

CHAPTER 6

IN SEARCH OF EXCELLENCE! ARE GOOD COMPANIES GOOD INVESTMENTS?**Petra's Search for Excellence**

Petra was an avid reader of management strategy books and she was convinced that she had found a way to make money on stocks. After all, the strategy books she read often had case studies about the best managed and the worst managed companies, and the skills (or lack thereof) of the managers in these firms. All she had to do was find the best run companies in the market and put her money in them and the returns would surely follow. In a stroke of luck, Petra found a listing of the 20 best companies in the United States in *Fortune* magazine and it was not long before she had all 20 stocks in her portfolio. As she bought the stocks, Petra did notice three things. One was that the stocks traded at lofty multiples of earnings, relative to their competitors. The second was that these stocks were widely held by mutual funds and pension funds. The third was that equity research analysts expected these companies to continue to deliver high earnings growth in the future, which Petra took as a good sign.

A year later, Petra was disappointed. While most of the companies in her portfolio were still considered well run and well managed, the stocks had not done well. In fact, she found the market reacting negatively to what she considered good news from these companies; an increase in earnings of 25% was often categorized as bad news because investors were expecting a growth rate of 35%. Worse still, two of the companies in her portfolio fell off their pedestals when their managers were revealed as inept rather than superior. On these two stocks, Petra lost a lot of money. Having learned her lesson, Petra has decided to switch her portfolio to the 20 worst companies in the United States for next year.

Motto: When you are considered the best, very good is not good enough.

Buy companies with good products and good management and the investment returns will come. This is a story that you have heard over and over from the most impeccable sources. Warren Buffett, for instance, has been noted as saying that he buys businesses and not stocks. As with other investment stories, this one resonates because it is both intuitive and reasonable. After all, who can argue with the proposition that well managed companies should be worth more than poorly managed firms? As you will see in this chapter, the story becomes much more complicated when you frame the question differently. Will you make more money investing in companies that are viewed as well

managed and good companies or in companies that have poor reputations? In this chapter, you will consider why you may not and what precautions you need to take when putting into practice such a strategy.

The Core of the Story

It seems so intuitive that good companies with superior management should be better investments in the long term that investors often do not need much convincing when they are presented with the argument. Consider some reasons given for buying good companies:

- *History backs you up:* If you look at a portfolio of companies that have done well in the stock market over long periods, you inevitably will find well-managed companies that have succeeded by offering needed products to their customers. Based upon this, there are some investors and investment advisors who argue that you should put your money into companies with good products and management and that you will reap the rewards from this investment over long periods. Better management, you are told, will deliver higher earnings growth over time while finding new investment opportunities for their firms.
- *Well managed companies are less risky:* There is a secondary reason that is offered for buying well-managed companies. If one of the risks you face when investing in companies is that managers may make poor or ill-timed decisions that reduce value, this risk should be lower for companies with good management. The combination of higher growth and lower risk should be a winning one over time.

What is a good company?

It is difficult to get consensus on what makes for a good company since there are so many dimensions on which you can measure excellence. There are many who measure excellence in terms of financial results; good companies earn high returns on their investments and reinvest their funds wisely. There are some who believe that good companies have managers who listen and respond to their stockholders' best interests and that corporate governance is the key. Finally, there are still others who believe that good companies respond not just to stockholders but also to other stakeholders including their customers, employees and society. Thus, you can have companies that make it on one list and not another. For instance, GE delivered superb financial results under Jack Welch but corporate governance was weak at the company. Conversely, Ben and Jerry's was ranked highly for social responsibility in the 1990s but faced financial disaster during the period.

Financial Performance

The simplest and most direct measure of how good a company is and how well it is run by its' management is the firm's financial performance. A well run company should raise capital as cheaply as it can, husband the capital that it has to invest well and find worthwhile investments for the capital. In the process, it should enrich investors in the company.

Most measurements of company quality try to measure its success on all of these dimensions. To evaluate the company's success at raising and investing capital, you can look at the return it earns on invested capital and the cost of that capital. The difference between the two is a measure of the excess return that the firm makes and reflects its competitive advantages. In the 1990s, for instance, a dollar measure of this excess return called economic value added acquired a significant following among both managers and consultants. It was defined as follows:

Economic Value Added = (Return on invested capital – Cost of capital) (Capital Invested)

For instance, the economic value added for a firm with a return on capital of 15%, a cost of capital of 10% and \$ 100 million in capital invested would be:

Economic Value Added = (15% - 10%) (100) = \$ 5 million

A positive economic value added would indicate that a company was earning more than its cost of capital and the magnitude of the value would indicate how much excess value the firm created over the period. The advantage of this measure over a percentage spread is that it rewards firms that earn high excess returns on large capital investments, since it is much more difficult to do,

To estimate the quality of a company's stock as an investment is easier to do. You can measure the return that you would have made from holding the stock over a prior period by adding up the price appreciation and the dividends on the stock, but by itself, this will indicate little since you have to control for market performance during the period. You will have to compare this return to what you would have made investing in the market on a stock of equivalent risk during the same period. This risk adjusted return will indicate whether the stock earned more or less than it should have, given what the market did during the period and the riskiness of the stock.

