Analysing Companies: Four Classic Mistakes

By Michael Kemp

The Holy Grail for most stock market investors is to achieve market-beating returns. If that's your goal then it's important to realize that you'll be pitting your stock-picking skills against plenty of savvy investment professionals, men and women who have devoted their careers to the process. While that might sound a bit like shaking the dust off your old High school tennis racket and taking on Roger Federer, the reality is, armed with some solid investment principles, the investment game doesn't have to be so one-sided.

To help you on the road to success this article takes a look at some common mistakes investors make when analysing companies, in the hope that you'll avoid making them yourself.

Blindly relying on historical data

Common sense tells us that investing is all about the future. After all, we only invest money today in the expectation we'll receive more back later on. But one of the toughest questions in investing (and also in trading) is how do we get a handle on what's going to happen in the future?

Eighteenth century politician Patrick Henry addressed this issue when he said, "I know no way of judging the future but by the past". Henry wasn't referring specifically to the stock market but it's certainly how the stock market behaves. How often do you see the share price of a company soar or collapse immediately following the release of a surprise profit result? Which shows that the market judges future profitability (embodied in the current share price) by past results.

So the question needs to be asked: when analysing companies, does past performance provide a useful guide to future performance? Like most things to do with investing there's a dichotomy of opinion on this issue. Consider the findings of stock market researcher, Ian Little, who concluded from his 1962 study on company earnings growth that:

Any unbiased reader of this chapter must come to the conclusion that there is no tendency for previous behaviour to be repeated in the future.

Confused? I don't blame you. Personally I deal with the problem by varying my use of the rear view mirror depending on the company I'm looking at. For example:

- I place more faith in historical data as a guide to the future if the company is operating in a relatively stable business sector (for example utilities and consumer staples).
- I also place more faith in historical data if the company has greater control over the prices it charges for the goods and services it sells and has a dominant position in its sector.
- When considering cyclical businesses (like mining, building and discretionary retail) I tend to look at long-term averages of historical data (10 years), so as to "flatten out" cyclical variations.
- Finally, all this rear gazing needs to be tempered with a solid appreciation of the dynamics of the business, its future prospects, the competitive forces within the sector in which it

operates, and a balanced view on what the future could possibly deliver. In other words, understanding the company is essential.

The mistake many investors make is to rely solely on historical data. They plug it into “black box” formulae - and then trust the output, but as investment great, Ben Graham, said:

There must be plausible grounds for believing that this average or this trend is a dependable guide to the future.

Selecting stocks simply because they have a low PE Ratio

In my earlier article *PE Multiple* I wrote about the dangers of relying on the PE ratio when selecting stocks. So I won’t go into a lot of detail here, but I will recap on the main points:

First up there’s the often stated problem of how the PE ratio is calculated – by dividing the current share price by the last reported earnings per share. The problem is the numerator (the current market price) is continually updated but the denominator (the earnings per share) is only as current as the last financial statement. Therefore price-sensitive information, released since the last earnings report, will be incorporated into the numerator but not the denominator.

That means recent bad news can see a conventionally calculated PE fall sending out a false signal that the company’s shares are cheap. In an attempt to overcome this deficiency, the PE is often calculated using estimates of prospective earnings rather than historical earnings.

A less appreciated problem is that PE ratios of companies are rarely directly comparable. That’s because the PE ratio is dependent upon a number of variables, for example market expectations regarding the company’s return on equity, growth in earnings and its operating and financial risk. Vary these and the “justifiable” or “fair” PE also varies. And since it’s extremely unlikely that any two companies carry the same combination of these variables comparability based solely on the PE ratio is ill considered.

Chasing dividend yield

I totally appreciate that the size of a company’s dividend is important to many investors, particularly to retirees who rely on the income to fund their living expenses. But selecting a single stock purely on the basis of its dividend yield (annual dividend divided by the current share price) is a mistake many investors make.

The first problem is, like the PE, it’s calculated using measures which are mismatched with respect to time. It’s typically calculated by dividing the historical annual dividend by the current share price. Perversely the dividend yield can increase following an announcement indicating the future dividend could fall (if the announcement causes the current share price to fall).

It might also surprise some shareholders to learn that it’s not always in their best interests to receive a dividend. If their company is bristling with new investment opportunities, all capable of delivering a great return on reinvested funds, then shareholders should prefer profits to be retained by the company rather than paid out as a dividend. If management can profitably reinvest the money then what shareholders lose as a current dividend should be more than compensated for by future appreciation in the share price.

So the simple question to be answered regarding dividends is not how big they are but rather: Is the money better off in the hands of shareholders in the form of a dividend or is it best retained by the company and reinvested?

One of the most successful companies on the planet (Berkshire Hathaway) hasn't paid a dividend since 1967. It's CEO, Warren Buffett, has been heard to say: *If you want a dividend then just sell some shares*. And at a current market price of $US 223 600 per share you wouldn't have to sell too many shares to be paid back those dividends you missed out on!

Paying too much for Growth

A common mistake investors make is to select stocks based purely on performance metrics. For example I hear people say "choose stocks with high return on equity and high earnings growth metrics". That's fine, but a great company doesn't equate to a great investment if the market is offering it at an outrageous price. Sometimes a company with lesser performance metrics represents a better investment simply because it's being offered at an attractive price relative to its potential future returns.

One thing I've noticed over the years is that a past record of high earnings growth and a high return on equity are like steroids for a company's share price. But when the company's return on equity eventually falters (commonly due to increasing competition as other companies are attracted to that high margin business space) and/or the earnings growth slows (as it almost invariably does) then the share price collapses. This often leads investors to believe that there's something fundamentally wrong with the company. More often the company is sound; it's just that the market had previously overpriced it.

Now, there's plenty more I could have talked about but there's only so much that can be said in an article of this size. But I've covered these and many more investing issues in much greater depth in my new book titled *UnCommon Sense* (Investment Wisdom since the Stock Market's Dawn).

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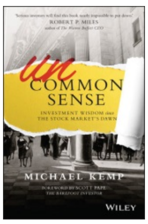

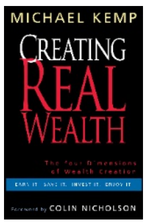

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.