SPECIAL REPORT

The most profitable approach to stock picking

authored by:

equitymaster.com

The investor's best friend

This report is exclusively for subscribers of Equitymaster's "The 5 Minute Wrapup".

Preface

More than half a century back, a 19-year old boy seemed to have given up all hope of making money in the stock markets. All the investing techniques that he practiced from reading the books came a cropper. Then accidentally, in one of the libraries he used to frequent, he stumbled upon a book. After merely glancing through the first few pages, he realized that his 'Eureka' moment had arrived. What followed over the next 50 years and more is the stuff of legends. Closely sticking to few of the very important principles laid out in the book and of course, picking up a few more as years passed by, he has created one of the biggest conglomerates in the world and is currently ranked amongst the world's richest men.

The book, he strongly feels, is by far the best book on investing ever written and remains as vital today as it was back then, when he first stumbled upon it. The man in question is none other than the Oracle of Omaha, Warren Buffett, one of the savviest investors the world has ever seen. The book is 'The Intelligent Investor', written by the Benjamin Graham under whom Buffett later studied.

Indeed, all it takes for successful investing is a few big 'Eureka' moments and the temperament to stick with those ideas under all circumstances. At Equitymaster, it is our constant endeavour to dig out those 'Eureka' ideas from the annals of history and present them before our readers in an easy to understand format.

What will follow over the next few pages is indeed a reproduction of some of these ideas, which are nothing but some very simple stock picking methods. Now, the most obvious question would be,"What are these methods and how useful are these?"

If history is any indication, these methods have turned out to be very useful in bear markets. In fact, some of these methods have gone on to give returns as high as 50% within a period of one year! Already excited? We have however saved the best for the last.

Implementing these ideas does not require exhaustive and painful analysis of annual reports. And these also do not require endless hours of brain storming and arguments that are normally associated with conventional stock picking.

Maximum rewards with minimal efforts and risks!

Sounds straight out of a fairy tale book, doesn't it? Trust us, it is as real as it can get. When the methods first hit us, these sounded out of sync with reality; forcing us to go back in history to the last bear market and implement it. And the results stunned us. A couple of these ideas massively outperformed the benchmark indices, giving returns in the vicinity of as much as 50% over a one year period, when the BSE-Sensex rose by about 13% only. In fact, none of these ideas gave negative returns.

In the next few pages, we lift the lid on these extremely profitable methods of stock picking. But before we proceed, a few words of caution are in order. We would like to point out that like with any form of equity investing, the returns are not guaranteed here as well. If anything, the report is an attempt to make considerably easy the complex task of wading through mind numbing lists of companies. In other words, this report would help investors get started in the process of stock selection. Please bear in mind that this is not a 'stock recommendation' report and any investments in the stocks mentioned here in without any thorough research would be at the reader's own risk!

Warm Regards,

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An attempt to dig out the tried and the tested

Not many in this part of the world would have heard of the famous value investing firm, Tweedy Browne Company LLC. As of Sept 2010, their eponymous value fund had beaten the S&P 500 on an annualised basis since its inception in 1993. However, this is not their only claim to fame.

Some years back, the firm conducted an extensive research in the field of equity investing. It was an attempt to find out a stock picking method or strategy that has given the highest returns over a long term period. Aptly titled, **'What has worked in investing'**, the findings of the study are likely to burn a big hole in the myths that people have about investing… especially the ones who do not believe in the concept of value investing.

The truth is finally out

So here we are. Finding the next market beating portfolio does not need sophisticated analysis nor does it involve losing sleep over which way interest rates are headed next or attempts at finding out whether India will run a trade deficit or a surplus in the next fiscal. It is entirely free of this so called mumbo-jumbo.

Instead, all it requires is finding out which stocks are trading the cheapest relative to their peers and sticking with them for a few years. Yes, that's all there is to successful investing. And we have the report for proof.

