More than half of the world’s stocks are ripe for takeover, says Forbes Magazine’s Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher. With this trend set to continue, now is a good time to take advantage.

A chance to take stock

One good strategy now is focusing heavily on takeover targets that don’t otherwise take you out of your way. The first two months of 2006 saw global all-cash takeovers nearly triple 2005’s record levels and the trend will keep accelerating – at least for a while.

At today’s valuations, well over half the world’s stocks can be taken over – financed by long-term borrowed money – so that the acquirer’s earnings per share immediately rise. A medium-grade corporation, on average around the world, can borrow long-term money at 6% – that’s a pre-tax number. The after-tax interest cost varies but is much lower, maybe 3% to 4%.

Suppose it is 4% for a given firm. If it takes over another company for a net price/earnings ratio of 15, which is an earnings yield of 6.6% – another post-tax number – it pockets the 2.6% spread as free found money and its earnings per share rise immediately. If it can grow the acquired business, it gets even more. With a 4% after-tax cost of borrowing, the acquirer can pay up to 25 times earnings and still have its earnings per share figure increase.

This won’t go away until either the stockmarket or long-term interest rates rise a lot or earnings fall apart. Since I don’t see the latter happening soon and global long-term rates aren’t rising much, I think this game will play a while. Companies that are good takeover candidates can only defend themselves by either borrowing money and buying back a load of their own stock – driving up the price and eliminating the arbitrage opportunity – or finding a favoured buyer, a white knight, to take them out before someone they don’t like does. Either is fine if you own the stock.

The best way to take advantage of this is to focus on companies where the acquirer can reap strategic advantages – meaning doing something business-wise that helps them. The most common ways are buying market share for economies of scale, or buying distribution, brand names and parallel products – but there can be many.

What you really want is to be able to see clearly a big set of firms who logically would like to own the business. But if your stocks aren’t acquired, those ones with strong strategic advantages will use those themselves and be fine. If you buy takeover candidates that you would be content to own if they weren’t taken over, you can’t lose – you win if they are taken over and you don’t lose if they aren’t. Here are four such examples I currently like.

American headhunting specialist Korn/Ferry International has features favouring a takeover. It combines a great brand name in its field with no one entity controlling it, so it can be taken over against its will, and a small market capitalisation of only £450m, so lots of competitors are big enough to buy it. Finally, it is cheap enough to be bought on borrowed money so that the acquirer’s earnings per share immediately rise. In this world, if it doesn’t start aggressively borrowing and buying back its own shares, then someone else will.

A better brand name is US jewellry retailer Tiffany – after all, it steps right out of half a century of movie appearances by the likes of Marilyn Monroe and Audrey Hepburn. Earnings are off a bit but, with a steady growth history and good basic profitability, an acquirer faces little real risk at 16 times trailing earnings. Again, there are no controlling positions.

Buying a strong bank that fits into a global network is a simple strategy as banking continues to globalise. An easy one is Bank of Ireland. It’s a good, big mouthful for any of many huge want-to-be global banks yet with a price/earnings ratio of 11 its 9% earnings yield lets another bank borrow at 6%, buy it, get the 5% spread and the tax rate differential.

Finally, Principal Financial Group in the US covers a full range of investment services, retirement plans and health and life insurance. Literally dozens of its competitors could buy it and make their earnings per share rise immediately. Here, if it doesn’t buy back a lot of its own stock, it will be pounced on by a happy peer. Again, at 15 times earnings, it is too cheap.

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