A process to generate alpha in equity investing

Investors should analyze companies that pass muster and only then create a portfolio

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In this space we have often shared several insights into the value investing philosophy as conceived by Benjamin Graham and further enhanced by Warren Buffett, John Templeton, Martin Whitman and other path-breakers of value investing. These columns, one hopes, provided a strong foundation to transform into intelligent investors in the value investing mould. However, some readers might not be satisfied with the philosophical aspects and might want a value investing process to be defined. Today, we define this process.

The investment universe: One should start by defining the investment universe. We can define it as all the listed stocks on the Indian stocks exchanges.

Business stability: As Graham always emphasized, stick to businesses that are "substantial", so that the chances of unstability in terms of their need in the business ecosystem is low. For India, currently, we can assume that a business doing sales of at least `1,000 crore is quite significant, substantial and stable.

Financial risk: One can reduce financial risk by sticking to companies with low debt. This helps in isolating businesses that either don't need to borrow that much being asset light and can generate enough growth capital from internal accruals, or businesses that can quickly pay off debt due to strong cash flows. Using a debt-to-equity ratio of 30% will provide adequate security on that front.

Efficient use of capital: A company's equity capital should be used efficiently. In India, cost of capital is typically 12-15%. So, companies that are earning more than 15% return on equity are adding value to the capital and equity holders. Buffett, too, has mentioned that he prefers investing in companies that return at least 15% on equity.

Undervalued stocks: All the above criteria help in reducing the investment universe to a segment of business that has a stable business model, low risk of bankruptcy and creates value for shareholders. But the most important part of investing is paying the right price. Most of the times, one cannot define the precise intrinsic value of a growing business. However, one can estimate that it is more than some conservative estimates. Normally, a price-to-book ratio of 1 is recommended. But since book value is mostly based on historical costs of the assets stated at cost and then depreciated further, and that India is a high inflation country, the replacement cost of the assets is higher than the stated book value. Therefore, a price-to-book value of 2 may be more appropriate.

However, we have used very stringent criteria as far as leverage and capital efficiency is concerned. For companies with highly profitable business models the value could be much higher—we could use a price-to-book value of 5 so that enough companies pass the threshold for further investigation. But to start, the value of 1 should be used. It can be made more lenient later to allow more high-quality companies with high intrinsic values driven more by intangible assets and strong cash flows. Maximum value, however, should be 5.

We did a historical evaluation of the Graham-and-Buffettsville portfolio starting from January 2003. We assumed that all the stocks that fit the above criteria were invested in equal proportion in the first week of January and then the portfolio was rebalanced after a holding period of one year, when again the stocks fitting the criteria at that time were invested in equally. Such an operation carried out from 2003 to 2015 would have yielded around 35% returns per annum. For the same period, the CNX Nifty would have returned 20-21% per annum.

Nobel laureate Eugene Fama would ask: What about the risks as defined by volatility and beta? Volatility would have been lower (20%) than Nifty (24%) and beta would have been 0.65. Nobel laureate William Sharpe would ask about the risk-adjusted returns which can be measured using the Sharpe ratio—this would have been 1.43 for our portfolio as compared to 0.56 for Nifty.

In our opinion, this is a decent investment portfolio with a promise of (in)decent returns and alpha generation of about 19-20%.

However, one should not blindly invest in such a portfolio. The criteria, though stringent, should yield 20-50 stocks. But if the choice is smaller, either relax some of the criteria or forego investing in stocks that year because the smaller universe may indicate an overall overvaluation of the markets.

For actually creating a portfolio, we would suggest that investors analyze the companies that pass muster and only then create an actual

portfolio with a minimum of 10 and ideally 20-30 stocks. When we applied the criteria, 31 stocks make the cut.

Any stock should only be bought only after the reader has analyzed it and is satisfied.

The process does prove that value investing works and one can generate alpha with a smart Graham-and-Buffettsville portfolio.

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