plus twice the expected annual growth rate)

  The growth figure should be that expected over the next seven to ten years.

- What the valuer actually does in these cases is to introduce a margin of safety into his calculations—somewhat as an engineer does in his specifications for a structure.

- We should point out that any "scientific," or at least reasonably dependable, stock evaluation based on anticipated future results must take future interest rates into account.

Industry Analysis

- Because the general prospects of the enterprise carry major weight in the establishment of market prices, it is natural for the security analyst to devote a great deal of attention to the economic position of the industry and of the individual company in its industry. Studies of this kind can go into unlimited detail.

- There is doubtless a promising area for effective work by the analyst, based on field trips, interviews with research men, and on intensive technological investigation on his own. There are hazards connected with investment conclusions derived chiefly from such glimpses into the future, and not supported by presently demonstrable value.

A Two-part Appraisal Process

- We suggest that analysts work out first what we call the "past-performance value," which is based solely on the past record. If it is assumed that its relative past performance will continue unchanged in the future.
- The second part of the analysis should consider to what extent the value based solely on past performance should be modified because of new conditions expected in the future.
- Is a job of this kind worth doing? Our answer is in the affirmative.
- The read should pursue it systematically and thoroughly before he considers himself qualified to pass a final buy-or-sell judgment of his own on a security issue.