Ken Fisher Portfolio Strategy

Forbes Magazine Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher explains the earnings to price ratio and how it can help investors to identify cheap stocks

Standing P/E ratios on their heads

While it is today terribly fashionable to say there are no cheap stocks to be found, it is also terribly wrong. They are abundant.

One way to consider cheapness is to ask if a stock’s earnings yield – that’s the ratio of earnings to price (E/P), or the inverse of the price/earnings (P/E) ratio – is greater or lower than low-grade corporate bond rates. That is best defined as the US’s long-run series, the Baa rate, which is currently 6.75%, and it is an apples-to-apples comparison.

If the earnings yield is higher and earnings won’t fall, the stock is cheap. That means stocks now must have a P/E of 14.8 or less. Currently about 30% of the world’s stocks do. But what if interest rates rise? Then the earnings must rise just as fast to maintain relative value. If a stock’s earnings yield is attractive and earnings grow faster than interest rates may rise, the stock is doubly cheap and appealing.

Make no mistake, as I outlined in this column in May, I’m also more optimistic than most that interest rates won’t rise as fast this year or next as most people expect. But if I’m wrong, the principle still applies. Think E/P versus earnings growth versus interest rates and rate changes and you’re on a rational path to value. Here are four high-quality firms I think are classic examples of cheap right now.

While the whole world frets about the US trade deficit’s record size, both the import and export components have also set records throughout 2004. One way to take advantage from here is to buy Canadian-listed CP Ships, one of the world’s leading shipper. It provides turnkey inter-modal transport services and more than 80% of revenue is North American imports or exports.

But even the other 20% is impressive.

As just one example, each year the group’s ships carry enough lumber from Australia to New Zealand to build more than 20,000 homes. Regardless of the US’s trade deficit, global trade will increase – particularly with Asia – and that will keep CP busy. The stock is beat-up, unappreciated, and sells for less than 50% of this year’s revenues and 15 times earnings.

Or, to keep your money closer to home try Sea Containers, which is a classic value play. This UK-based firm operates passenger ferries servicing the English Channel (through Hovertravel) and the Atlantic, Baltic and Irish seas. It also operates the Great North Eastern Railway in the UK. And it owns a 50% stake in GE SeaCo, one of the world’s largest marine container leasing fleets. Its minority stake in Orient-Express Hotels, a secondary activity to Sea Containers, is alone worth half this stock’s total market capitalisation. Yet all of Sea Container sells for 20% of annual revenue and 14 times 2004 revenues.

Wolseley is the world’s premier distributor of heating and plumbing products and a major player in building supplies to the North American professional builder market. By leveraging its massive distribution footprint and dominant brand names in local markets, the company has expanded sales faster than the overall economies it serves.

The strength of North American residential building, in particular, which comprises 60% of sales, should propel Wolseley for some time to come. But its real value can be seen in Europe where, despite less buoyant economies, it has steadily grown revenue at double-digit rates. Selling at 15 times trailing earnings and less than 15 times 2004 earnings is too cheap for a firm that is top in its category.

Finally, if you prefer to sit on your investments for a while, think about Natuzzi, Italy’s leading global furniture maker, which is particularly strong in leather chairs and couches. It’s really tops in leather. Every day more than 4,000 people somewhere pick a Natuzzi product to furnish their home.

You can see their products in their stores-within-a-store across Britain – or most other major countries for that matter. Part of Natuzzi’s strength is in its style sense but it is also very well-run. The stock is owned by some of what I consider to be the US’s top value investors, including Chuck Royce and Tweedy Browne. At 70% of annual sales and 15 times 2004 earnings, you can see why.

kens@fisherinvestments.co.uk

The foregoing constitutes the general views of Fisher Investments and should not be regarded as personalized investment advice or a reflection of the performance of Fisher Investments or its clients. Nothing herein is intended to be a recommendation or a forecast of market condition. Rather it is intended to illustrate a point. Current and future markets may differ significantly from those illustrated here. Not all past forecasts were, nor future forecasts may be, as accurate as those predicted herein. Investing in the stock markets involves a risk of loss. Investing in foreign stock markets involves additional risks, such as the risk of currency fluctuations. Past performance is never a guarantee of future returns. This article is from the year 2004 and statements made as of this date may no longer be applicable.