Chapter 15

Stock Selection for the Enterprising Investor

The intelligent investor must follow specific methods that are not generally accepted on Wall Street, since those that are so accepted do not seem to produce the results everyone would like to achieve.

Summary of Graham-Newman Methods

- Arbitrages: ?
- Liquidations: ?
- Related Hedges: ?
- Net-Current-Asset (Bargain) Issues:
  Acquire as many issues as possible

Price <= 2/3*(net current asset – total liability)/outstanding shares

Should be less inflexible – e.g may not rule out a company which had shown a deficit in a year such as 1970, if large average earnings and other important attributes made the stock look cheap. The enterprising investor may confine his choice to industries and companies about which he holds an optimistic view, but we counsel strongly against paying a high price for a stock (in relation to earnings and assets) because of such enthusiasm.

Secondary Companies

- In order for examination and possible selection would come secondary companies that are making good showing, have a satisfactory past record, but appear to hold no charm for the public.

- Research the companies from *S&P’s Stock Guide*

  - The Standard & Poor's 500 Guide, 2006 Edition, ISBN-10: 0071468234
  - www.standardandpoors.com/

A Winnowing of the stock guide

1. Low P/E ratio: <=9 at end of 1970; <=10 after 1970

2. Financial condition:
   - Current assets >= 3/2*current liabilities
   - Debt/net current assets <= 110% (industrial companies)

3. Earning stability: No deficit in the last 5 yrs covered in the Stock Guide

4. Dividend record: some current dividend

5. Earnings growth: Last year's (1972) earnings more than those of 1966

6. Price: < 120% net tangible assets

Single Criteria for Choosing Common Stocks

- Favorite single criterion
  - Low P/E ratios of important companies (DJIA)

    Exception: the low P/E criterion applied to DJIA at end of 1968 worked out badly when the results are measured to mid-1971
  - Diversified group of stocks selling under NCAV (or NWCV)

    Drawback: opportunities dry out

- Experiments of single criterion:
  - Single criterion

1. Low P/E (not confined to DJIA)
2. High dividend return
3. Very long dividend record
4. Very large enterprise, as measured by #s of outstanding shares
5. A low price in relation to the previous high price
6. A high quality ranking by S&P

  - Experimental results
    - 90 randomly chosen issues declined 22% vs S&P 0%, DJIA -5%

Single Criteria for Choosing Common Stocks (cont.)

- Experimental results
  - 90 randomly chosen issues declined 22% vs S&P 0%, DJIA -5% from 12/31/1968 to 08/31/1971

  Moral of Intelligent Investor: to avoid second-quality issues in making up a portfolio, unless – for the enterprising investor – they are demonstrable bargains.

  - Other results show that only 3 groups are better than S&P (also DJIA)

    1) industrials w/ the highest quality ranking (A+) – except 10 public-utility issues
    2) companies w/ > 50 millions shares outstanding shows no change
    3) stocks selling at a higher P/E (over 100) showed a slight (1%) composite advance

  - Discovers
    - Companies that combined major size w/ a large good-will component in their market price did very well as a whole in the 2.5 year holding period
    - **Our own preference, however, remains for other types that show a combination pf favorable investment factors, including asset value >= 2/3 market price.**

Bargain Issues, or Net-Current-Asset Stocks

- Stocks of prominent companies selling at or below Net-current-asset value in 1970 (eliminate those which had reported net losses in the last 12-month period in 1970 we would be still left with enough issues to make up a diversified list)

TABLE 15-2 Stocks of Prominent Companies Selling at or Below Net-Current-Asset Value in 1970

Company	*1970 Price*	*Net-Current-Asset Value Per Share*	*Book Value Per Share*	*Earned Per Share, 1970*	*Current Dividend*	*High Price Before 1970*
Cone Mills	13	$18	$39.3	$1.51	$1.00	41½
Jantzen Inc.	11⅛	12	16.3	1.27	.60	37
National Presto	21½	27	31.7	6.15	1.00	45
Parker Pen	9¼	9½	16.6	1.62	.60	31¼
West Point Pepperell	16¼	20½	39.4	1.82	1.50	64

- If the “market doesn’t like a company”, not only renowned trade names but land, buildings, machinery, and what you will, can all count for nothing in its scales. – **this is why these companies are deep undervalue**.
- How can we make money in them w/o taking a serious risk?
  If you can find enough of them to make a diversified group, and if you don’t lose patience if they fail to advance soon after you buy them.

Special Situations or “Workouts”

- Situation #1: Acquisition of Kayser-Roth by Borden’s

- Situation #2: National Biscuit Co. offered to buy control of Aurora Plastics Co.

- Situation #3: Universal-Marion Co asked its shareholders to ratify dissolution of the concern

- The trick here, of course, is to have the judgment, buttressed by experience, to pick the deals most likely to succeed and also those which are likely to occasion the smallest loss if fail.