Corporate Governance

Managers in publicly traded firms often forget that they run these firms for the stockholders and instead view their enterprises as persona fiefdoms. One measure of corporate excellence is the degree to which managers are responsive to stockholders. More responsive firms should be viewed more favorably by markets than less responsive firms.

How can you best measure management responsiveness? Looking at what managers say is close to useless since almost every one of them claims to have to the best interests of stockholders at heart. Nor is it easy to find clues in what managers do. One practical alternative is to look at how the board of directors for a firm is put together and how much power top managers are willing to cede to the board. Some CEOs employ the tactics used by Worldcom and Enron and put together boards of crony directors, with little or no time to oversee what managers are doing. Alternatively, others find groups of well-informed experts who will keep them on their toes and ask them tough questions.

In recent years, *Business Week* has ranked the boards of directors of large U.S. corporations based upon a number of criteria. They consider the number of directors on the board, the number of insiders (employees or consultants) on the board, whether the CEO is the chairman of the board, whether the board meets independently on a regular basis without the CEO to assess performance and set compensation and whether directors owned sufficient stock in the firm in making their judgments. For example, in 1997, the best ranked corporate board was at Campbell Soup where there was only one insider on the board, compensation decisions were made independent of the CEO and every director was required to buy at least 3000 shares in the firm. The worst ranked board in 1997 was at Disney, where Michael Eisner packed the board with pliant directors, seven of the seventeen directors were insiders and the CEO not only chaired the board but also was part of the committee for setting compensation. The *Business Week* list of the best and worst boards in 2002, with reasons for the ranking, is provided in Table 6.1 below:

Table 6.1: Rankings of Boards of Directions in 2002: Business Week

<i>Best Boards</i>	<i>Worst Boards</i>
1. <i>3M</i> : Only 1 insider on a nine-person board. No directors with business ties to CEO.	1. <i>Apple</i> : Conflicts of interest as CEO of Apple sits on boards of companies whose CEOs are on Apple's board.
2. <i>Apria Healthcare</i> : Three shareholder activists on board. CEO is not chairman of board.	2. <i>Conseco</i> : Board does not meet without the CEO present.
3. <i>Colgate Palmolive</i> : Directors own substantial stock and do not sit on very many other boards.	3. <i>Dillard's</i> : Seven directors (including CEO's children) have connections to the company.
4. <i>GE</i> : Recently added champion of corporate governance to board. Questions exist about Welch's retirement package.	4. <i>Gap</i> : Substantial self-dealing and interlocking directorships
5. <i>Home Depot</i> : Only 2 insiders on 12-member board. Independent directors meet regularly without management.	4. <i>Kmart</i> : Passive board as company sinks deeper into trouble.

6. <i>Intel</i> : No insiders and has a lead director to act as counter weight to CEO.	5. <i>Qwest</i> : No outside director has experience in Qwest's core business.
7. <i>Johnson & Johnson</i> : Directors own significant amounts of stock and do not sit on more than 4 boards.	6. <i>Tyson Foods</i> : Of 15 board members, ten have ties to the company.
8. <i>Medtronics</i> : Directors hold regular meetings without CEO.	7. <i>Xerox</i> : Too many directors sit on too many boards.
9. <i>Pfizer</i> : No executives sit on audit, nominating or compensation committees.	
10. <i>Texas Instruments</i> : Directors are well invested in company.	

Source: Business Week

In the aftermath of the corporate scandals of 2002, where investors in many companies discovered that errant boards had allowed CEOs to run loose, there are other services that have woken up to the need to assess corporate governance. Undoubtedly, *Business Week* will have competition as these services devise their own measures of corporate governance at companies.

Social Responsibility

While stockholders have a critical stake in the well being of firms, there are other groups that are affected by decisions made by managers; employees and customers, for instance, can be affected adversely by decisions that make stockholders better off and society overall can bear a cost for decisions that enrich stockholders. In fact, proponents of what is called the balanced scorecard have argued that traditional financial analysis gives too much weight to what companies do for their stockholders and too little to what they provide other stakeholders in the firm. A good firm, they argue, does well financially for its stockholders while also generating benefits for employees, customers and society.

