The Street

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Anatomy of a Winning Investment – 2 Keys to Success

By Guest Contributor

The following commentary comes from James P. O'Shaughnessy, author of the newly released fourth edition of What Works on Wall Street, and Patrick W. O'Shaughnessy, a contributing author to the book.

Our latest research reveals ways to improve return and reduce volatility, the most exciting finding since we first published *What Works on Wall Street* in 1996.

The new fourth edition ups the ante, and represents a large leap forward in our understanding of the characteristics that have signaled winning investments, leading to significant improvements in excess returns for strategies tested back to 1963 and in some cases back to 1927.

Our research tells us that there are two keys to long term investing success: Finding a great strategy and sticking with it. All of the strategies that we have tested, including the very best from this latest edition, have periods of time where they do poorly relative to the market – and it is perseverance through these periods that is essential to profiting from these strategies. As Peter Lynch said, "the key to making money in stocks is not getting scared out of them." The same is true of investment strategies.

We have learned a lot, but we want to highlight two key lessons from the fourth edition. These stock picking methods build on the original lessons from the first three editions of What Works on Wall Street, and we believe that they can help investors pick even better stocks for their portfolios.

Buy stocks that look cheap in several ways

The first three editions of the book focused on the best individual factors we could find. For example, price-to-sales originally looked like the king of the value factors. Our latest research suggests that using multiple factors to build a "composite" value factor delivers the best overall returns with a greater degree of consistency. To create a composite factor, we average scores across several different value factors, resulting in a final score between 1 and 100. A score of 1 would mean that the stock looks cheap in every way, and a score of 100 would indicate a very over priced stock. One version of a composite value score uses the following factors:

- Price-to-sales
- Price-to-earnings
- Price-to-book
- Price-to-cash flow
- EBITDA/Enterprise Value
- Shareholder yield (dividend yield + rate of share repurchases)

Each of these factors gets a score of 1 to 100 for each stock in the universe, and the final value score is simply an average of these scores. An example from the recent past helps to illustrate the effectiveness of this method.

Ford (F)(2008 return of -66%): Ford was the cheapest stock in the **S&P 500** by price-to-sales at the end of 2007 thanks to sales of close to $168 billion. Using just price-to-sales, Ford would have looked very attractive. But when viewed through the lens of our new value composite, Ford looked like a very weak prospective investment at the end of 2007. Its value score was 75, well below the median. In fact, it looked very expensive using most other metrics.

The impact on returns of this improved measure of value is significant. Between Jan. 1, 1964 and Dec. 1, 2009, the best 10% of stocks based on the price-to-sales, rebalanced annually, had an annualized return of 14.49% with a standard deviation of 20.68%. This continues to be an impressive improvement over our All Stock benchmark (stocks with an inflation adjusted market cap greater than $200 million), which returned 11.22% per year with a standard deviation of 18.99%. But this new value composite helps us build a much more successful portfolio: the best 10% had an annualized return of 17.3% with a much lower volatility of 17.10%. Ultimately, the more ways a stock looks cheap, the better its chances of being a solid investment.

Quality matters

Our research has always shown that selecting stocks based on their valuation, momentum and/or yields is the best way to build a portfolio. This new fourth edition confirms these beliefs – but also reveals there are also factors that can help investors avoid potential traps. Some stocks are cheap for a reason, have unjustified momentum, or unsustainable yields. An entire chapter in the book covers several factors in the financial strength and earnings quality categories. Two examples are Cash Flow to Debt and Accruals. Companies with low (or negative) cash flows relative to their total debt outstanding tend to underperform the market by wide margins. The 10% of stocks with the worst cash flow to debt ratios had an annualized return of just 2.41% – nearly 9% worse per year than the All Stocks universe. Companies with the worst earnings quality, where non-cash earnings (accruals) are rising also significantly underperform the market – here by nearly 7% per year.

Using these and other factors – such as change in total debt, external financing, and debt to equity – we create composite factors for financial strength and earnings quality with scores between 1 and 100, again where 1 represents the most attractive stocks and 100 the least attractive. At the end of 2001, Enron's stock had appreciated by 88% in the past twelve months, making it a favorite for momentum investors. Had we evaluated it using our earnings quality score, its score of 95 – among the worst in the entire universe – would have eliminated it from consideration. In late 2007, **Citigroup** (C) had a dividend yield of 7.3% making it a common holding in high yield strategies, but our financial strength composite rated it a 98 – nearly dead last. The important point is that while value, momentum and yield are great factors, not all stocks with those characteristics are created equal. Avoiding stocks with questionable quality can help investors pick better stocks to own.

Given that it has been 15 years since the original publication of What Works on Wall Street – and that these strategies have continued to work despite public awareness – the future may be very bright for these intuitive, disciplined investment strategies. We believe that the refined portfolio-building methods presented in the book can help disciplined investors achieve market-beating returns.

O'Shaughnessy
ASSET MANAGEMENT

Contact Information:

For financial advisory firms & advisors:
Ari Rosenbaum, Director of Financial Advisor Services; (203) 975-3340; Ari.Rosenbaum@osam.com

For institutions:
Chris Loveless, President & Chief Operating Officer; (203) 975-3304; Chris.Loveless@osam.com

6 Suburban Avenue, Stamford, CT 06901 | Tel: (203) 975-3333 | Fax: (203) 975-3310 | osam.com