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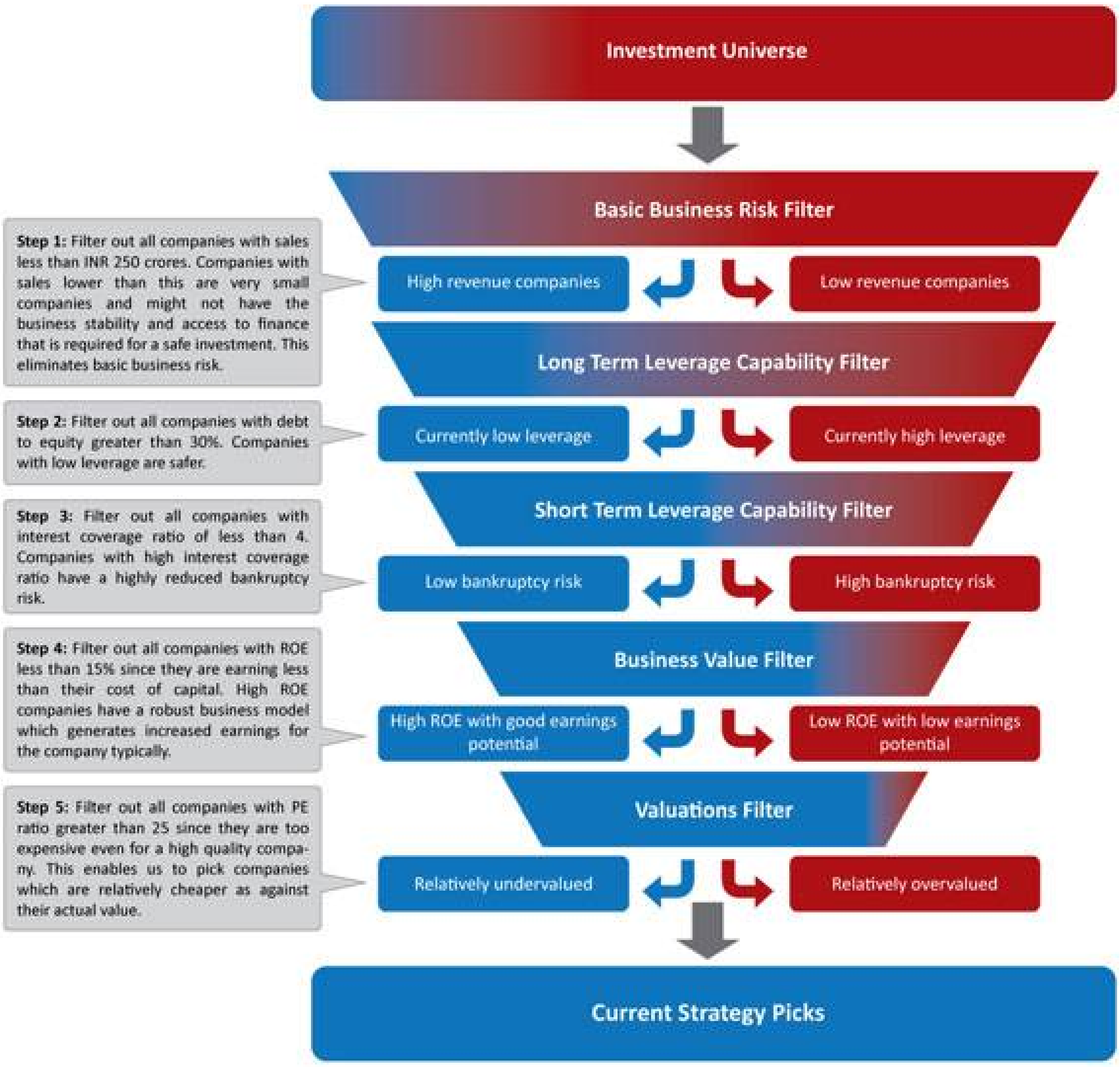
Value investing: Top 10 stocks based on Graham-Buffet methodology

In a previous article, 'Want to ride the bull market? Here's how you can do by Graham-and-Buffett way', we received a lot of requests to suggest specific stock picks. People new to value investing also wonder whether any well-known stock will be available after such stringent screening steps on low risk and low valuations.

Typically, the expectation is that if you are looking for low risk and high quality, then you have to be ready to pay high valuations or if you want 'cheap stocks', i.e. low price multiples, then one has to contend with low-quality, high-risk companies. And the question uppermost in everyone's mind is: "What kind of returns should one expect with this kind of a strategy?". In short, what kind of returns are 'satisfactory returns' as Graham would say?

As in any investing strategy that we undertake for further research, we first pass it through a qualitative test of consistency with the value investing philosophy and principles. We think that a recap of the strategy will satisfy anyone as to its soundness and consistency.

As a brief recap, we put down here the prior-suggested methodology:



Step 1: Filter out all companies with sales less than Rs 250 cr. Companies with sales lower than this are very small companies and might not have the business stability and access to finance that is required for a safe investment. This eliminates the basic business risk.
Step 2: Filter out all companies with debt to equity greater than 30%. Companies with low leverage are safer.
Step 3: Filter out all companies with interest coverage ratio of less than 4. Companies with high interest coverage ratio have a highly reduced bankruptcy risk.
Step 4: Filter out all companies with ROE less than 15% since they are earning less than their cost of capital. High ROE companies have a robust business model, which generates increased earnings for the company typically.
Step 5: Filter out all companies with PE ratio greater than 25 since they are too expensive even for a high-quality company. This enables us to pick companies which are relatively cheaper as against their actual value.
Applying these filters enables us to reduce and even eliminate a lot of fundamental risks while ensuring a robust business model, strong earning potential and a good buying price. This is a structured strategy and can be applied by each and every one to ensure basic hygiene in the companies you can think of potentially investing in.

We applied the strategy starting 15 January, 2003 (data before that is not very reliable) on 4,600 companies. We downloaded the relevant data on these companies from Reuters and started applying the filters one by one.

Since we were going back in time to January 2003, we started with a reduced sales filter since inflation has been rampant over the years. However, without precisely accounting for inflation, but rather approximately accounting for it, we started out with an Rs 85-crore sales as the cut-off for the first year in sales. This was increased by Rs 15 crore every year and so for the current year it is Rs 250 crore.

Further, we used a slightly more stringent criteria of ROE greater than 20% and PE less than 20.

The number of companies for each year varied significantly with the range being 39 companies to as high as 126 companies. The average number of companies in a particular year was 77. We assumed that the capital would be invested equally in all the companies that pass the filters.

Application of our methodology exhaustively on historical data revealed strong returns. On comparing the annual returns of the strategy vis-a-vis BSE 500 and Nifty TRI, the strategy outperforms the index more than 70% of the times (with respect to the BSE 500).

Digging deeper into the returns analysis, we can easily identify the contrarian nature of the methodology as well: for the 1-year periods ending 14-Jan-05 and 15-Jan-14, when market improvement was flat to single digit, our structured strategy yielded relatively robust returns (22.3%

and 12.9%, respectively).

	Strategy	BSE 500	Nifty TRI
15-01-2003	Inception		
15-01-2004	98.87%	108.15%	84.25%
14-01-2005	22.31%	5.59%	1.36%
16-01-2006	57.03%	46.97%	48.90%
15-01-2007	16.25%	41.86%	46.21%
15-01-2008	47.20%	57.01%	50.88%
15-01-2009	-55.25%	-60.47%	-54.36%
15-01-2010	170.79%	108.83%	93.91%
14-01-2011	10.81%	5.08%	8.85%
16-01-2012	-15.04%	-16.28%	-12.77%
15-01-2013	32.90%	26.12%	25.90%
15-01-2014	12.94%	0.50%	5.65%
31-10-2014*	111.12%	47.16%	43.53%

* annualized since 15-Jan-14.

To furthermore test the effectiveness of the strategy, we started with a capital of Rs 1 lakh on 15th January, 2003 and allocated the money equally in all companies after applying the filters.

15th January was chosen because we wanted to capture the movement in the entire year, and investor activity typically takes about 2 weeks to resume after the holiday season. We rebalanced the portfolio each year and allocated the money equally in the new stocks.

Cumulatively, the strategy delivered astounding returns with a CAGR of 29.1% and the money growing 20 times in 11 years! The Rs 1 lakh invested on 15th January, 2003 had grown to Rs 20,20,000 in 11 years.

In comparison, if the money had been invested in the BSE 500 index, it would have grown to just Rs 8,97,000 with a CAGR of 20.4% and in Nifty TRI, it would have grown to Rs 9,11,000 with a CAGR of 20.6%.

For 31st October 2014, after application of the sales filter (sales greater than Rs 250 cr) and interest coverage ratio (interest coverage ratio less than 4), we made the criteria even more strict (compared to the prior published methodology) and applied a filter of ROE greater than 20% (vs. prior 15%) and PE less than 20 (vs. prior 25). Finally after putting in Debt/Equity less than 30%, 39 companies qualified the screening process as of 31st October, 2014.

Out of these, we present below 10 stocks. Please note that these 10 stocks are not selected on the basis of any criteria and they are just the most well-known of the lot.

The stocks are (in no particular order):
Zensar Technologies
Coal India Ltd
NMDC Ltd
Cairn India Ltd
V.S.T. Tillers Tractors Ltd

Tech Mahindra Hexaware
Tech Indraprastha Gas Ltd
Infosys Ltd
Engineers India Ltd

Our aim to showcase these 10 stocks is to illustrate that high quality companies with strong balance sheets also withstand the stringent Graham-Buffet screening process. We would recommend investors to progressively form a portfolio having exposures to a few of these stocks for the current month after due diligence and having discussions with their trusted financial advisors.

We would also recommend a maximum ceiling allocation of 5 per cent for any stock and that, in our understanding, an ideal portfolio should constitute about 20 stocks and not less than 10 stocks.

Consequently, going forward, investors could gradually and systematically shape their portfolios on the basis of our periodic recommendations (perhaps about 2 stocks from the published list of 10 each month, after carrying out their own research and diligence) that we endeavour to highlight via this forum so that within a year they would form a complete portfolio.

While we typically stay away from suggesting individual stocks, we applied our suggested method to find out the top stocks as per the Graham-Buffet methodology.

Investors could opt to gain selective exposure to a few of our recommendations (which we would periodically furnish), thereby systematically creating their portfolio over the course of a few months after performing their own investment research and/or in counsel with their trusted investment advisors.

(The author is Executive Vice President, Traded Markets and Investment Research, ArthVeda Fund Management Pvt. Ltd. (www.arthvedacapital.com). ArthVeda and the author might be buying, holding or selling the mentioned securities. Views and recommendations expressed in this section are his own and do not represent those of EconomicTimes.com.)