When All Stocks Are Value Stocks - Think QDI

Value stocks are those that tend to trade at lower prices relative to their fundamental characteristics than their more speculative cousins, the growth stocks; they have higher than usual dividend yields and lower P/E and P/B ratios. So when all stock prices are down significantly, have they all become value stocks? Or, based on the panicky fear that tends to overwhelm media and financial experts alike, haven't they all taken on the speculative characteristics of growth stocks?

Well, to a certain extent they have, because the lower value stock prices go, the more likely it is that they will eventually experience the 15% ROE that typifies the classic growth stock. Interestingly, by definition, growth stocks are expected to be associated with profitable companies, a fact that speculators often lose site of. There are three features that separate value stocks from growth stocks and two that separate Investment Grade Value (IGV) stocks from the average, run-of-the-mill, variety.

Value stocks pay dividends, and have lower ratios than growth stocks. IGV stock companies also have long-term histories of profitability and an S & P rating of B+ or higher. Would you be surprised to learn that neither the DJIA nor the S & P 500 contains particularly high numbers of IGV stocks? Still, since 1982, value stocks have outperformed growth stocks 62% of the time. So when an ugly correction has a makeover, it's likely that all value stocks transform themselves into growth stocks, at least temporarily.

Will Rogers summed up the stock selection quandary nicely with: "Only buy stocks that go up. If they aren't going to go up, don't buy them." Many have misunderstood this tongue-in-cheek observation and joined the buy-anything-high investment club. You need dig no further than the current lists (June '08) of "most advancing issues" to see how investors are buying commodity companies and financial futures at the highest prices in the history of mankind.

This while they are shunning IGVSI (Investment Grade Value Stock Index) companies that have plummeted to their most attractive price levels in three to five years. Many of the very best multinational companies in the world are at historically low prices. Wall Street smiles knowingly (and greedily) as Main Street hucksters tout gold, currencies, and oil futures as retirement plan safety nets. Regulatory agencies look the other way as speculations worm their way into qualified plans of all varieties. Surely those markets will be regulated some day--- after the next Bazooka-pink, gooey mess becomes history.

How much financial bloodshed is necessary before we realize that there is no safe and easy shortcut to investment success? When do we learn that most of our mistakes involve greed, fear, or unrealistic expectations about what we own? Eventually, successful investors begin to allocate assets in a goal directed manner by adopting a more realistic investment strategy--- one with security selection guidelines and realistic performance definitions and expectations.

If you are thinking of trying a strategy for a year to see if it works, you're being too short-term sighted--- the investment markets operate in cycles. If you insist on comparing your performance with indices and averages, you'll rarely be satisfied. A viable investment strategy will be a three-dimensional decision model, and all three decisions are equally important. Few strategies include a targeted profit taking discipline--- dimension two. The first dimension involves the selection of securities. The third?

How should an investor determine what stocks to buy, and when to buy them? We've discussed the features of value and growth stocks and seen how any number of companies can qualify as either dependent upon where we are in terms of the market cycle or where they are in terms of their own industry, sector, or business cycles. Value stocks (and the debt securities of value stock companies) tend to be safer than growth stocks. But IGVSI stocks are super-screened by a unique rating system that is based on company survival statistics--- very important stuff.

In the late 90's, it was rumored that a well-known value fund manager was asked why he wasn't buying dot-coms, IPOs, etc. When he said that they didn't qualify as value stocks, he was told to change his definition--- or else. IGV stocks include a quality element that minimizes the risk of loss and normally smoothes the angles in the market cycle. The market value highs are typically not as high, but the market value lows are most often not as low as they are with either growth or Wall Street definition value stocks. They work best in conjunction with portfolios that have an income allocation of at least 30%--- you need to know why.

How do we create a confidence building IGV stock selection universe without getting bogged down in endless research? Here are five filters you can use to come up with a listing of higher quality companies: (1) An S & P rating of B+ or better. Standard & Poor's combines many fundamental and qualitative factors into a letter ranking that speaks only to the financial viability of the companies. Anything rated lower adds more risk to your portfolio.

(2) A history of profitability. Although it should seem obvious, buying stock in a company that has a history of profitable operations is inherently less

risky. Profitable operations adapt more readily to changes in markets, economies, and business growth opportunities. (3) A history of regular, even increasing, dividend payments. Companies will go to great lengths, and endure great hardships, before electing either to cut or to omit a dividend. Dividend changes are important, absolute size is not.

(4) A Reasonable Price Range. Most Investment Grade stocks are priced above $10 per share and only a few trade at levels above $100. An unusually high price may be caused by higher sector or company-specific speculation while an inordinately low price may be a good warning signal. (5) An NYSE listing--- just because it's easier.

Your selection universe will become the backbone of your equity asset allocation, so there is no room for creative adjustments to the rules and guidelines you've established--- no matter how strongly you feel about recent news or rumor. There are approximately 450 IGV stocks to choose from--- and you'll find the name recognition comforting. Additionally, as these companies gyrate above and below your purchase price (as they absolutely will), you can be more confident that it is merely the nature of the stock market and not an imminent financial disaster.

The QDI? Quality, diversification, and income.

About the Author

Steve Selengut http://www.sancoservices.com http://www.kiawahgolfinvestmentseminars.com/ Author of: "The Brainwashing of the American Investor: The Book that Wall Street Does Not Want YOU to Read", and "A Millionaire's Secret Investment Strategy"