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Investing

Picking stocks: more than just P/E ratios and dividend yields

By Michael Chu, Investment Advisor

In the past, we've discussed the evidence behind using specific variables for picking stocks, such as price-to-earnings (P/E) ratio and dividend yields. Both of these variables have strong track records, but we don't use them in isolation.

Using more variables, provided they are effective and make sense, gives us a well-rounded approach in making stock decisions. For example, if we only used dividend yield to select stocks, we might exclude many good companies that are focused more on growing their business than on paying out dividends. Or, if we only used P/E ratios, we might exclude companies that have high depreciation or depletion expenses, such as oil companies.

Fortunately, there are other variables that have similar characteristics to why we use P/E ratios and dividend yields. These other variables look at companies from slightly different angles, giving us a more complete picture of which stocks have a better chance of doing well. We'll discuss three of them: price-to-cash flow, price-to-sales and price-to-book.

First, let's look at *price-to-cash flow*. Cash flow is net income, but without depreciation and other non-cash expenses. It's sometimes preferable to P/E because cash flow is harder to manipulate than earnings. Also, it's better for comparing companies that have high or variable amortization, depletion or depreciation expenses. Over 45 years, picking low price-to-cash flow stocks outperformed the market average by 5% (16.2% versus 11.2%). High price-to-cash flow stocks did much worse, underperforming by almost 8% (3.5% versus 11.2%).

Price-to-sales is similar to P/E, but it measures price against annual sales instead of earnings. Over 45 years, picking low price-to-sales stocks returned 14.5% versus 11.2% for the market benchmark. On the other hand, high price-to-sales stocks returned only 3.3%.

Price-to-book is the current price divided by the company's book value. Book value is what the company's assets, such as machinery or property, would be worth if you sold them. Over 45 years, picking low price-to-book stocks returned 13.8% versus 11.2% for the market benchmark. But high price-to-book stocks returned only 8.8%.

You may have noticed that the amount of outperformance using price-to-book value isn't as much as the other variables. But that doesn't make it less useful. That's because we don't use the variables in isolation. Rather, we combine the variables to pick the best overall stocks. We've found that it's better to choose a stock that's ranked pretty good in all these variables, rather than a stock that is outstanding in one variable but mediocre in the remaining variables. Sure, there will be times when one variable does extremely well – the problem is, we don't know when that will be. By combining the variables, we reduce the periods of underperformance and improve the consistency of outperformance.

Michael Chu is an Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

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Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca