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On Low-P/E Investing

JOHN B. NEFF, CFA
with FRED H. SPEECE, JR., CFA

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Speece: Is there room for stock picking in the market today?

Neff: Yes. I think the opportunities today are as good as they have ever been. I have continued to play the low-P/E game since I gave up my Windsor responsibilities, but I do it in a much more concentrated form. In my dotage, I actively manage my own money, a little charity money and some for my kids, and an individual retirement account, but it is a fair chunk of change. I typically own 8 to 10 stocks, which, of course, is the opposite of what you are supposed to have in the way of diversification. I buttress that allocation with about 30 percent in fixed income. So, if the wolf comes to the door, at least I have an anchor to windward.

Over the past 10 years, I have earned about 20 percent a year on my equities. I have not done as well so far this year, but the year is not over yet.

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Speece: What are the enduring principles of investing?

Neff: Obviously, having a low P/E is the primary principle. Then, look for solid companies with strong fundamentals in strong, growing industries and hone your analytical prowess. A company's prospects should include fundamental growth of 7 percent or better. The company should not have cyclical exposure without a compensating P/E multiple.

Seek out companies on the ‘‘squash’’—that is, ones that are making new lows. At Wellington Management Company, I would sweep the list of stocks making new lows each day and review *Value Line* each week, not for *Value Line's* opinion but for the 10 or 12 statistical yardsticks it provides. The new low list

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gives you one entry for consideration and *Value Line*, another. So, I would look for companies that were moving up the quality ladder.

Also, look for miscategorized companies. A current example of a miscategorized company is Lyondell Chemical Company, which is the fourth-largest chemical company in the United States but which also happens to own the eighth-largest oil refinery in the country.

Even if you have done a thorough analysis, sometimes you get surprised. And at times, these are good surprises, as in the case of what I call ''free plus.'' For example, at Wellington, we owned Atlantic Richfield Co. when it discovered oil on the North Slope of Alaska. That discovery was not part of our analysis. We knew that Atlantic Richfield was looking all over the world for oil, but we did not know it was going to hit it big when it did. We also owned Tandy (now RadioShack Corporation) in the 1970s—one of the lesser-recognized growth stocks—and all of a sudden the market got excited about personal computers, which Tandy just happened to be merchandising all over the United States. That was not an original part of our analysis, and we didn't pay for that outcome—hence ''free plus.''

The other plus that you sometimes get is a buyout. Somebody else in the market wants to capitalize on the same virtues that you see.

Play to your strengths. Know your good plays and your not-so-great ones. I, for instance, don't own many technology stocks because of my limited technology knowledge.

Another good idea is to develop a curbstone opinion. Shop around the neighborhood, and ask family and friends about companies to get their perspective. With a curbstone opinion on top of basic fundamental analysis, you will be much more comfortable moving when you get the price opportunity. Match your opinion against what caused the stock's price to drop and you can easily determine if the timing is propitious for investment.

Speece: If instead of seeking low-P/E stocks of decent companies you were seeking high-P/E stocks of weak companies, couldn't you be successful by shorting them?

Neff: Certainly, it would seem so. One of the problems, though, is that if you short a stock and you are right, regardless of your holding period, you realize a short-term gain on which you pay ordinary income tax of 35 percent. In addition, if you short a future, regardless of your holding period, 60 percent of the gain is long term and 40 percent is short term. So, taxes are a problem, leading me to short infrequently.

Speece: How did you handle the periods when the market was not appreciative of your style?

Neff: Actually, it worked itself out, believe it or not. The first bad spell was the Nifty Fifty period in the early 1960s. During this time, the Nifty Fifty stocks were selling at P/Es in the low 40s. Their P/Es eventually fell to the low 20s, then to the low teens, and eventually to single-digit multiples in some cases. That meant that those growth stocks finally became out-of-favor stocks, and we loaded up with the likes of Tandy, Hospital Corp., and Browning-Ferris, among others.

By holding the line, we absolutely got killed in the 1971–73 period, but we eventually hit pay dirt with lesser-recognized growth stocks. We came blazing out of the aftermath of the early 1970s earning around 80 percent compared with the market's 40 percent, and we really recouped. So, ultimately, we just waited out the bad spells. And we repeated similar scenarios three or four times after that.

