

OPENING SHOT **JAMES K. GLASSMAN**

Digging for Deep Values

Investing, like so many other endeavors, is a quest for an edge. You can certainly invest in a bundle of companies, such as those that make up Standard & Poor's 500-stock index, and achieve market returns—historically, about 10% a year, on average. But most of us would like to do better. // That's not easy. The efficient market hypothesis holds that the

price of a stock reflects everything that could possibly be known about it right now, including profits anticipated in the future. So you can assume that, for most stocks, today's price is "correct"—that is, investors are unlikely to be missing important information about a company.

Still, as Warren Buffett wrote in his 1988 letter to Berkshire Hathaway shareholders: "Observing correctly that the market was frequently efficient, [certain economists] went on to conclude incorrectly that [the market] was *always* efficient." The fact that it is not is the source of Buffett's success as an investor.

Where to look. There are two major areas of inefficiency in the stock universe: micro-cap stocks and value stocks. While I am a fan of micro caps, the smallest of the small (see "Opening Shot," July 2010), I worry about their volatility. The ex-

tremes of their ups and downs are about twice that of large-capitalization stocks. Value stocks, on the other hand, are both inefficient and relatively tame.

A value stock is one that is unloved. Its price is low compared with the underlying company's net worth or performance. In his classic book *What Works on Wall Street*, James O'Shaughnessy looked at data over 52 years (ending in 2003) and found that stocks chosen on the basis of value indicators often turned out to be winning investments. Stocks with lower ratios of price to earnings, price to book value (a company's net worth, or assets minus liabilities) and price to sales outperformed stocks with higher ratios.

The reason seems to lie in investor psychology. While we revel in a bargain price for a car or a steak dinner, we tend to buy stocks others like, too, with prices that reflect that popularity. "Sev-

eral academic studies," says the *Ibbotson S&P Classic Yearbook*, "have shown that the market overreacts to bad news and underreacts to good news. This would lead us to conclude that there is more room for value stocks ... to improve and outperform growth stocks."

Whatever the reason, value stocks have, over time, thrashed growth stocks. Research by Eugene Fama and Kenneth French that differentiates between growth and value by using price-to-book-value ratios finds that over the past 81 years, large-cap growth

deep value stocks, the super bargains. I have three methods. I browse the pages of the *Value Line Investment Survey* (www.valueline.com), particularly its weekly listings of stocks selling at the widest discounts from book value. Second, I troll the news for companies experiencing troubles that may pass. Finally, I poach from the picks of some of the better bargain-hunting mutual fund managers.

Value Line's rating system stresses momentum, so stocks that receive a top rank of 1 for "timeliness" typically fall into the growth

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stocks have returned an average of about 9% annualized, compared with 11% for value stocks. For small caps, the difference is even greater: 9% annualized for growth, 14% for value. There is a trade-off, however. For large caps, value stocks are about 40% more volatile than growth stocks; with small caps, growth stocks and value stocks are about equally volatile.

So the question is how to find value stocks—especially

category. Instead, I'm looking for stocks that will be discovered in a few years, such as **IMATION CORP. (SYMBOL IMN)**, a maker of removable data-storage products.

Imation is an ideal deep-value stock, with a price-to-book-value ratio of about 0.6 and a price-to-sales ratio of just 0.3. For both of these indicators, a ratio of less than 1.0 typically signifies a bargain. Imation has no debt, and at last report it had \$300 million, or \$8 per

share, in cash. Yet the stock traded for just a bit more than \$11 (prices and related ratios are as of March 10). Of course, there's a catch: The Oakdale, Minn., company has been losing money lately. In 2006, Imation earned more than \$2 per share. If the company can get back to that level of profitability, which I think is possible in a few years, investors should be rewarded handsomely.

In the troubled-company department, I recently ran across **EAGLE BULK SHIPPING (EGLE)**, a maritime transporter that depends a great deal on coal exports from Australia, which have fallen off because of record floods in that country. To make matters worse, a large South Korean client of Eagle's recently went bankrupt. The recession hurt, too, and Eagle's shares have plummeted from a high of \$36 in 2008 to just \$4. At that price, the stock trades at about 40% of book value. Will Eagle come back? There's no way to tell for sure, but the company remains profitable, and Value Line projects cash flow

(earnings plus depreciation and other noncash charges) of \$1.50 per share this year.

As for poaching, I use Morningstar's Web site to look up the top holdings of some of my favorite value-leaning mutual funds. A good example is Yacktman Fund (YACKX), which, under manager Don Yacktman, has returned an annualized 11.8% over the past ten years, compared with 2.4% for the S&P 500. One of the fund's chief holdings is **PFIZER (PFE)**, with a P/E of just 9 (based on estimated 2011 profits) and a dividend yield of 4.1% (a high yield often indicates value). Yes, Pfizer will soon lose patent exclusivity for Lipitor, its blockbuster anti-cholesterol drug, but that's the reason to *buy* the stock, not sell it. Knowledge of the loss is already built into the share price—and then some.

The portfolio of Roumell Opportunistic Value (RAMVX) bears watching. The fund, launched this year, is run by James Roumell, a Chevy Chase, Md., money manager who was one of the stars of the *Wall Street Journal's* now-

defunct weekly stock-picking contest. Roumell, whose performance numbers over the past decade are similar to Yacktman's, says his main criterion for deep value is a positive answer to the question, "Would I take this company private in a heartbeat?"

Consider Roumell's analysis of telecom giant **CISCO SYSTEMS (CSCO)**. With the stock at \$18, Cisco's market cap is about \$99 billion. From that, subtract the company's net cash (cash on the balance sheet minus debt outstanding) of \$24 billion. That leaves \$75 billion. Now look at cash flow (Morningstar.com is a handy source for these figures). It was \$10 billion for the fiscal year that ended July 2010. Subtract \$1 billion in capital investments, for a *free* cash flow figure of \$9 billion. That's the money that can be used to pay dividends, buy back shares, make acquisitions or just be put aside for the future.

If you divide that \$9 billion into Cisco's adjusted market cap of \$75 billion, you get 12%. That figure is effectively what Cisco would yield if it

distributed all of its free cash flow in the form of dividends. The calculation allows Roumell to judge Cisco as if he were investing in a bond. "We will sell," says Roumell, "if the yield falls to 7%"—because Cisco will no longer be a deep value.

Roumell also wants to be convinced that "there is at least an 80% probability" that free cash flow won't decline from last year's level. He is confident that it won't. With Internet usage continuing to grow at a rapid pace, demand for Cisco's networking products will remain strong, he says. That should lead to higher sales, profits and cash flow.

Cisco was a lot easier for most investors to buy in the late 1990s, when it was considered a growth stock and its price was soaring, than it is today, when it's labeled a value stock and has fallen 31% in the past year. Deep-value investors need to have the discipline and imagination to go it alone. ■

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