As per the report, a portfolio of stocks that are trading at the cheapest valuations when measured on conventional valuation parameters like price to book value, price to earnings and dividend yields have shown remarkable consistency in attaining market beating returns for a sufficiently long period of time. And this is true not of the US stock markets alone. Similar research conducted on companies listed in other markets like the UK, Germany, France and Japan have also confirmed that indeed a sufficiently diverse portfolio of the cheapest companies has very high odds of beating the benchmark indices over a long term horizon.

After thinking global, let's go local

Will similar approach work in India? While we are not aware of any such study undertaken in this country, we are of the opinion that human nature is the same everywhere and hence, the approach is likely to prove as successful here as anywhere else. Although in not as detailed a manner as the Tweedy Browne guys, we applied one of these methods on Indian stocks with the year 2003 as our base year. We were overwhelmed by the results.

We simply picked 10 stocks that looked the cheapest on a price to book value (P/BV) method and tracked their performance for a year. At the end of first year, while the BSE-Sensex had jumped 13%, the portfolio so selected was higher by 47%!

Take your pick

Excited? Want to know which stocks are trading at the lowest P/BV multiple currently? Over the next few pages, we give you cheap stocks based on not one but four different criteria. These are cheap stocks based on P/BV method, P/E method (price to earnings), dividend yield method (dividend per share divided by stock price per share; the higher the yield the better) and stocks that are trading at less than half of their 52-week high market cap levels. All the methods have been shown by the report to consistently give market beating returns.

As far as the layout is concerned, we cover one theme on one page and also make a mention of some of the key points that an investor has to keep in mind when using the concerned valuation methodology for identifying cheap stocks. Furthermore, **since our universe of stocks (which excludes companies with a market capitalization of less than Rs 10 bn)** is going to be the same for all the methodologies, it is quite possible that a company's name could come up more than once. In other words, a company that appears cheap from a P/BV perspective could also come as our top picks in the P/E method.

P/BV: Liquidation will never feel so good!

"The book value deserves at least a fleeting glance by the public before it buys or sells shares in a business undertaking" – Benjamin Graham

Company	Industry	PBV (x)
Mahanagar Telephone Nigam Ltd.	Telecommunication Services	0.4
Gujarat Narmada Valley Fertilizers Co. Ltd.	Fertilisers	1.0
Dredging Corpn. Of India Ltd.	Shipping Transport Infra. Services	1.1
Anant Raj Inds. Ltd.	Commercial Complexes	1.2
Shipping Corpn. Of India Ltd.	Shipping Transport Services	1.2
Jammu & Kashmir Bank Ltd.	Banking Services	1.3
Gujarat State Fertilizers & Chemicals Ltd.	Fertilisers	1.3
Gujarat Fluorochemicals Ltd.	Organic Chemicals	1.3
Nirma Ltd.	Cosmetics, Toiletries, Soaps & Detergents	1.3
Karnataka Bank Ltd.	Banking Services	1.3
Maharashtra Seamless Ltd.	Steel Pipes & Tubes	1.3
Hexaware Technologies Ltd.	Computer Software	1.4
Graphite India Ltd.	Refractories	1.4
Prakash Industries Ltd.	Steel	1.5
Bannari Amman Sugars Ltd.	Sugar	1.5
Peninsula Land Ltd.	Housing Construction	1.5
Heidelberg Cement India Ltd.	Cement	1.5
Indian Bank	Banking Services	1.5
S J V N Ltd.	Electricity Generation	1.5
Jindal Saw Ltd.	Steel Pipes & Tubes	1.5
Federal Bank Ltd.	Banking Services	1.6
Escorts Ltd.	Tractors	1.6
Sterlite Industries (India) Ltd.	Copper & Copper Products	1.6
Bajaj Holdings & Invst. Ltd.	Investment Services	1.7
Jai Corp Ltd.	Steel	1.7
Grasim Industries Ltd.	Synthetic Textiles	1.7
P T C India Ltd.	Trading	1.7
Patni Computer Systems Ltd.	Computer Software	1.7
Allied Digital Services Ltd.	ITES	1.7
Lakshmi Vilas Bank Ltd.	Banking Services	1.7

Data source: CMIE Prowess

Excludes stocks with market capitalisation of less than Rs 10 bn

Share prices as of October 15, 2010

Miscellaneous expenditure and acculmulated losses have not been taken into account for the above calculations

- The above table lists out the 30 companies that are trading at the steepest discount to their most recent book values.

