Look to Section 3 of the SSG

What Is a Reasonable Price?

by Nancy Isaacs

I guess what originally intrigued me about NAIC investing methods, and what has kept me hooked over the last six years, was the amazing simplicity of the concept. I learned early on to use the Stock Selection Guide (SSG) to find fundamentally sound growth companies that could be purchased at a reasonable price for the long term.

Fundamentally sound growth companies! Those are the companies that have been growing sales and earnings per share (EPS) consistently over five to ten years while achieving a healthy and consistent profit on each dollar of sales (profit margin) and on each dollar of net worth (return on equity) — proven companies that are among the very best in their respective industries.

We learn that our primary concern is with the company's quality as described above. If the company being evaluated doesn't meet those criteria, we know that no price would represent a bargain. It would be like knowingly purchasing the proverbial "lemon" instead of a safe and reliable automobile. But once we determine a company is of high quality, an industry leader, we need to determine whether it can be purchased at a reasonable price. If not, we reduce the chance of achieving our investment goal of 15 percent annually, which allows us to double our money in five years.

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So what is a reasonable price? $15? $40? $100? The absolute price of a share of stock is meaningless unless it is in some way tied to the company's value, which is determined by the company's earnings potential. If you were to start a business or even purchase an existing business, you'd probably wonder whether you'd enjoy working in that field and whether its demands might provide an acceptable lifestyle for you and your family. But from a business perspective, your first question would probably be: How much can I earn, and does the business provide the potential to produce even greater earnings in the future? Accordingly, the price you'd be willing to pay for the company (or invest in a new business) would be determined by its potential to produce earnings.

Similarly, the price we are willing to pay for a share of stock in a public company should be based on those same considerations. A price of $15 might be acceptable for a company earning $3 per share, but it might be too expensive for a company earning $2 per share. We quantify this difference by calculating what's known as the price-earnings, or P/E ratio, calculated by dividing price by earnings per share (P/E = price ÷ EPS). At $15 per share, the P/E ratio for a company earning $2 per share would be 15 ÷ 2 = 7.5. The P/E for a company earning $3 per share would be 15 ÷ 3 = 5. So even though the price per share is the same in absolute dollars, investors are actually paying more for the $2 earner (P/E = 7.5) than they are for the $3 earner (P/E = 5).

Wise investors think of a stock's price in terms of its relationship to earnings, known as the "multiple." How many times earnings are investors willing to pay for a share of stock? One guide we can use to make a quick determination is what NAIC investors refer to as Relative Value (R/V). There are many public companies from which too choose. Many are of high quality. Unfortunately, we're not the only ones evaluating them. If we've figured out a company is of high quality, you can be sure thousands of other investors have figured it out as well, and they accordingly bid up the price.

The calculation of Relative Value allows us to review those companies that are of high quality (if they weren't, we would never have gotten this far) and to rule out those that are overvalued (too expensive).

What is a reasonable P/E? There are various guidelines. Value Line, for example, provides the average P/E for the 1,700 stocks it follows, which was 16.5 at press time. But even more meaningful is a consideration of the specific company's current P/E as compared with its average P/E over the last five years. Why? Because we learn that companies have what we refer to as a signature P/E. I think of it as each stock's DNA. For each company, there seems to be a unique relationship between its earnings per share and the price investors have been willing to pay for those earnings historically. For various short-term reasons, stockholders may pay more or less for a share of stock in relationship to its

