Chapter 14

Stock Selection for the Defensive Investor

The defensive investor who follow our suggestions will purchase only high-grade bonds plus a diversified list of leading common stocks. He is to make sure that the price at which he bought the latter is not unduly high as judged by applicable standards.

Defensive Investor’s two Approaches

1. Acquire a true cross-section sample of the leading issues, whose shares sell at especially high multipliers, and also less popular and less expensive enterprises.

2. Apply a set of seven standards to each purchase, to make sure that he obtains
   (1) a min quality in the past performance and current financial position of the company
   (2) a min quantity in terms of earnings and assets per dollar of price

Seven Criteria of Stock Selection (2nd approach)

1. Adequate size of the enterprise: >=$100 mil @ 1970; $ 2 bil now

2. A sufficiently strong financial condition
   - Current asset >= 2* current liability
   - Long term debt <= net current assets (or "working capital")
   - For public utilities, the debt <= 2* stock equity at book value

3. Earning stability: some earnings for the common stock for the past 10 yrs

4. Dividend record: uninterrupted payments for at least the past 20 yrs

5. Earning growth: min increase of at least 1/3 in per-share earnings in the past 10 yrs using 3 yrs average at the beginning and end

Seven Criteria of Stock Selection (2nd approach) – cont.

6. Moderate P/E ratio: current ratio <= 15* average earnings of the past 3 yrs

7. Moderate ratio of price to assets:
   Current price <= 3/2 x the book value last reported

   however, a multiplier of earnings below 15 could justify a higher multiplier of assets. As a rule of thumb we suggest that the product of the multiplier times the ratio of price to book value should <=22.5, which is correspondent to 15 times earnings and 3/2 times book value. It would admit an issue selling at only 9 times earnings and 2.5 times asset value, etc.

General comments:

- *These criteria are especially for the needs and the temperament of defensive investors. They will eliminate the great majority of common stocks as candidates in two opposite ways.*
- *The last two criteria are exclusive in the opposite direction, by demanding more earnings and more assets per dollar of price than the popular issues will supply.*
- *We have included a modest requirement of growth over the last decade. Without it the typical company would show retrogression.*
- *The suggested maximum figure of 15 times earnings might well result in a typical portfolio with an average multiplier of, say, 12 to 13 times.*

Application of our criteria to the DJIA at the end of 1970

30 stocks in the DJIA at 09 30, 1971

5 DJIA issues meeting certain investment criteria at end of 1970

Data categories

- Current price
- Earning per share, current and average
- Dividend since
- Current dividend
- Net asset value
- P/E
- Current div yield
- Earning growth history
- CA/CL
- NCA/debt (NCA – net current asset)
- Price/net asset value (what is net asset value?)

The public-utility “solution”

1. Public-utility stocks are more comfortable and inviting for investors. For the defensive investor the central appeal of the public-utility stocks at this time should be their availability at a moderate price in relation to book value.

2. Exclude one criterion, namely, the ratio of CA/CL. The working capital factor takes care of itself in this industry as part of the continuous financing of its growth by sales of bonds and shares. We do require an adequate proportion of stock capital to debt.

3. The position of the utilities as regulated monopolies is assuredly more of an advantage than a disadvantage for the conservative investor. The dividend return was significantly high.

4. Data on 15 stocks at 09/30/71 - price, earned, div., book value, P/E, Price/book value, div yield, EPS

5. Our old ally, experience tells us that it is better to sell and pay the tax than not sell and repent.

Investing in stocks of Financial Enterprises

1. "Financial companies" include banks, insurance companies, savings and loan association, credit and small-loan companies, mortgage companies and investment companies (e.g., mutual funds).

2. They have a relatively small part of their assets in material things – such as fixed assets and merchandise inventories – but most categories have short-term obligations well in excess of their stock capital. The question of financial soundness is, therefore, more relevant here than in the case of typical manufacturing or commercial enterprise. The financial regulation and supervision against unsound financial practices are critical to these companies.

3. The same arithmetical standards for price in relation to earnings and book value should be applied to the choice of these companies as we have suggested for industrial and public-utility investments.

Railroad Issues

1. Competition from automotives, buses, airplanes, trucks is very high

2. The market level of railroad shares as a whole was seriously affected by the financial disaster – e.g. Penn Central Transportation Co.

3. There is no compelling reason for the investor to own railroad shares.

Selectivity for the Defensive Investor

1. The selection of stocks from different analysts is different due to the various personal preference.

2. The future itself can be approached in two different ways – ***the way of prediction*** (projection) and ***the way of protection***.

3. The predictive approach is also called qualitative approach since it emphasizes prospects, management, and other nonmeasurable, albeit highly important, factors that go under the heading of quality.

4. The protective approach is call the quantitative or statistical appraoch which is our committed approach.

5. Our advice to the defensive investor is that he let it alone – emphasize diversification more that individual selection. If one could select the best stock unerringly, one would only lose by diversifying. So find a balance between these two.