

Arne Alsin: How to achieve above-average returns

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It's self-evident that the majority of investors are average – and that average investors generate average returns. The salient question is this: what does an investor have to do to be something other than average; specifically, to be “above average”? The answer is easy to state but difficult to apply. To be non-average requires an investor to think and behave differently from most investors.

One way to think differently is to process the available information differently. All investors assign a relative weight to information inputs. So thinking differently can be facilitated by recognising where the majority of investors assign too much weight to certain information (information is “overrated”) or too little weight (information is “underrated”).

Here are some examples of inputs that are overrated or underrated by most investors in the stock market:

■ **Revenue growth (overrated).** Most investors know that robust revenue growth creates a lot of value for the shareholder. A company that compounds sales at, say, 15 per cent, doubles its revenue base in just five years. All things being equal – for example, the number of shares, profit margins, growth prospects – this sort of growth (15 per cent compounded) translates into a business value that doubles over a five-year period.

The problem is that most investors already know this. As a result, companies that have healthy sales growth are quite popular. It's difficult to find a company with robust sales growth where that growth is not already reflected in its stock price.

■ **Margin leverage (underrated).** Most investors have a distinct linear bias when they analyse stocks. They take current conditions and linearly extrapolate them into the distant future. This is a critical mistake, particularly when it involves financial metrics such as profit margins.

In 2003, Boeing was suffering through a particularly difficult cycle. Everything that could go wrong did go wrong, such as a loss of market share, accusations of defence department fraud, as well as the firing and prosecution of leading executives. The net profit margin sank to a low of 1.6 per cent.

Boeing's stock price at the time, in the mid-\$20s, reflected the linear mindset of the majority of investors. They saw a continuation of low margins and priced the stock accordingly. In the four years since, Boeing's net profit margin has increased by 300 per cent, to well over 5 per cent. The stock is up by a similar magnitude and now trades at over \$90 a share.

While the margin lever is woefully underrated – even ignored by many investors – you can see from the Boeing example that the margin lever is much more powerful than the sales lever. When profitability and margins are at a cyclical nadir, such as with Boeing's 1.6 per cent margins in 2003, a 300 per cent improvement in just four years is within the realms of possibility. In spite of its popularity with investors, the sales lever does not have comparable power. It is almost impossible for a big company to increase sales by 300 per cent in just four years.

■ **Low price/earnings ratios (overrated) and high p/e ratios (underrated).** A lot of investors think that outsized gains can be achieved by buying low p/e stocks and avoiding high p/e stocks. This strategy is not only too popular, it's too simplistic. That's because many low p/e stocks are expensive and many high p/e stocks are cheap.

Because of Boeing's depressed earnings in 2003, its p/e was more than 40 – yet the stock was selling at a bargain price. Conversely, stocks selling at a low p/e might be quite expensive. At the same time, Boeing was cheaply priced at a 40 p/e in 2003, General Motors was expensively priced at a 7 p/e. Since then, GM stock has lost 40 per cent of its value in concert with a decline in operating margins.

It is fair to say that there are undervalued and overvalued stocks in both the low p/e and high p/e categories. Since the low p/e category is popular with investors, undervalued stocks are quickly recognised. Since searching for value in the high p/e category is underrated by most investors, many opportunities in this category are overlooked.

■ **Short-term information (overrated) and long-term information (underrated).** More than ever before, investors are bombarded with information that is used to make investment decisions. The problem is that almost all of this information is short-term in nature. The information is either about what just happened or about what is about to

happen.

Thinking with a three- to five-year mindset when the crowd is only thinking about the next quarter or two can be quite valuable. Back in 2003, 18 out of 19 analysts who followed Boeing were neutral or negative near the \$25-low in the stock. Their earnings expectations, at the time, were reasonably accurate for Boeing's upcoming quarters. But by overemphasising the short term, they completely missed the long-term opportunity.

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