How to pick stocks and beat the markets with Smart Alpha?

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Graham-Buffett strategy, that we discussed, mentioned seven stocks which passed its criteria. From that day to end FY 2015 that basket of 7 stocks have delivered about 65% returns. In addition, most are high dividend yielding companies have delivered fairly high dividends during this period. Including dividends the returns range from one barely preserving capital to the highest delivering just below 200% returns. Many of those might still be undervalued though some have become overvalued.

Hope someone bought something in the markets at that time, of course, after their own due diligence. (Never trust anyone else's advice!). Because, after that the markets have had a huge run up during FY 2015 with both Sensex and Nifty delivering around 25% returns and BSE500 and CNX500 delivering around 34% returns for FY 2015. For the past one month all are down by about 5% from their recent peaks.

The question on everyone's mind is: Is it time to sell? This is a very strange question to a value investor. Since markets have fallen off their peaks stocks are cheaper and hence it is definitely a time to buy. In fact, in our opinion even if the markets go up by 50% more over next one year it might still be a time to buy. Of course, one should always exercise caution and buy only when one finds a large number of stocks available below their intrinsic value.

So to make it easy for investors to continue their investing whether markets go up or down significantly, we have designed an investment framework—the Smart Alpha framework—based on the value-oriented philosophy of Ben Graham and his smartest student, Warren Buffett.

The Graham-and-Buffettsville Smart Alpha Framework

First Criteria: Reduce Business Risk

Graham mentioned that when one buys a stock one is investing in the business. So one faces business risk, i.e the risk of the business losing customers and sales. Hence investing in fairly stable businesses with large revenue streams and a big customer base is crucial. This reduces the business risk. To sort through the more than 4000 companies available in the Indian stock markets we apply the first criteria: Select companies greater than INR 1000 crores in sales.

Second Criteria: Reduce Financial Risk

Graham was an investor in bonds, stocks as well as all forms of hybrids. So his eye for safety in stocks was very keen. The bonds of an over-leveraged company are risky. And if bonds are risky then the stock of that company is even more riskier! So the company could face financial risk and go bankrupt falling into the hands of the bondholders, leaving nothing for stockholders. To reduce the chances of bankruptcy, we apply the second criteria: Select companies with Debt/Equity < 30%.

Third Criteria: Focus on Value Creators

Buffett has mentioned that companies which earn below their cost of capital are value destroyers. He prefers to invest in companies with a Return on Equity of more than 15%, the value creators. This helps us stick to companies which are adding value to their equity holders: Select companies with ROE>15%

Fourth Criteria: Don't Lose Capital

Buffett says there are only two rules to investing:

• Rule #1: Don't lose capital

• Rule #2: Don't forget Rule #1

Given that we don't want to lose our investment capital, we should not overpay. Further, is there a criteria which can help us not only not overpay but in addition help reduce the chances of the portfolio value falling too much? One such criterion, in our opinion, is Dividend Yield. Dividend Yield is the inverse of Price-to-Dividend ratio. If Price to Dividend is low then we are probably not overpaying. This translates to the Dividend Yield being high. A high Dividend Yield also guards against a big fall. Assuming a company sports a 2% yield and the market falls by 50%, if the company falls with it, it will now be sporting 4% dividends and will become very attractive to income-oriented investors in high tax brackets. To reduce price risk and preserve your capital better: Select companies with Dividend Yield >2%

Now lets see how many companies pass these filters?

Start with 4000+ companies

- **Apply First Criterion: Sales > INR 1000 crores**
609 companies are left, more than 3000 removed

- **Apply Second Criterion: Debt-to-Equity <30%**
187 companies left, more than 400 removed

- **Apply Third Criterion: ROE>15%**
99 companies left, nearly half removed

- **Apply Fourth Criterion: Dividend Yield >2%**
25 companies left, more than 70 removed

Which are these companies? We will come to that. However, before that we should notice that these are very tough criteria and very few companies are able to meet these criteria. Definitely what we are left is high quality. But it has also passed a very stringent value criteria of dividend yield. We are left with a highly selective group of companies.

Typically, dividend paying companies are large, stable businesses with enough cash flow generation to be able to pay a steady dividend.

To believe in this strategy going forward one would like to see how it has performed in the past. We ran such a strategy on the Indian stock market universe starting from Jan 2003 and ending Mar 2015. The historical strategy evaluation process shows the following:

The Smart Alpha framework delivered 34.4% cagr. In comparison Nifty delivered 19.8% cagr. Were the higher returns generated a result of higher risk taking? The logical discussion above already shows that the risk-averse value-oriented philosophy of Graham and Buffett has already reduced the various important risks significantly. However, a quantitative check using the academic finance's definition of risk is always good. The volatility of Smart Alpha is 18.5% vs. 24% for Nifty. Beta of Smart Alpha is 0.6. On the typical academic finance risk factors it seems that Smart Alpha is actually safer than Nifty.

The value investor's idea of risk is captured in Buffett's two rules of investing. The historical strategy evaluation shows that the chances of losing capital for a holding period of two years or more is negligible while to have similar chances of capital preservation with Nifty one would have to hold it for 5 years.

Now for the current Smart Alpha Portfolio how do the fundamentals and valuation ratios look?

Key Fundamentals

	Smart Alpha Portfolio	Top 500+ companies Benchmark
ROE	21.5%	17.3%
ROCE	21.3%	16.5%
Sales to Asset	0.45	0.38
Gross Debt to Equity	0.15	0.61
Net Debt to Equity	-0.16	0.38
Interest Coverage	52.43	9.28

The fundamentals of Smart Alpha portfolio look superior on all counts.

Key Valuation Metrics

	Smart Alpha Portfolio	Top 500+ companies Benchmark
P/E	10.30	21.21
P/BV	2.04	2.63
EV/EBITDA	4.88	10.44
EV/EBIT	6.60	13.69
P/Sales	1.34	1.33
Div. Yield	3.6%	1.3%

Do the valuations look cheap?

The valuation metrics of Smart Alpha portfolio again show that the Smart Alpha portfolio is cheaper on all counts.

The most important criteria for us is that the Dividend Yield is 3.6%! This gives a lot of stability to the portfolio as well as provides a steady stream of income to one.

Now that the lessons in teaching fishing are done, we can have the fish. **Of course, important reminder: Do not trust anyone else's advice in the financial markets. Be your own judge and do a thorough analysis before buying any company. Always buy a minimum of 10 companies in your portfolio and ideally 20. Do not allocate more than 10% to any single company. Also we, our company or our clients might be owning, buying or selling the mentioned companies for various reasons.**

Smart Alpha Portfolio: Current Basket passing the criteria

1	MOIL
2	NMDC
3	CAIRN INDIA
4	ENGINEERS INDIA
5	HINDUSTAN ZINC
6	MPHASIS
7	COAL INDIA
8	POWER FINANCE
9	GUJARAT MRL DEV. CORP.
10	NIIT TECHNOLOGIES
11	CLARIANT CHEMS INDIA
12	TECHNOCRAFT INDUSTRIES
13	MUTHOOT FINANCE
14	BALMER LAWRIE
15	MUNJAL SHOWA
16	SAVITA OIL TECHNOLOGIES
17	BAJAJ AUTO
18	INDIABULLS HOUSING FIN
19	OIL & NATURAL GAS
20	SONATA SOFTWARE
21	SUN TV NETWORK
22	UNICHEM LABORATORIES
23	HERO MOTOCORP
24	D B CORP
25	HEXAWARE TECHS.

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