For instance, in 1980, oil was supposedly going to rise to $60 a barrel, and everything electronic was a hot item in the market. We did not do well that year. But those sectors got killed in 1981, and we did very well in the ensuing years.

Then, of course, came 1987. Equity market prices rose to 22–23 times earnings, and we built a 20 percent liquidity position in 1987; we simply could not find reasonably priced stocks to buy, so we fell behind in the first three quarters of that year. Following the famous crash in October 1987, we more than recouped our underperformance through 1988.

Then, in the early 1990s, the financial intermediaries went bust, or at least the market thought so. Thirty percent or more of our portfolio was positioned in financial intermediaries—thrifts, banks, and insurance companies. Shareholders complained that these financial intermediaries were all going to fail. Some did, but obviously they all did not, and they were eventually good investments.

Speece: How did your investors in the Windsor Fund react to these periods of underperformance?

Neff: Inflection points occur in the market, and around them performance can suffer, but you have to stick to your guns. We were a low-P/E fund, and that strategy was in the mutual fund charter, so the shareholders knew what they were getting. All we had to do was execute our strategy well. Obviously, the press would be on our back, particularly, when performance was not stellar.

Another bone of contention was when we, the low-P/E shooters, owned several of the big growth stocks from time to time, thus raising a few eyebrows. I'd even be questioned in the hallway about some of these positions. We owned Dell twice at single-digit multiples, and we also bought Home Depot, IBM, Xerox, Seagate Technology, Digital Equipment, and McDonald's Corporation when they reached single-digit multiples. So, we owned some genuine growth stocks after they were beat up badly enough by the market to meet our low-P/E hurdle.

Speece: The focus now is on tracking error and style adherence, which keeps managers from pursuing strategies perceived as "too different." Is this new way of thinking healthy for the market and investors?

Neff: No, it isn't healthy. Essentially, these tools enforce closet indexing. And it is hard to beat the averages (whatever average you are supposed to beat) if you cling to the index. So, managers should have some freedom to manage money intelligently. Nevertheless, funds (and managers) do need to be categorized. The client has investment needs and desires, and the manager has an obligation to deliver a service that measures up to these expectations in some fashion, be it low P/E or whatever measure is most appropriate for that client.

To give managers complete flexibility is also not necessarily healthy. Consider hedge funds, where investors often do not know what they are getting. Therefore, being somewhere between this highly structured closet index enforcement and total investment freedom is probably the best approach.

Speece: Do you think active managers can outperform the S&P 500 Index over extended periods?

Neff: The S&P 500 has not been particularly difficult to beat because it is not really an index fund but, rather, a managed fund. It is run by a committee, and the committee decides which equity securities are included. Consider the case of technology stocks in the late 1990s. At one time, the tech sector grew to represent about 34 percent of the S&P 500. So, in part because of large additions of tech stocks, this very large weighting provided an opportunity for investors to get on the other side of it and take advantage of that structure in the market. Frankly, the S&P 500 Index Committee gives investors a lot of opportunities.

Speece: Are dividends and share repurchases equally attractive to investors?

Neff: Yes, but yield is important, too. Citigroup, which was recently upgraded to AAA, is buying its own stock. If it is as undervalued as I think it is, this will be an awfully good return on capital. In addition, Citigroup increased its dividend by about 10 percent a year. A new chart in the *Wall Street Journal* on Mondays shows the Dow Jones Industrial Average companies ranked by estimated growth rate and P/E. Citigroup is at the top of the list with 10 percent growth and a P/E multiple of 10–11. But nowhere is its yield mentioned, and its yield is awfully good at 4.1 or 4.2 percent. It compares quite favorably with the average 2 percent yield of stocks and is almost as good as the yield on the long Treasury bond.

Our goal at Windsor was always to earn a total return (growth rate plus yield) of twice the P/E we paid, but that is hard to do these days. The lesser-recognized growth stocks typically had a 12 percent growth rate with a yield of 2–3 percent, which equaled a 15 percent total return. We bought them for 7.5 times earnings. Windsor's advantage at a return of 13.9 percent versus 10.7 percent for the market translated into 315 bps, of which about 200 came from superior yield. In other words, we had a portfolio yield about 200 bps better than market price for which we paid essentially nothing. In this same vein, Citigroup is now a buy, if I am right, on 10–12 percent growth simply because it is selling at about 10 times earnings.