- Book value of a company is the residual value of assets that belong to the company's shareholders after all liabilities, both near term as well as future, have been accounted for.

- Thus, if the price of a company trades at a big discount to its book value per share, the stock is likely to provide attractive returns if in due time, the market recognizes that the stock deserves a valuation at least equal to its book value.

- Hence, the trick is to separate those companies that will rise in value relative to their book value from the ones where the share price will remain depressed for many years to come.

- Choosing the company with a low debt to equity (D/E) ratio is a good starting point as a conservative financial structure helps the firm to live out the bad times. All the companies listed in the table have a D/E (Debt to Equity) ratio of less than 0.5, indicating that most of them will be able to survive the downturn with less pain than their debt laden peers.

- It is also important to consider that the company in question is not making an operating loss otherwise the book value is likely to erode, rendering the P/BV metric unreliable.

- Thus, while P/BV may not be the only criteria in choosing a good stock, it nevertheless is a good starting point for zeroing in on a company that is fundamentally strong but due to some near term concerns; it is trading at attractive valuations.

P/E: Tapping the power of the earnings

"If you remember nothing else about P/E ratios, remember to avoid stocks with excessively high ones. A company with a high P/E must have incredible earnings growth to justify its high price." – Peter Lynch

Company	Industry	PE (x)
Peninsula Land Ltd.	Housing Construction	6.0
Nava Bharat Ventures Ltd.	Electricity Generation	6.3
Birla Corporation Ltd.	Cement	6.3
Gujarat Fluorochemicals Ltd.	Organic Chemicals	6.9
Prakash Industries Ltd.	Steel	7.2
Grasim Industries Ltd.	Synthetic Textiles	7.7
Gujarat State Fertilizers & Chemicals Ltd.	Fertilisers	8.1
Graphite India Ltd.	Refractories	8.4
Balmer Lawrie & Co. Ltd.	Diversified	8.6
Patni Computer Systems Ltd.	Computer Software	9.0
Jindal Saw Ltd.	Steel Pipes & Tubes	9.0
Sesa Goa Ltd.	Minerals	9.1
Allied Digital Services Ltd.	ITES	9.3
Maharashtra Seamless Ltd.	Steel Pipes & Tubes	9.6
Bannari Amman Sugars Ltd.	Sugar	10.0
Polaris Software Lab Ltd.	Computer Software	10.3
Heidelberg Cement India Ltd.	Cement	10.3
M R F Ltd.	Tyres & Tubes	10.5
H C L Infosystems Ltd.	Trading	10.8
Deccan Chronicle Holdings Ltd.	Media-Print	11.2
Mcleod Russel India Ltd.	Tea	11.3
N I I T Technologies Ltd.	Computer Software	11.6
Amara Raja Batteries Ltd.	Storage Batteries	11.6
Hexaware Technologies Ltd.	Computer Software	11.7
Infotech Enterprises Ltd.	Computer Software	11.7
Saraswati Industrial Syndicate Ltd.	Diversified	11.7
Mindtree Ltd.	Computer Software	11.9
Hindustan Zinc Ltd.	Other Non-Ferrous Metals	12.2
Mphasis Ltd.	Computer Software	13.0
A C C Ltd.	Cement	13.1

Data source: CMIE Prowess

Excludes banking & financial companies and stocks with market capitalisation of less than Rs 10 bn

Share prices as of October 15, 2010

- If P/BV is all about assets, P/E is all about the earnings power.

- Since some businesses do not operate with a lot of assets (like IT, where employees are the key assets but are not reflected in the balance sheet), it is possible that they might not have figured on the low P/BV list.

- But this does not mean the stock is not cheap. If its price looks very attractive to the level of its earnings then the company's name might show up on the low P/E list.

- The above table does just that. While it has most names common with the P/BV list, there are certain names that are unique to only low P/E list.

