

GROWTH AT A REASONABLE PRICE (GARP): MY INVESTMENT STRATEGY

My investment strategy has been one that favors large cap growth, but 1999's "irrational exuberance" and the subsequent burst bubble have really changed growth investing, including mine. In general many investors have moved from the long-term, buy-and-hold style to short-term trading, effectively killing the momentum of growth stocks as they are sold short-term to take profits. I have included more mid-cap companies and incorporated more value-oriented criteria into my stock screening.

My screening process includes a company's past growth and future expectations for growth and consideration of the overall quality of the company, which has to do with management, debt, and risk. Once a company has passed these tests of growth outlook and quality, it must be determined that the stock is not overpriced. These are the elements of growth at a reasonable price (GARP), and most of these criteria are listed for companies I recommend on my Growth Stock Recommendation List.

GROWTH

I still look for growth first and foremost. But how do you identify growth stocks? Investorwords.com defines a growth stock as: "Stock of a company which is growing earnings and/or revenue faster than its industry or the overall market. Such companies usually pay little or no dividends, preferring to use the income instead to finance further expansion." I used to only consider companies whose growth outlook was greater than the overall market (S&P 500 Index). Now I will recommend stocks with a slightly slower growth outlook, if their dividend yield makes up for that difference, and if the stock is appropriate for the portfolio in question.

Although past results are no guarantee of future performance, they are the only certain data we have for judging a company's strength and a management's credibility. One of the first things I consider is a company's *history* of earnings and revenue growth.

EARNINGS PER SHARE (EPS) AND REVENUE GROWTH

Generally I look for companies that have positive earnings and have been increasing EPS and revenue for several years in a row. This consistency in the right direction is an indication of competent management. Occasionally I will recommend a stock that does not yet have this positive record, if I feel the evidence indicates that earnings and revenues will start to increase progressively from this year on.

5-YEAR GROWTH FORECAST

First, I should say that *these are estimates*. They are provided by equity research analysts who cover these stocks for brokerage firms. Theoretically these people are experts about the companies they follow, but there is no guarantee their forecasts will be accurate. The estimates are stated as an annualized percentage growth. The most recent estimate for the S&P is 13%; so I look for stocks with estimates of 14% or greater annualized growth. **NOTE:** I think more often than not analysts' growth estimates err on the high side. I often subtract 5% from the long-term growth estimate and see if the stock still passes my screen. Then I am more confident of the outlook.

OVERALL QUALITY

MANAGEMENT

This criterion is a difficult one to quantify, but there are telling elements in news releases and objective statistics that highlight good management: a) credibility in that their predictions of the company's earnings are almost always accurate, i.e. they don't report disappointing earnings and negative guidance about future earnings; b) they have recognized the need for changes to the business model and made the changes needed to continue growth, such as acquisitions that enhance the company or sales of unprofitable segments of the company; c) their company has had consistently positive earnings and earnings growth; d) they have been with the company for a long time; and e) their salary, bonuses, and stock options are not unconscionably high.

DEBT/EQUITY

Too much debt is particularly bad in a rising interest rate time like now. Interest payments on debt should not be growing faster than profits. I look at total debt as a percentage of total equity. My general guideline is that debt must be lower than equity, i.e. less than 1.0. (It's difficult to establish a guideline for financial companies, which naturally assume more debt.) While too much debt is typically a warning sign, some debt can be good if it is used to increase the return on equity. If the growth is strong enough, more debt is acceptable.

MISCELLANEOUS/INTANGIBLES

Other positive qualities I look for are things like: being the leader in the industry; being the first to market with a stellar new product; having the lowest costs in a competitive industry; being well-positioned to benefit from an imminent major change in the industry; personnel or corporate governance changes that improve the company's value to shareholders.

VALUE

The following criteria establish whether the stock is overpriced or a good opportunity for purchase.

PRICE/EARNINGS

As a benchmark, the P/E (price divided by earnings per share) for the S&P 500 is currently about 20. As a rule of thumb I choose stocks with P/Es lower than or not much higher than the S&P multiple, because their price still has upside potential without being over-priced compared to the rest of the market. Stocks in high-growth sectors, such as biotech, usually trade at P/Es higher than the broad market, so I will not rule out a stock because of a higher P/E in such a sector; and lower growth sectors, such as energy, are awarded lower P/Es, so I instead compare their P/Es to those of their industry peers.

The P/E is also called the "multiple", because it indicates how much investors are willing to pay for a stock, i.e. how many *times* the earnings per share the price will attain. Sometimes the multiple is just obviously too high, driven up by pure momentum and not by fundamentals, or so low there seems to be little downside risk. The first situation is one to avoid buying into, and the second should be researched further before buying, because there is always some downside risk.

PRICE/SALES

The P/S can be used to identify stock prices that are too high relative to revenues, and is a better measurement than P/E in my opinion. For one thing, in the case of a company that has negative EPS, the P/E will be negative and of no value as an indicator of value. As long as future earnings are projected to be positive, the P/S can be used to detect how accurately the stock is valued, even if current earnings are negative. Generally a P/S ratio less than 1.5 indicates an under-priced growth stock. Again, with stronger growth forecast for the stock's future, a higher P/S can be allowed. Another reason P/S is a better indicator is that EPS can be more easily manipulated

by accounting. EPS reports often include a number of "one-time charges" or large write-offs that result in adjusted EPS and end up confusing the data.

FORWARD P/E

Whereas the "regular" P/E is a backward-looking measure, indicating the ratio of price to the earnings of the previous 12 months, the Forward P/E gives us a picture of what we are more interested in: the future. It compares the current price to the earnings projected for a future time period. In my Growth List I am using earnings estimates for 2004, but will switch the Forward P/E denominator to earnings estimates for 2005, probably later in the third quarter. The Forward P/E for the S&P is 17, compared to the current P/E of 20. The Forward P/E should be less than the current P/E, because that indicates earnings are estimated to be greater in the future. Generally I look for two things in the Forward P/E: 1) that it is smaller than current P/E; and 2) that it is "reasonable", i.e. that it is less than that of the S&P for some sectors, and for higher growth sectors that it is not exorbitant.

P/E/G

This criterion is often the first I look at, because it reflects several ingredients: price compared to earnings, compared to the growth outlook. I feel it really lets you know if the stock is priced accurately, according to its current earnings performance and considering its growth forecast. As a rule of thumb a stock is fairly valued when its P/E is the same as its long-term growth rate, which results in a P/E/G of 1. However, if a stock is a consistent grower, it is more valuable and deserves a higher P/E/G. I feel comfortable recommending a stock with a P/E/G over 1 (but less than 2) if the long-term growth rate is at least 14%, and other criteria are met.

Sometimes there are reasons to avoid, rather than buy, stocks with "undervalued" P/E/Gs (i.e. less than 1): a) the growth forecasts seem too high; b) anticipated changes in the company, the industry, or the economy will negate the positive outlook currently held; c) the price is so low because investors do not have confidence in the company or its leadership.

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30 July 2004