Speece: What do you think of companies that are pouring their cash into buybacks and, in some cases, even borrowing money to repurchase stock rather than paying dividends or investing in the business?

Neff: The P/E of the stock is the determining factor. Coca-Cola Company and General Electric both repurchased stock at a high P/E, which didn't make any sense at all to me. If the company is trading at 25 times earnings, that is a 4 percent return on equity, which is really not very good. In the case of Citigroup and others, however, stock buybacks make more sense. Ultimately, the P/E and the price paid is the right yardstick for evaluating stock buybacks.

Speece: What is your opinion of money management firms not letting their analysts and portfolio managers meet with corporate management?

Neff: It is absurd. How can analysts do their job unless they spend time with management?

Speece: What is your take on corporate executives and ethics—on both the money management and corporate sides?

Neff: All things considered, the situation is good. But obviously there are outliers like Enron Corporation. It seems to me that as an analyst and investor you can protect yourself by meeting management and observing how they handle themselves. On balance, I think close to 95 percent of corporate management is on the level.

Speece: In what appears to be a momentum-oriented market, is low-P/E investing still viable?

Neff: Yes. There have always been camp followers. Ever since I've been in the business, the technicians have been around playing off the charts, playing the momentum game. But if you can get on the other side of that with solid fundamentals, it is just opportunity time.

All kinds of decent companies in decent industries sell at low multiples. Make your basic case—growth rate and earnings—and if in a year or so it is not materializing, then sell the stock, return to your analysis, and find another low-P/E stock. In following this strategy, usually not much is lost because the stock was so beat up when you bought it that you get your money back, or at least 95 percent of it back, and then you go on to the next one.

Speece: What do you do to protect yourself against the value trap?

Neff: You just have to be right on your fundamental analysis. If your analysis is wrong and the growth rate and earnings estimates don't materialize, then you need to be disciplined and get out of that stock and go on to the next one.

Speece: What is the difference between a value manager and a low-P/E manager?

Neff: Value is in the eye of the beholder. Low P/E is easily calculated and definitive.

Speece: What is your signal to sell?

Neff: As I've been saying, if an investment is not working, get out. If it is working and the market embraces it, sell into that technical strength as patiently as possible. At Windsor, we would model the expected growth rate and yield—total return—and, based on that return, determine the price that the stock should sell at relative to the market. As the stock approaches that price, we started selling.

Essentially, the portfolio usually had a 100 percent appreciation potential. I know that sounds a bit pushy, but we used it as a benchmark for when to start selling the stock. Generally, we would begin selling at 65 percent of the 100 percent and patiently sell into strength. Depending on how large a percentage of the stock we owned, we could be totally out of the stock by the time the price fell to about 40 percent of the portfolio's targeted appreciation potential.

Speece: Could you add more value with large-cap or small-cap stocks?

Neff: I am not smart enough to differentiate. I have never understood the press's intrigue with large cap versus small cap. We found opportunities in both areas and exercised them accordingly.

Furthermore, if you are alert, you can see somebody else's acquisition intrigue. And as a result, we got about two to three buyouts a year. The characteristics that attracted us, such as being a good company in a good industry and at a low price (P/E), would attract corporate purchasers as well.

Speece: How did you view debt when you were at Windsor?

Neff: It would bother us if a company had a lot of debt, and we would characterize it as a penalty relative to the P/E. Eventually, we would sell such a company simply because it was carrying so much debt.

Speece: Have hedge funds helped or hurt us?

Neff: The costs associated with hedge funds, both to the market and to the investor, are simply too great. The opportunity for gang warfare—particularly when a number of managers are chasing the same principle and thus owning the same individual stocks—sets the market up for a difficult time.

Remember the demise of Long-Term Capital Management? That situation was not caused by hanky panky, just by poor decision making. But now, superimposed on the probability that other funds will be making other bad decisions is the increasing likelihood that more and more funds will be engaging in hanky panky.

The basic problem is that hedge funds are taking too much off the top in fees. Remember the 13.9 return on Windsor versus the 10.7 return on the S&P 500? If we had been a hedge fund, that 13.9 would have been 11.2, and that is without a 1 percent a year management fee, which I did not figure into the calculation. Our basic management fee at Windsor was 16 bps. Compare that with where we are today. The top hedge fund manager made $1.5 billion in 2005. My point is that hedge funds are way, way, way too greedy, although generalizing about them is fraught with peril because the industry is filled with so many permutations.

