The Income Statement Is Your Road To Riches

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The Income Statement Is Your Road To Riches

By Jim Fink (bio at end)
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Valuing a stock — and buying below the estimated value — is the key to successful investing.

In *Great Investors Focus on the Balance Sheet*, I discussed how shareholder's equity (i.e., book value) on the balance sheet can be used as the rock-bottom liquidation value for a company.

Deep value investors, like Benjamin Graham, liked to buy stocks below book value, but such opportunities are extremely rare these days, except in the high-risk areas of deeply-troubled, illiquid U.S. microcap stocks and Chinese stocks with questionable accounting.

Graham versus Fisher

Let us look at the intellectual battle between Ben Graham (Balance Sheet) and Philip Fisher (Income Statement).

In his early days, Warren Buffett followed the "cigar butt" deep-value quantitative approach of his Columbia Business School professor and mentor, Graham, but Buffett's investment approach began to evolve closer to growth with the 1958 publication of Philip Fisher's book *Common Stocks and Uncommon Profits*.

Unlike stodgy Graham who was born in the "old world" of London, England and worked most of his adult life in New York City, Fisher was a free-wheeling Californian from San Francisco who took an adventurous and optimistic view of stock investing, not focused on current assets but future growth.

Unless a company plans to liquidate, which is rare, measuring a stock's value based on book value is arguably irrelevant. A company that plans on continuing in business as a going concern will never sell its productive assets, so the proper way to value a company is by its current cash-generating ability and potential to grow that ability in the future.

Although the future is unknowable, Fisher analyzed qualitative "scuttlebutt" (e.g., management expertise and integrity, along with the company's competitive position) to make educated guesses. Consequently, whereas Graham focused on the "here and now" balance sheet, Fisher focused on the "forward-looking" income statement, which measured changes and trends in the balance sheet.

Buffett: East Meets West

Warren Buffett is from the plains of Nebraska, the middle of the country, so he was used to looking both ways and was perfectly willing to mold his investment philosophy from the best of both the east (Graham) and west (Fisher) coasts.

It did not hurt that Buffett's business partner since 1978, Charlie Munger, has lived in California for most of his life (born in Omaha just like Buffett, however) and was a Fisher devotee.

For many years, Buffett characterized his investment style as "85% Graham and 15% Fisher" but, recently, he has stated that Graham's approach does not work with the huge investment size required to move the performance needle in Berkshire Hathaway's $105 billion stock portfolio:

> It has less and less application as you get into bigger and bigger companies with larger sums of money. Moving much more towards Fisher now and less Ben Graham because we are working with larger sums. With smaller sums, we would be looking at better margins/cheaper stocks.

One could argue that Buffett's investment style is now 85% Fisher and 15% Graham! Adding a qualitative component requires good judgment and is more difficult to do well than Graham's numbers-based approach, but the rewards are much higher because few investors get the qualitative part right, which leads to market inefficiencies that can be exploited by smart people like Buffett.

DCF = False Certainty

So, in honor of Philip Fisher and growth investing, let us take a look at the income statement as a source of stock valuation for companies that are ongoing concerns and have no plans to liquidate.

In theory, the best way to value a stock is to estimate all of its future free cash flows on an annual basis and discount them at an appropriate annual interest rate to reach a net present value. Most discounted cash flow (DCF) models calculate free cash flows for the next 10 years (based on a constant or slowly-declining growth rate) and then add a large terminal value based on a multiple of the 10th-year free cash flow to simulate in one final number the net present value of all future cash flows in perpetuity from year 11 to infinity.

However, performing a full-fledged DCF analysis is not only time-consuming, but requires an endless number of input assumptions that are likely to turn out to be wrong.

Many legendary value investors feel the same way about DCF.

For example, Jean-Marie Eveillard said in a 2008 interview:

> We never use discounted cash flows. Buffett does not consider discounted cash flow either, because the way things work, after 10 years, you have a residual value which is often about half the net present value. So not only do you pretend to know what is going to happen over the next 10 years but even beyond. So, we never do discounted cash flow, which I think is garbage. It is as bad as the efficient market hypothesis.

Similarly, David Winters said in 2007:

> I think of DCF as garbage-in, garbage-out. Conceptually it is right, but the ability of anybody to make accurate estimates is low. Somebody showed me a DCF model last week and I looked at it and I was pretty skeptical. They had a terminal growth rate of 2%, and I asked, "What happens if it becomes 5%?" The value went up by 100%.

