

Stock Picking Techniques: The Practice Of Applied Money Managers

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ABSTRACT

This study examines the diverse methods practitioners of money management use in order to choose stock investments. The authors discover they use discounted cash flow, multiples, balance sheet approaches. Additionally, they consider industry forces such as demographics and psychographics.

Keywords: Stock Picking; Demographics; Psychographics; Discounted Cash Flow Approaches; Asset Valuation Approaches; Debt; Book Value; Market Value Demographics; Psychographics and Industry Analysis

INTRODUCTION

There is a debate about whether markets are efficient or not. The theorists who are in the efficiency camp believe that all public information is reflected in the stock prices. The proponents of the efficiency market hypothesis (EM) believe that investors may not beat the average rate of return (ROR) of an index such as the S&P, for example (Fama, 1970). The one method according to which the investors can beat the market is by having private (non-public) information. Thus, the recommendation of that viewpoint would be to not attempt to surpass the ROR at a given risk. In other words, the efficiency camp would suggest investing in an index fund since one cannot do better than the index fund. Furthermore, there are greater fees involved with managing money actively.

The other viewpoint - that of inefficiency in the stock market - would argue that superior security analysis could lead to superior ROR at a given risk (Rosenberg, Reid and Lanstein, 1985). Thus, it behooves investors to pursue practical money management actively so they can beat the S&P index, let us say. The basic viewpoint, which contradicts the efficiency hypothesis, is technical analysis. It is diverse methods which purport to forecast rate of return developments. Technical analysis recommends to its proponents to aggressively invest based on historical trends and patterns (Lo, Mamansky and Wang, 2000).

The third viewpoint that differs somewhat from the efficiency view is fundamental analysis which is an approach that examines economic, financial, political, social, and legal factors. It believes these factors importantly affect prices since they affect ROR and risk of the investments. Its proponents feel that superior analysis of money managers will lead to higher ROR, thus better investments. Security analysis is valuable since it will attain the aforementioned. The implication is that money managers ought to pursue active fundamental analysis to attain better values and ROR.

Fundamental analysis usually uses a top-down approach which consists of 1) a market and economy analysis, 2) an industry analysis, and 3) a company analysis. A company analysis is the most critical one. According to the evidence, superior ROR for diverse firms could occur in an environment of declining ROR for an industry. Of course, this is the exception rather than the rule, but, nevertheless, it is informative. It is easier to have superior company ROR in an industry which is doing well (Cavaglia, Brightman and Aked, 2000).

There are several approaches in stock picking: 1) the asset valuation approach, 2) the diverse multiples ratio approach, 3) the dividend yield view, 4) the discounted CF approach, and 5) the view of Fama and French who found that market cap, degree of debt of the firm, and the ratio of BV/MV influence the ROR (Fama and French, 1992).

The asset valuation approach examines the financial statements and utilizes book value per share (BVPS) as its criteria. This approach divides the book value (BV) of the equity by the number of shares. It argues that this can be a comparable concept to the price per earnings per share (P/E) of the firm. The second approach - the replacement cost per share - says that the price per share will not deviate too much from the replacement cost per share since arbitragers will buy the firm if replacement cost per share falls below price per share. The third approach of liquidation value per share (LVPS) sets a floor price for the stock. The respondents use those approaches frequently. They choose BVPS, RCPS and LVPS by 72%, 44% and 70%, respectively.

The second basic group of valuation techniques is the multiples one (Goodman and Peavy, 1983). There are several such ratios of which the most important are the price/sales, price divided by cash flow (P/CF), price over operating profit (P/OP), and price over earnings per share (P/E) ratios. By far, the most popular is the P/E ratio. The reason that the authors look at this is to know how much the market pays for the earnings per share (EPS) of a stock. However, other ratios, or multiples of other variables, have been developed. The first is the P/sales. It was developed since EPs can be volatile. Sales are less volatile, so the criteria would have less volatility. P/CF was also developed for the above reason and especially since a few firms may have negative EPs but positive CF. Finally, a few analysts want to know what the ratio is for operating profit due to the fact that they want to separate operating profit from financial and tax issues. The respondents choose P/E, P/OP, P/sales and P/CF by 82%, 73%, 60% and 40%, respectively. These answers show that portfolio managers use these multiples substantially in managing money.

