Stock Selection is Similar to Greyhound Race Handicapping
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Dear Fellow Investors:

We have looked at many academic studies over the years which break the market down by valuation. These studies like Fama-French, Bauman, Dreman/Ibbotson and Nicholson show that the lowest quintile of stocks as measured by price-to-earnings (PE), price-to-book or price-to-cash flow ratios all reach the same conclusion. Valuation matters over all the time periods studied, and if anything, proves to matter more greatly over longer holding periods. In each case, the "ugly duckling" portfolio outperforms the other categories. Why do stocks with such low expectations perform so well and are there examples available in the current market which has rebounded nicely from 2009 lows?

In the summer during my college years I worked mostly swing shift from 4pm to Midnight at the Crown Zellerbach Mill in Camas, Washington. I had no social life, but I had plenty of time to handicap greyhound races. The Multnomah Kennel Club was straight across the Columbia River from our house in Gresham, Oregon. Most of the time, I would make my selections through morning analysis and send my bets with one of my cousins. I wouldn't know the results until later. You might be surprised to learn that I had a certain criteria for selecting dogs. We looked for dogs based on the quality of its history, early speed, post position, late speed and how well it had been running lately. Greyhound handicapping and common stock selection are different from baseball in that there is no penalty for letting pitches go by. When the pitches look fat to us, we sent specific wagers.

We made money on our analysis by being patient and waiting for high probabilities to show up. However, there was a valuation opportunity that I passed up by not being there. Between races the "Tote Board" showed how many bets were being placed to win, place or show on each of the nine greyhounds. Since I had been attending greyhound races for ten years, it was easy to see occasional mispricing. Sometimes a dearth of show bets would get placed on a quality dog. This low price to potential earnings made it a bet that would pay off in a big way if repeated faithfully over the course of the season (June-August). It was Fama-French and Nicholson in action. I bought a new truck in 1978 with the money my Dad and I made from those picks.

Which dogs are mispriced and trade in the bottom PE quintile currently? Big Medicine Makers like Abbott Labs, Merck, and Johnson & Johnson are the cheapest on a market-relative basis I've seen in my 31 years. "Staple" consumer stocks like Gannett, Nordstrom, Disney and WalMart trade like we are late in the economic recovery, not early. Finally, certain financials trade at microscopic PE ratios like Goldman Sachs and Aflac. Which sectors look most over-priced based on Fama-French? Growth cyclical stocks in Energy, Basic Materials and the Heavy Industrial sectors trade at high price to book ratios. Along with commodities, they have too many bets placed on the "Tote Board".

Best Wishes,

William Smead

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