Valuation Requires Humility

Not only is future cash-flow growth uncertain, but so is the appropriate interest rate used to discount that future growth. In his classic investment book *Margin of Safety*, value investor Seth Klarman argued that calculating a stock's value requires "predicting the future, yet the future is not reliably predictable." Consequently, one should be humble and conservative in one's predictions and then discount those predictions by a substantial margin of safety in case the prediction is overly optimistic.

How large a margin of safety depends on the stock; for small-cap stocks with a limited financial history, a 30%-40% discount makes sense whereas a discount of only 15%-20% would be reasonable for a large-cap blue-chip stock with decades of financials.

Considering the macro-economic backdrop is also important, especially today when interest rates are near record lows and corporate profit margins are near record highs. Stock valuations get crushed when interest rates rise and/or earnings fall. If your financial adviser claims that he does not need a margin of safety, he is engaging in counter-productive "future babble" and I suggest that you find another adviser! As financial blogger Barry Ritholtz once wrote:

> Investing is about making probabilistic decisions with limited information about an unknowable future. The variables are well known, as are the possible outcomes. Anyone who claims to know the future, who says they can tell you what the economy will do, what earnings will be and, therefore, where the stock market is going is lying to you. Understanding the variables and valuation should help you make better investing decisions.

P/E Multiples are Simpler

A much-simpler valuation method than DCF is to skip over the estimate of 10 years of free cash flows and just use a multiple of today's free cash flow (or earnings or book value) to calculate a stock's value. In essence, a multiple-based valuation just calculates a terminal value from the get-go, where one takes a "snapshot" value from the current year's income statement and assigns a multiple to it to get the stock price.

For example, if a company's earnings per share (EPS) is $1.00 and the multiple of earnings you choose is 10, then the stock value would be $10 ($1.00 x 10). This begs the question, how can you determine the proper multiple? One possibility is to look to the past for guidance about the future. One could look at the average multiple of earnings the company or the industry has sold for in the past, but a company's future could look very different from its past and a particular company's business prospects could be very different from the industry average.

Another possibility is to use the multiplier formula for the terminal value in a DCF analysis: 1/(cost of equity capital – growth rate). But, again, borrowing from a DCF analysis requires us to estimate cost of capital and a terminal growth rate, which is guesswork. Still, at least the formula illustrates the two factors that go into choosing an earnings multiple. Cost of equity is the rate of return demanded by investors to compensate them for business risk. The average cost of equity is around 10% and the average long-term annual growth rate in EPS is around 3.8%.

It makes sense that the higher the cost of generating equity returns, the lower the value of that equity, i.e., the lower the price-to-earnings (P/E) ratio. The higher the rate at which equity can grow earnings, the higher the P/E ratio. So, if you subtract average EPS growth of 3.8% from the average 10% cost of equity, the result is 6.2% and the reciprocal (1/0.062) is 16, which just so happens to be the long-term average P/E ratio of the stock market.

Balancing Growth and Risk

Average figures do not tell you much about the P/E ratios of individual stocks, and calculating the cost of equity of individual industries and stocks can be a pain, so legendary fund manager Peter Lynch offered up a shortcut in his book *One Up on Wall Street*:

> The P/E ratio of any company that is fairly priced will equal its growth rate.

That is simple! In essence, Lynch is arguing that a P/E ratio-to-growth (PEG) ratio of 1.0 is the correct definition of a stock's intrinsic value. So, if a company is projected to grow its earnings at 40% annually, its P/E ratio should be 40, whereas if its earnings are projected to growth only 10%, its P/E ratio should be 10.

This suggests that, if a stock is trading at a P/E ratio below its growth rate, the stock is an under-valued buy, and if it is trading at a P/E ratio above its growth rate it is a sell. Keep in mind that the inverse of the P/E ratio is the earnings yield, which is a measure of investment return. A stock with a P/E ratio of 12 means that the company generates $1.00 of earnings per $12 of stock value, or a snapshot rate of return on investment of 8.33% (1/12).

Similarly, a stock with a P/E ratio of 20 means that the company generates $1.00 of earnings per $20 of stock value, or a snapshot rate of return on investment of 5.00% (1/20). An investor in the higher-PE stock is willing to accept a 3.33% (8.33-5.00) lower initial rate of return because, over time, the 8% (20-12) higher annual growth rate will enable him to catch up in total return and even surpass the total return of the investor in the lower-PE stock (assuming the higher growth actually occurs, which is one of the risks).