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

PRESENT PRICE 40.960 HIGH THIS YEAR 45.750 LOW THIS YEAR 25.750

	Year	A PRICE HIGH	B PRICE LOW	C Earnings Per Share	D Price Earnings Ratio HIGH A÷C	E Price Earnings Ratio LOW B÷C	F Dividend Per Share	G % Payout F÷C X 100	H % High Yield F÷B X 100
1	1996	9.1	6.1	0.37	24.6	16.5	0.110	29.7	1.8
2	1997	15.0	8.1	0.44	34.1	18.4	0.120	27.3	1.5
3	1998	25.0	12.1	0.53	47.2	22.8	0.130	24.5	1.1
4	1999	33.9	19.2	0.62	54.7	31.0	0.130	21.0	0.7
5	2000	36.0	22.1	0.76	47.4	29.1	0.140	18.4	0.6
6	TOTAL		67.6		208.0	117.8		120.9	
7	AVERAGE		13.5		41.6	23.6		24.2	
8	AVERAGE PRICE EARNINGS RATIO		32.6	9	CURRENT PRICE EARNINGS RATIO			48.8	

Figure 1. **Column A:** Enter the highest price at which the stock sold for each year.

Column B: Enter the lowest price at which the stock sold for each year.

Column C: Enter the year-end earnings per share for each year.

Column D: Divide high price by earnings per share for each year.

Column E: Divide low price by earnings per share for each year.

- Add the high P/Es in Column D and divide by 5 to calculate average high P/E.
- Add the low P/Es in Column E and divide by 5 to calculate average low P/E.
- Add average high P/E and average low P/E and divide by 2 to calculate average P/E.

earnings at a given point in time, but over the long term the P/E seems to veer toward its "signature" or average P/E.

If a company's current P/E mirrors its average P/E, we consider the stock to be fairly valued (R/V = 100 percent). If a company's current P/E falls below its five-year average, we may have found a bargain. If the current P/E falls above the average, the stock may be overvalued (too expensive). There is one caveat, though. If the current P/E is too much below that average, a red flag should go up. Why is the price so low? What do other investors know that I may need to uncover by doing some extra research?

Let's compare this concept to the purchase of a home. Assuming the last six houses of the same model in the same neighborhood have recently sold at about $150,000, then $140,000 might be considered a bargain, and $160,000 would be considered a bit expensive. But if one is selling at $100,000, you might be quick to order up an inspection. Leaky roof? Termites? Faulty furnace?

To calculate Relative Value, we divide the current P/E by the five-year average P/E (current P/E ÷ five-year average P/E = Relative Value). Current P/E is simply the current price of the stock divided by the trailing (most recent) four quarters of EPS. That's how the P/E figure in the newspapers is calculated. If you use a computer program for your SSGs, current P/E is calculated for you at the lower right of Section 3.

Average P/E is arrived at by completing Section 3, displayed above. All of the data can be found on a Value Line sheet, in a Standard & Poor's report, on one of many Internet sites, or in any of the NAIC-type data files available by subscription for use with one of the computer programs. Completing Section 3 manually takes a few minutes, but it's not difficult.

Upon reviewing the average high and low P/Es for each year (Columns D and E), you may want to eliminate any that are obviously anomalous. If, for example, a company achieved unusually low EPS for one year for whatever reason (hopefully a reason outside the realm of normal business operations, i.e., a one-time event), the P/E will appear abnormally high. Just eliminate that year and average the remaining four so that you are arriving at a more meaningful average P/E.

We're looking for reasonably priced stocks, or a Relative Value no higher than 110 percent. Again, the calculation is simply current P/E divided by average P/E. In the example in Figure 1 for Walgreen (NYSE:WAG), the calculation would be 48.8 ÷ 32.6 x 100 = 149.7 percent. When the Relative Value falls within the range of about 85 percent to 110 percent, you've probably found a company that is selling at a reasonable price. That's when you begin a full analysis, using the SSG, to project future growth rates, future P/Es, future high and low price, risk reward ratios, total return etc.

My own practical application of Relative Value is to first determine which companies on that list meet my "high quality" criteria described above. Those that fail are immediately deleted from the list. I then compare each remaining stock's current P/E with its five-year average P/E. If current P/E is much higher than average P/E, I will probably place the company on my watch list. But if current P/E is close to or even below the average P/E, the company becomes a subject for serious study. I can usually eliminate most of the companies on my list this way, a process that provides quality time for researching and completing SSGs on the remaining few from which to find an appropriate investment. ■

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