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Want to ride the bull market? Here’s how you can do by Graham-and-Buffett way

To scout for value stocks we must first understand what "value" stands for.

For finance academics and most finance professionals a "value stock" is a stock which has either a low price-to-book ratio or low price-to-earnings ratio or low price multiples of other fundamentals, such as, sales, cash flow, EBIT etc.

Albeit generally accepted as the definition of "value", this is not true to value investing principles of "Graham-and-Buffettsville". (Graham-and-Buffettsville is a hypothetical intellectual village populated by investors who believe in the value investing principles as enunciated by Warren Buffett and his guru Benjamin Graham.)

The Graham-and-Buffettsville definition of a "value stock" is a stock which is available at a "significant discount" to "intrinsic value". Intrinsic value of a stock is the value of the equity of that company based on a discounted cash flow analysis.

"Significant discount" is a discount anywhere from 20% to 80% from the conservatively estimated intrinsic value of the stock.

This definition is able to filter out low quality companies which might not be a "value" even at low price to book ratios. Further, it also allows high quality companies which might be a good value even at seemingly higher price to book ratios.

The screening process by which we can create a pool of better companies is as follows:

Step 1: Filter our all companies with sales less than INR 250 crores. 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. So we will select companies with sales equal to or greater than INR 250 crores.

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 are good.

Step 4: Filter out all companies with ROE less than 15% since they are earning less than their cost of capital.

Step 5: Filter out all companies with PE ratio greater than 25 since they are too expensive even for a high quality company.

From the remaining pool of companies one can now start evaluating one by one. However, if this pool is still very large one can start making the filters more stringent.

One can look at companies larger than sales of INR 500 crores or even 1000 crores. One can look at zero debt companies. One can look at ROE >20% and one can look at PE ratio less than 20 and price-to-book less than 1.5.

From a pool of about 25 or so companies one can start picking companies by reading their annual reports and their corporate profiles on their websites. Specifically, one is trying to understand:

*their lines of business, i.e. the sectors and industries that they participate in

*their product or service lines, i.e. their primary revenue streams

*their geographic exposure, i.e. where do they primarily sell

*their customer segments, i.e. who buys from them and why

One should be able to understand the product-customer mix, the business model, i.e. what are the margin drivers and profitability drivers. One should be able to understand their market share and competitive strengths in the market place including their primary competitors and peers.

Looking at the past several years of sales and profits over a full business cycle, i.e. in good macro-economic conditions and bad ones, one should be able to estimate their normal sales and earnings. Using that one should be able to do a reasonable estimate of their intrinsic value and evaluate whether a company is available at a significant discount and consequently whether that investment enjoys a margin of safety.

A portfolio of 10-15 such picks should provide one with "satisfactory returns" (in the words of Graham) if held for a more than a year and rebalanced periodically on a long-term holding basis.

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