Session 13

Value Investing: The Passive Screeners

Tests

1. Looking at stock returns over the decades, it is clear that stocks with low price to book ratios have delivered higher returns than stocks with high price to book ratios. Which of the following may best explain the extra returns?
    a. Low price to book stocks have higher growth potential than high price to book stocks.
    b. Low price to book stocks generally have higher returns on equity than high price to book stocks.
    c. Low price to book stocks may be riskier than high price to book stocks.
    d. Low price to book stocks are more likely to have intangible assets on their balance sheets.
2. In recent years, investors have migrated from using PE ratios to EV/EBITDA multiples to assess whether companies are cheap or expensive. Which of the following explains this shift?
    a. A distrust of accounting earnings and a trust in cash flows.
    b. Differences in depreciation methods across companies
    c. Differences in debt policy across companies
    d. Fewer companies have negative EBITDA than have negative net income.
    e. All of the above
3. In passive value screening, which of the following combinations are you looking for?
    a. Low price (PE, PBV etc), low growth, low risk, high returns on investments.
    b. Low price (PE, PBV etc), high growth, high risk, high returns on investments.
    c. Low price (PE, PBV etc), high growth, low risk, high returns on investments.
    d. Low price (PE, PBV etc), low growth, high risk, low returns on investments.
    e. Low price (PE, PBV etc), low growth, low risk, low returns on investments.
    f. Low price (PE, PBV etc), high growth, high risk, low returns on investments.
4. Passive value investors often look for cheap companies with good management and significant competitive advantages (big moats). Which of the following combinations of quantitative screens would you use to find these companies?
    a. Stable earnings, high return on capital
    b. Volatile earnings, high return on capital
    c. Stable earnings, low return on capital
    d. Volatile earnings, low return on capital
5. Assume that you use passive value screens on the entire market and come up with a list of 25 companies that pass your screens. If most of the companies on

this list come from one sector, which of the following may explain why this might be happening?

a. The over represented sector is under valued.
b. The over represented sector shares a risk characteristic that you did not screen for.
c. The over represented sector is in a declining business where future growth is questionable.
d. The over represented sector is facing increasing competition, potentially lowering returns on capital and equity.
e. Any or all of the above

Solution

1. Looking at stock returns over the decades, it is clear that stocks with low price to book ratios have delivered higher returns than stocks with high price to book ratios. Which of the following may best explain the extra returns?
    a. Low price to book stocks have higher growth potential than high price to book stocks.
    b. Low price to book stocks generally have higher returns on equity than high price to book stocks.
    c. Low price to book stocks may be riskier than high price to book stocks.
    d. Low price to book stocks are more likely to have intangible assets on their balance sheets.

Explanation: Low price to book stocks tend to have higher returns on equity and less growth potential than high price to book stocks. They may be riskier than high price to book ratio companies, perhaps because they are in businesses where earnings are unstable or because they have high debt ratios.

2. In recent years, investors have migrated from using PE ratios to EV/EBITDA multiples to assess whether companies are cheap or expensive. Which of the following explains this shift?
    a. A distrust of accounting earnings and a trust in cash flows.
    b. Differences in depreciation methods across companies
    c. Differences in debt policy across companies
    d. Fewer companies have negative EBITDA than have negative net income.
    e. All of the above

Explanation: Net income is more affected by accounting choices and can be altered by changing depreciation methods (even if the change is only in the reporting books). It is also true that you lose fewer companies from your sample because of negative earnings when you use EBITDA multiples rather than PE ratios.

3. In passive value screening, which of the following combinations are you looking for?
    a. Low price (PE, PBV etc), low growth, low risk, high returns on investments.
    b. Low price (PE, PBV etc), high growth, high risk, high returns on investments.
    c. Low price (PE, PBV etc), high growth, low risk, high returns on investments.
    d. Low price (PE, PBV etc), low growth, high risk, low returns on investments.
    e. Low price (PE, PBV etc), low growth, low risk, low returns on investments.
    f. Low price (PE, PBV etc), high growth, high risk, low returns on investments.

Explanation: You want the best of all worlds, a cheap company with no reason to be cheap. Having low growth, high risk or low returns on equity are all reasons a company should trade at a lower multiple of earnings/book value.

4. Passive value investors often look for cheap companies with good management and significant competitive advantages (big moats). Which of the following combinations of quantitative screens would you use to find these companies?
   a. **Stable earnings, high return on capital**
   b. Volatile earnings, high return on capital
   c. Stable earnings, low return on capital
   d. Volatile earnings, low return on capital

Explanation: Excess returns are defined as the difference between your return on capital and your cost of capital. Presumably, stable earnings companies should have low costs of capital and combined with a high return on capital, that should give you large positive excess returns (the essence of wide moats).

5. Assume that you use passive value screens on the entire market and come up with a list of 25 companies that pass your screens. If most of the companies on this list come from one sector, which of the following may explain why this might be happening?
   a. The over represented sector is under valued.
   b. The over represented sector shares a risk characteristic that you did not screen for.
   c. The over represented sector is in a declining business where future growth is questionable.
   d. The over represented sector is facing increasing competition, potentially lowering returns on capital and equity.
   e. **Any or all of the above**

   Explanation: If you get a preponderance of companies from one sector, that sector may either be undervalued, risky on some dimension that you have not captured or have lower returns/growth collectively than you anticipate.