- While looking for low P/E stocks, close attention should be paid to continuation of 'E', or earnings. If there are little chances that earnings are not likely to fall precipitously and the company has a conservative financial structure, then investments in such a company should be considered. As in the earlier table, the P/E table also includes only those companies that have a D/E of less than 0.5.

Dividend yield: Higher the better

"Reinvesting dividends is the critical factor giving the edge to most winning stocks in the long run" – Jeremy Siegel, Author of the best selling 'Stocks for the Long Run'

Company	Industry	Yield (%)
Hero Honda Motors Ltd.	Two & Three Wheelers	6.1
H C L Infosystems Ltd.	Trading	5.9
Engineers India Ltd.	Industrial Construction	4.9
Gateway Distriparks Ltd.	Transport Logistics Services	3.9
Graphite India Ltd.	Refractories	3.7
Balmer Lawrie & Co. Ltd.	Diversified	3.6
Bajaj Holdings & Invst. Ltd.	Investment Services	3.5
Crisil Ltd.	Business Consultancy	3.3
Greaves Cotton Ltd.	Engines	3.3
N I I T Technologies Ltd.	Computer Software	3.1
Castrol India Ltd.	Lubricants, Etc.	3.1
Clariant Chemicals (India) Ltd.	Dyes & Pigments	3.1
I T C Ltd.	Tobacco Products	2.9
Jammu & Kashmir Bank Ltd.	Banking Services	2.8
Shipping Corpn. Of India Ltd.	Shipping Transport Services	2.8
Kennametal India Ltd.	Machine Tools	2.8
Grindwell Norton Ltd.	Abrasives	2.7
Merck Ltd.	Drugs & Pharmaceuticals	2.7
Colgate-Palmolive (India) Ltd.	Cosmetics, Toiletries, Soaps & Detergents	2.6
Jagran Prakashan Ltd.	Media-Print	2.6
Tata Investment Corpn. Ltd.	Investment Services	2.5
Gujarat Narmada Valley Fertilizers Co. Ltd.	Fertilisers	2.5
Eclerx Services Ltd.	ITES	2.5
S J V N Ltd.	Electricity Generation	2.5
Oil & Natural Gas Corpn. Ltd.	Crude Oil & Natural Gas	2.5
Wyeth Ltd.	Drugs & Pharmaceuticals	2.4
Navneet Publications (India) Ltd.	Books & Cards	2.4
Oil India Ltd.	Crude Oil & Natural Gas	2.4
Nava Bharat Ventures Ltd.	Electricity Generation	2.4
A C C Ltd.	Cement	2.3

Data source: CMIE Prowess

Excludes stocks with market capitalisation of less than Rs 10 bn

Share prices as of October 15, 2010

Dividends are calculated for the latest completed financial year

- In the low P/E list, we discussed the possibility of a company paying out all of its earnings. Practically though, this is next to impossible.

- A company has to retain some of its earnings as future growth needs capital infusion. The company then decides to pay out a part or full portion of the earnings it does not need for capital infusion. This 'paid out' part is popularly called as dividends.

- Thus, an investor who invests in companies benefits in two ways. First, through dividends and secondly, through the growth that comes about because of retained earnings.

- Higher the dividend better it is because it not only signals the management's intention of rewarding shareholders; it also reduces dependence on the rise in the company's stock price, which can prove to be quite fickle at times.

- Thus a lot of investors pay great attention to the dividend policies of the company and its dividend yield, which is nothing but a company's dividend for the latest financial year upon its current share price.

- The above table lists the companies that are trading at the most attractive dividend yields with respect to their stock prices. All these companies have a conservative financial structure with D/E of less than 0.5.

- Of course dividends of a company are in no way certain. In fact companies, especially those belonging to cyclical industries might induce a nasty cut in their dividend payouts. The trick will be to identify those companies where despite a slowdown dividends are not under a lot of threat.

- Companies with a long track record of increasing or stable dividend payout and products that are non cyclical in nature are likely to be the ones that will not indulge in huge dividend cuts.

