Kimura Dreamvisor Newsletter summary 19th of June

Selecting cheap stocks on the basis of PEDY

A simple indicator to select value stocks.

In the 'Nikkei Money' publication august 2006 (published today) there was a special issue focusing on ways to select cheap stocks for medium term investors and 'Salaryman'. The author of this report wrote an article named 'How to focus on stocks using PEDY'. In this issue a lot of trustable analyst and investors discuss about the essence of essential investment techniques to invest over the long term in equities. I would really encourage individual investors willing to make serious money to read this issue.

I already introduced the PEDY ratio a few times (English wording is Price Earnings Dividend Yield). The lower the PEDY the cheaper the stock, as the higher the dividends yield the cheaper it is. When searching relatively low Per stocks with a high dividend yield this type of screening certainly lead to a low risk efficient investment. The juice is the correct use of dividend yield. The dividend is the profit share received by shareholders and covers the cost of holding the shares. Investors rely much more on dividend earnings than PER or PBR and usually react strongly to dividend rise or decrease. If the company management lacks self confidence they would not pay high dividend. Therefore this is a more efficient tool compared to a simple screening of low Per stocks.

Current TSE 1st section per is 19,1x, dividend yield is 1.18 % therefore average PEDY is 16,2 x. Consequently either flat or stagnant earnings with a PEDY of 11x or strong earnings growth with a PEDY under 16x would mean stock is cheap. The best way to use it： when one is convinced there is potential for earnings and dividend to rise, by calculating the latent dividend increase rate one can find a shining diamond.

Nikkei Money magazine made a screening of low PEDY stocks putting aside the free float and earnings rise/fall：Kawasaki Kisen(9107), Hanwa Kogyo (8078),Mitsui OSK (9104), NYK (9101), Sato Corp (8065), Tanaka Shoji(7619), Nissan Motor (7201), Nippon steel (5401), JFE Holdings (5411), Sumitomo Corp(8053), Takachiho electric(2715), Isuzu(7202), Sakata Inx(4633), JFE corp(3332). At today's closing PEDY ranges from 3,2x to 7,0 x. However if those are cheap by the ratio one must no forget that the earnings peak cycle has passed for shipping and Steels.

To invest on value style a reverse trend strategy is necessary.

There are reasons to explain the cheapness of value stocks. Liquidity is key point when investing money in the stock market when money is invested over the short term, long term holding is not important. Most of this money is concentrated on high growth /low profitability very large caps. Value stocks do not correspond to this and consequently equal a very small portion of trading volume, most investors do not focus on those.
Investors could also avoid such stocks because they belong to unethical sectors like Pachinko game or consumer finance... This said foreign investors, whose logic is different from Japanese investors, bought large chunks of those stocks. Thus reducing undervaluation.
Value investors are contrarian by nature. They turn their back on market favorites. They focus on analyzing the real value and up to what point a company can be valued according to economic background and earnings improvement momentum. If the stock goes down value investors will further increase position by averaging down. Provided such company fundamentals remain strong the investor shall recalculate the price expectation gap.

Apart form bargain sale situation value investors do not engage in program trading, the ultimate timing is once to two times a year. As I mentioned at numerous occasions when advance/decline ratio goes under 70 % the gap with TOPIX 55 days moving average is close to 10 %. Putting aside unpredictable bad surprises this buying timing is optimum.

Value investors and traders have not much in common. Traders have to follow the trend. When the stock traders bought goes south, it is out of the question to average down, they must instantly cut losses. Even if the stock approach bottom zone they are in no position but to cut losses. For a professional trader lost cut is every day's cup of tea. This said as traders can ignore totally the true value of stocks this magnify their chances to make money on a day to day basis.
If one has deep pockets and the possibility to trade intra day maybe it is worth doing it but if one does not want to hold large positions the value investment strategy is the best over the medium to long term.