Speece: Many endowments think they need to have 15 or 20 percent in hedge funds. Are they equipped to handle this kind of investment?

Neff: No, but not because of the endowment's internal shortcomings but because an investment of that size, through the leverage it entails, is more than a trillion dollars.

Speece: You earlier mentioned Lyondell. Is this a company you are looking at now?

Neff: Yes, I like Lyondell. It is a chemical company that was spun off from Atlantic Richfield in the late 1980s and is one of the United States' largest chemical companies. In the spin off, Lyondell got a refinery in Houston, which is the eighth largest in the country. Lyondell owns 58.75 percent of the refinery, and CITGO Petroleum Company, which is 100 percent owned by Venezuela, owns the other 41.25 percent.

The refinery was recently put up for sale for roughly $5 billion. If the sale happens, this company will go from being very highly leveraged—although it has paid down $1.7 billion in debt in the past 18 months—to investment grade.[1] When it is investment grade, it will begin to repurchase its stock, which is now around $21. Earnings will be $4 this year, so it is selling at about 5.6 times earnings and has a 4.1 percent yield. In addition to repurchasing its stock, Lyondell will also raise its dividend if the refinery sale goes through.

Speece: We will now open questioning to the audience.

Question: Why are you so confident that Citigroup is undervalued?

Neff: I like Citigroup because of its economies of scale and size. Obviously, it is a AAA credit, and the company has developed skills in many different areas. Although, in the United States, Citigroup does not have a big presence in retail banking, it is big in credit cards. I'm expecting about 10–12 percent growth.

If you are really asking how it can get a 20 percent return on equity, my answer is because it is good.

Question: Why don't other investors realize that?

Neff: One of the problems with Citigroup is the cloud that hangs over it from the Sandy Weill days when, quite frankly, its ethics faltered in terms of its Japanese private banking business, Enron, and so on. The company is paying a price for that, not only out of pocket but also in terms of its reputation. But Charles Prince has done a prince of a job to distance the company from the problems of the past. But a big question and the company's biggest challenge is whether Citigroup will lose its entrepreneurial edge by virtue of having to be much more guarded on the ethics side.

[1] On 16 August 2006, Lyondell purchased CITGO's 41.25 percent interest for $2.1 billion, including CITGO's portion of the refinery's debt.

Question: Some analysts believe P/E is not as important as price to cash flow. Do you look at price to cash flow?

Neff: Yes. I do look at price to cash flow. I have never been a fan, however, of EBITDA (earnings before interest, taxes, depreciation, and amortization). It seems to me that interest, taxes, and depreciation are legitimate business expenses, and an evaluation tool that ignores them has minimal value. I really would rather stick to low P/E.

Question: Can you comment on being the chairman of the Advisory Council of the CFA Centre for Financial Market Integrity?

Neff: The CFA Centre for Financial Market Integrity is an initiative by CFA Institute to address some of the less-admirable machinations and hanky panky going on in the global financial marketplace. The Centre's intent is to be a leading voice on issues of fairness, efficiency, and investor protection in global capital markets and to promote high standards of ethics, integrity, and professional excellence within the investment community.

Question: What do you think of the market today?

Neff: I think the marketplace is friendly and the economy is doing well. I am estimating $90 of S&P 500 earnings in 2007, up about 10 percent from 2006. It seems to me that the market has the ideal elements for solid corporate earnings. First, we have a decent growth rate, 3 percent or so constant-dollar GDP; good productivity at about 2 percent; moderate wage increases; moderating medical costs; and the ability to get some decent price increases.

If we keep the current P/E, a 13.5 multiple, that means 8–10 percent appreciation plus a 2 percent yield, which equals a 10–12 percent total return and which compares quite well with long bonds. I just cannot get too excited about alternatives right now.

Question: If you had to pick one important lesson, what would you pick?

Neff: That is a difficult question because there are so many lessons. But if I had to pick one, I would pick the low-P/E equity strategy. That is certainly the crux of it. There are so many stocks that meet this criterion. To effectively pursue this strategy, however, do not be afraid to take on a stock that is under market attack because your aim is to buy low P/Es in decent companies in decent industries. There are not too many outstanding industries, but there are many decent ones.

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