The dividend yield is a proxy for risk. If it rises, ROR rises, and if risk falls, ROR falls. As a repercussion, if dividend yield increases, price of a stock rises, and if dividend yield decreases, price of the stock falls. One derivation of the cost of equity (coe) is by using the Gordon model and manipulating the formula so that it becomes a dividend after the first period over the stock price plus the growth rate of the dividends and the price. This is stated as $(D1/P) + g$. A substantial percentage of practitioners (66%) utilize the DDM approach which is an additional view that can be used.

The fourth approach is the discounted cash flow (DCF) models. Presumably, the reason investors want to invest in a security is to receive the money generated by that security. Since they receive the cash over time, in order to make sense out of competing investments, they need to express the values in terms of now. Thus, they use the DCF approaches. The other models the authors use should really be complementary to the DCF models. Fundamentally, the present value of cash flow of diverse definitions determines the value of a stock. Two of the DCF views are the discounted dividend (DDM) and the DCF model. Applied financiers choose DDM and DCF models by 40% and 82%, respectively.

Fifth, the authors wanted to test the theory of Fama and French who showed that debt level, market cap and the BV/MV of a firm affect ROP and price. Specifically, they showed that higher (lower) debt firms have higher (lower) ROR. This is reasonable because higher/lower debt has higher/lower risk. Next, market cap is a substitute for the "fame" of a firm. Fama and French show that non recognized firms do better than well recognized firms in their ROR. Finally, they show that the higher/lower BV/MV is, the higher/lower the ROR. The reason is that if BV/MV is higher (lower), the stock price is relatively lower (higher), and so its ROR becomes higher/lower. The respondents chose the above by 61%, 69% and 49%, respectively.

In industry analysis, analysts use demographics and psychographics to evaluate the demand for the product and, consequently, the ROR of the industry. The examination of demographic and psychographic factors, however, continues with the company analysis as well. If one was to examine an automobile, a builder, a brewer, a personal computer and a pharmaceutical firm, they would receive different results. Population size and growth affect all of the aforementioned industries quite substantially. Age distribution would influence the pharmaceutical firm much more than the other firms. Geographic distribution may not affect the pharmaceutical company or the distiller at all,

while it may be very important for automobile demand. Income distribution affects the car, builder and personal computer firms a lot but does not influence pharmaceutical sales much and probably affects the money spent on drinking minimally. Family size affects the number of autos, the size of houses and the sales of PCs, but has no bearing on pharmaceutical or alcohol sales. Occupation of family influences PC sales substantially and influences the other firms less. Family formation is crucial for builders and it really does not affect the other firms much. Head of the family may affect size of houses and perhaps auto sales somewhat but would not influence the others much (Reilly and Brown, 2003).

Portfolio managers apply the concepts of demographics strongly in their managing of portfolios. The three top choices they have are age distribution (77%), population growth/level (73%) and geographic distribution (66%). Following those demographic attributes, they choose income distribution (63%), family size (39%) and occupation of family (31%). Lastly, family formation and head of family receive only 18% and 13 % of the responses, respectively.

Lifestyles importantly can affect all of the above firms where the auto and housing producer would be influenced the most. The practitioners responded that they emphasize it 19% of the time.

CONCLUSION

The authors have shown that practitioners of money use several different techniques in picking stocks. They use discounted cash flow methods, but they supplement them with multiples and asset values approaches as well. They also choose equities in a context of the industries in which the equities are found. Thus, they use industry analysis of the demographic and psychographic kinds. An Appendix highlighting the specific stock market picking techniques, as well demographics and/or psychographics criteria used to forecast profitability potential in a certain market has been provided.

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APPENDIX

A. Question A

If you use stock picking, which specific technique do you use?

- 1. Discounted dividends -----
- 2. Discounted cash flow -----
- 3. Book value per share -----
- 4. Liquidation value per share -----
- 5. Replacement value per share -----
- 6. Price to sales value per share -----
- 7. Price to operating profit per share -----
- 8. Price to earnings per share -----
- 9. Market capitalization -----
- 10. Degree of leverage of the firm -----
- 11. Book value over market value of equity -----
- 12. Dividend yield -----
- 13. Tobin's Q -----
- 14. Other, please, specify -----

B. Question B

If you use demographics and/or psychographics to forecast profitability potential in a certain market, how do you weigh the following different aspects of the market?

- 1. Geographical distribution -----
- 2. Age distribution -----
- 3. Income distribution -----
- 4. Population growth and level -----
- 5. Family size -----
- 6. Family formation -----
- 7. Ethnic distribution -----
- 8. Head of the family -----
- 9. Education of family -----
- 10. Occupation of family -----
- 11. Attitudes of family -----
- 12. Other, please, specify -----

NOTES