Finding Safe Stocks Likely to Outperform

Over the long term, investing in stocks will give a higher return than most other asset classes, especially if the return is considered after the corrosive effect inflation has on purchasing power. However, investing in stocks is not without risk. Some companies fail. Most stock prices fluctuate over time. If there was no risk, then the return would be much lower. The task for investors is to know how to select stocks for their portfolio that are truly investment grade businesses and that can be bought at a price that is low relative to value. Here are some guidelines.

Only Buy Investment Grade Stocks

There are over 2,000 securities listed on the Australian Securities Exchange. Most are not investment grade. To get to a short list of potentially investment grade stocks is simple: run a filter that lists stocks that make a profit (Price Earnings Ratio > 0), pay a dividend (Dividend Yield > 0) and have a liquid market (say a Market Capitalisation > $500 million). That will generate a list of around 200 stocks and will keep you away from the real rubbish stocks. I publish a scan each week on my members website www.bwts.com.au. The scan may also be done in Stock Doctor.

That are Rising in Price

A good way is to look for stocks that are making new 52-week highs in the last week, which can be done by running a simple scan of the above investment grade stock list. My ideal is to find the ones that have been going sideways for a year or more and are now starting to rise, rather than stocks that have been rising for a year or more, where it may be late to join the party. This is based on my two models that are explained in my book *Building Wealth in the Stock Market.* I publish a scan each week on my members website www.bwts.com.au.

With Growing Earnings and Dividends

This is best seen in visual form by graphing earnings per share and dividends per share for at least the last ten years. Most leading broking websites have the data from which to do this. Some companies publish a graph in their investor presentations, available on the ASX website Announcements page.

With a Moderate Price Earnings Ratio

There are various definitions for price earnings ratio, so understand your source and use it consistently. Moderate is in the eye of the beholder, and must take into account the characteristics of the business that underlies the stock. I use these guidelines: For value stocks that are generally in cyclical industries, I prefer a price earnings ratio that is significantly below the market average. For growth stocks that are often in less cyclical industries, I prefer a price earnings ratio that is not too far above the market average. The market average is published weekly in the Weekend Australian Financial Review.

With a Relatively High Grossed-up Dividend Yield

Relatively high is again in the eye of the beholder. My guidelines are: for value stocks that are generally in cyclical industries, I prefer their dividend yield to be above the market average; for growth stocks that are often in less cyclical industries, prefer their dividend yield to be not too far below the market average. The market average is published weekly in the Weekend Australian Financial Review and may be grossed up assuming 75% franking.

With an Appropriately Low Debt to Equity Ratio

The word appropriate is important. What is appropriate depends heavily on two things. Firstly, on the nature of the industry the business operates in: the more cyclical the industry the lower the appropriate debt to equity ratio. Secondly, on your level of risk tolerance and experience: the lower your risk tolerance and the less experience you have, the lower the appropriate debt to equity ratio. My rule of thumb is a maximum of 40% debt to equity for a cyclical business and 60% for a non-cyclical business. There are varying definitions of ratios here, so understand the ratio you are using and adjust the rule of thumb accordingly. The ratio is easily calculated from the Statement of Financial Position (balance sheet): Non-current financial debt divided by Shareholders Equity expressed as a percentage.

With a Strong Return on Equity

Of course, strong here is in the eye of the beholder. I base it on my cost of capital, which is a term that describes the return I want that will compensate me for the inherent risk of investing in stocks. My cost of capital is 12.5%. So, I want a return on equity that is higher than 12.5%. The ratio is easily calculated from the accounts: earnings before tax from the Statement of Financial Performance (P&L account) divided by Shareholders Equity from the Statement of Financial Position, expressed as a percentage. It is important to look at the trend over recent years. The ratio is available in Stock Doctor. One point to remember is that the ratio is affected by the level of debt and some analysts prefer using a return on assets ratio.

This article has been designed as a basic guide to keep private investors generally safe in the market. However, it must be recognised that any business can get into trouble. It is therefore a good policy to recheck the key measures above each half year to make sure the business remains on track. It is even better to work at improving your understanding of the business. After all, by investing in a stock, you have become a part-owner of the business, not just someone who is trading the stock price. There is no real substitute for sifting through the list based on the above guidelines and selecting the best businesses that will have good management and a strong competitive advantage in their market.

This article was written for the Australian Investors Association and published in the September 2016 issue of *The Investors Voice.*

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Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

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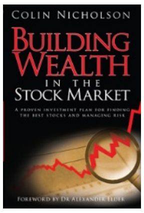
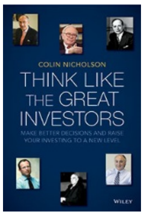
I have written two books, both of which are available for purchase from the ***Buy Books*** menu:





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Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website