In any event, no matter how high a company's current earnings growth rate, it is unwise to pay a stock price equal to a P/E ratio of more than 40. Wharton finance professor Jeremy Siegel studied the stock performance of the "Nifty Fifty" large-cap growth stocks from the market peak in 1972 until 1998, and concluded that *on average* a P/E of 40 times was around the highest justifiable price to pay for a good growth stock.

A few growth stocks like Coca-Cola and Merck were worth paying a P/E ratio of more than 70, but that is very rare in hindsight and impossible to predict ex-ante (i.e., before the fact). Over the 27-year period of Siegel's study, Coke and Merck generated annualized total returns of around 16% and grew earnings each year by only 13.5% and 15.1%, respectively, both of which are much-lower numbers than the 70-plus P/E ratios that Siegel says were "warranted" in 1972.

These P/E ratio and earnings-growth figures do *not* indicate long-term PEG ratios of 4-plus (70/16) that conflict with Lynch's recommended 1.0 PEG ratio. First, Lynch measured the PEG ratio (*both* P/E ratio and earnings growth rate) as a snapshot at the time of purchase in 1972 and it is inconsistent to measure the P/E ratio only at the start but measure earnings growth as a long-term average over a 27-year period.

The snapshot earnings growth rates of Coke and Merck were probably much higher than 13.5% and 15.1% back in 1972 when Siegel's study began, so their snapshot PEG ratios in 1972 could have been closer to 1.0. The snapshot 1.0 PEG criterion assumes that both earnings growth and the P/E ratio will decline over time, so that a 1.0 PEG ratio in later years will be based on a much-lower P/E ratio than what existed at the start.

Second, Coke and Merck turned out to be super growth stocks that could sustain high earnings growth for a much longer period of time than the vast majority of stocks, so they proved the exception to the general rule of high earnings growth being unsustainable. No basic valuation model should be expected to accurately value freakish outliers.

The Need for Reliable Earnings

In reality, Lynch's valuation method is *too* simplistic because it assumes all companies with equal growth rates have equal business risk and that is not the case. One company currently growing earnings at 30% may face a high likelihood of an earnings deceleration in the near future, whereas another company growing at 30% may easily be able to maintain a high growth rate for the foreseeable future. Both companies would be valued the same even though one company's earnings growth was much more sustainable and that would not make sense.

Such is the flaw of using a snapshot multiple.

So, I would only consider using a P/E ratio on stable stocks with a prolonged operating history and a modicum of earnings-growth reliability. For value investor Joel Greenblatt, reliable earnings are critical to his stock-valuation methodology:

> I care very much about long-term earnings power, not necessarily so much about the volatility of that earnings power but about my certainty of "normal" earnings power over time. My goal is to buy a company at a low multiple to normal earnings power several years out and that the company earns good returns on capital at that level of normal earnings. I usually just look at a simple multiple to normalized earnings. If I can buy something at a very low multiple and I have confidence in the earnings stream, I do not have to calculate a DCF to know whether I want to buy it.

"Normal" Earnings Per Share

Now that we have established some guidelines for the proper P/E multiple to assign to a company's "normal" earnings per share, the next issue to be addressed is how to read an income statement to determine what "normal" earnings per share for a company actually are. Often, the earnings per share reported by a company are not normal and must be adjusted before a P/E ratio is applied and a stock value determined.

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See About the Analyst below

About the Analyst

Jim Fink is chief investment strategist for *Jim Fink's Options for Income* and *Velocity Trader*. He has traded options for more than 20 years and generated personal profits of more than $5 million. Jim also serves as an investment analyst at Investing Daily's flagship investing publication, *Personal Finance*.

Hopelessly overeducated, Jim holds a bachelor's degree from Yale University, a master's degree from Harvard's Kennedy School of Government, a law degree from Columbia University, and an MBA from the University of Virginia's Darden School of Business. For good measure, he has been a member of the Illinois and D.C. bars and is a CFA charterholder.

Prior to joining Investing Daily, and when not incurring student loans hiding out in academe, Jim practiced telecommunications regulatory law for nine years until he realized that he made more money trading stock options than writing briefs. After attending business school, Jim switched gears to the investment realm full-time, working for a university endowment, a private wealth management firm, an insurance and financial planning company, and as a Senior Analyst for an online investment newsletter service that encourages the wearing of funny hats.

A possible but unlikely descendant of legendary brawler and boatman Mike Fink, Jim defies his heritage, believing that investing success requires patience and analysis, not swashbuckling bravado. Besides his passion for analyzing and writing about stocks, Jim likes to hike in the desert Southwest, vacation in Las Vegas, play tennis, and feed his toddler son Cheerios.