Farthest from 52-week high: That sinking feeling!

"Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall" – Warren Buffett

Company	**Industry**	**Ch. from 52 Wk High (%)**
Shree Global Tradefin Ltd.	Other Financial Services	-52.5
N M D C Ltd.	Minerals	-49.9
Karur Vysya Bank Ltd.	Banking Services	-40.9
H C L Infosystems Ltd.	Trading	-36.7
Praj Industries Ltd.	Industrial Machinery	-36.1
Bannari Amman Sugars Ltd.	Sugar	-35.9
Tech Mahindra Ltd.	Computer Software	-35.0
Prakash Industries Ltd.	Steel	-34.7
Peninsula Land Ltd.	Housing Construction	-33.8
Onmobile Global Ltd.	Computer Software	-33.2
Engineers India Ltd.	Industrial Construction	-33.1
Financial Technologies (India) Ltd.	Computer Software	-32.6
Hindustan Copper Ltd.	Copper & Copper Products	-32.6
Dredging Corpn. Of India Ltd.	Shipping Transport Infra. Services	-32.2
Deccan Chronicle Holdings Ltd.	Media-Print	-29.4
Mindtree Ltd.	Computer Software	-29.0
Astrazeneca Pharma India Ltd.	Drugs & Pharmaceuticals	-28.5
Mahanagar Telephone Nigam Ltd.	Telecommunication Services	-27.8
Gujarat Mineral Devp. Corpn. Ltd.	Coal & Lignite	-27.0
Allcargo Global Logistics Ltd.	Transport Logistics Services	-26.5
Honeywell Automation India Ltd.	Other Electronics	-25.9
Patni Computer Systems Ltd.	Computer Software	-25.7
Heidelberg Cement India Ltd.	Cement	-25.6
Sesa Goa Ltd.	Minerals	-24.6
Hathway Cable & Datacom Ltd.	Other Recreational Services	-24.5
Mcleod Russel India Ltd.	Tea	-24.3
Solvay Pharma India Ltd.	Drugs & Pharmaceuticals	-23.4
Jai Corp Ltd.	Steel	-23.4
National Aluminium Co. Ltd.	Aluminium & Aluminium Products	-23.1
Sterlite Industries (India) Ltd.	Copper & Copper Products	-23.0

Data source: CMIE Prowess

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Share prices as of October 15, 2010

- Extreme contrarians have a habit of combing through a list of stocks that have hit fresh 52-week lows. The above table is likely to satisfy their urge to a great extent. While there is just one stock out there that is trading at less than 50% of its 52-week highs, it should be noted that such stocks abound during a bear market. For the time being though, we show stocks that are trading the farthest from their 52-week highs.

- What is the definition of a stock that has fallen by 95%? A stock that has fallen 90% and then has halved from there!

- Hence, the idea is to find a stock that has fallen way below what its fundamentals indicate. Even if there is a slight improvement in fortune, one is likely to come out with handsome returns.

- However, it should be borne in mind that this approach would require the maximum research as there are no traditional metrics like P/BV and P/E to relate to.

- Furthermore, it will also help if one remembers Peter Lynch's quote – "Just because a **stock** goes down doesn't mean it **can't go lower**".

Conclusion

After having presented you with all the data, we would like to conclude by giving you a solid reason on why this method is likely to work better than most others. You see nature has set forth some immutable laws for mankind. And no one has the power to alter them. Like for other things, there is also an immutable law for making profits. And this law states that in order to make profits one should 'Buy Low and Sell High'.

All the methods discussed above have this immutable law as a foundation. If the road to profit maximization is not about buying the lowest priced stocks then what it is? Now, the most obvious question would be which of the above methods should one use? We are of the opinion that investing cannot be reduced to one single formula. Otherwise, everyone would have used the formula and gotten rich. A combination of these methods along with some qualitative research on the stocks under consideration is likely to yield the best results. And last but not the least – patience is absolutely of the essence here. One's investments are likely to bear fruit only over a period of 2-3 years. Achieving attractive returns before that should be attributed more to luck than skill.