If you accept this argument, you are then faced with a practical question of how best to measure these benefits generated for society. While attempts have been made to quantify these benefits, the fact that many of these benefits are qualitative indicates that any measurement of social responsibility will be both qualitative and subjective. In fact, most rankings of firms as corporate citizens are based upon surveys, some of the general public and some of other firms in their peer group. Consider, for instance, how Fortune comes up with its widely publicized list of the ten most admired firms each year. The Hay Group, which is the consultant firm that does the rankings, takes the ten largest companies (by revenues) in 58 industries, including large subsidiaries of foreign-owned companies. They

then ask 10,000 executives, directors, and securities analysts to select the ten companies they admire most in any industry. They also were asked to rate the companies in their own industries based eight criteria: Innovation, financial soundness, employee talent, use of corporate assets, long-term investment value, social responsibility, quality of management, and quality of products and services. To arrive at each company's final score, which determines its ranking in its industry group, they average the scores that survey respondents gave it on these eight criteria. The ten most admired firms of 2002 are listed in Table 6.2 below:

Table 6.2: Most Admired Firms in 2002: Fortune Magazine Survey

<i>Ranking</i>	<i>Company</i>
1	General Electric
2	Southwest Airlines
3	Wal-Mart Stores
4	Microsoft
5	Berkshire Hathaway
6	Home Depot
7	Johnson & Johnson
8	FedEx
9	Citigroup
10	Intel

Source: Fortune Magazine

This list appeared early in 2002. A couple of the firms on the list ran into rough weather during the course of the year – Citigroup for its role in the Enron disaster and GE for some of its financial decisions and Jack Welch’s pay packets. It is very likely that one or both firms will not make the 2003 list.

The Theory: Building Quality into Value

Companies with good management and superior products should have higher values than companies without these attributes. There are few who would take exception to this statement. In fact, most valuation approaches incorporate these effects into the inputs and the resulting value reflects these inputs.

Inputs in a DCF valuation

The value of any firm is a function of the cash flows generated by that firm from its existing investments, the expected growth in these cash flows and the cost of coming up

with the capital needed for the investments. There are several places in valuation where you get to reward companies that have good managers and that have made good investment choices:

- ❑ The obvious place to start is with current earnings. Firms with good projects and superior managers should report higher earnings from their existing investments. These higher earnings should increase value.
- ❑ The growth in earnings for a company are a function of how much the company reinvests back into its business and how well it chooses its investments. A firm that is able to find more investment opportunities that generate high returns will have a higher growth rate and a higher value.
- ❑ At some point in time, every company becomes a mature business earning its cost of capital (and nothing more) and growing at rates lower than the economy. A company that makes the right strategic decision and builds up substantial competitive advantages may be able to delay or defer this day of reckoning. The resulting high growth can increase value.
- ❑ Finally, companies with good managers may be able to reduce the cost of funding their assets (the cost of capital) by altering the mix of debt and equity and the type of debt they use.

As an example, companies like Microsoft and Wal-Mart are highly regarded because they seem to be able to continue to grow earnings at healthy rates, notwithstanding their sizes. If you consider this the result of superior management, you may value them on the assumption that they will continue to grow and earn high returns. This, in turn, will increase their values.

By incorporating the effects of good management and products into your valuation, you can avoid one of the biggest dangers in valuing firms, which is that story telling can be used to justify growth rates that are neither reasonable nor sustainable. Thus, you might be told that a dotcom retailer will grow at 60% a year because the online retailing market is huge and that Coca Cola will grow 20% a year because it has a great brand name. While there is some truth in these stories, a consideration of how these qualitative views translate into the quantitative elements of growth is an essential step towards consistent valuations.

Can different investors consider the same qualitative factors and come to different conclusions about the implications for returns on capital, margins, reinvestment rates, and, consequently, growth? Absolutely. In fact, you would expect differences in opinion about the future and different estimates of value. In a good discounted cash flow valuation, the fact that a firm is better managed or has a stronger brand name should be incorporated into the inputs and eventually into value. There is no rationale for adding extra premiums for good management.

EVA and Excess Return Models

In an earlier section, economic value added was defined as a function of three inputs – the return on invested capital, the cost of capital and the capital invested in the firm. To see the connection between economic value added and firm value, consider a simple formulation of firm value in terms of the capital invested in existing assets and the excess returns that you expect to make on these assets and new investments in the future:

Firm Value = Capital Invested currently + Present value of expected EVA in future years

The value of a firm is the sum of the capital invested in assets in place and the present value of all future economic value added by the firm.

Consider a firm that has existing assets in which it has capital invested of \$100 million. Assume that this firm expects to generate \$ 15 million in after-tax operating income on this investment and that it faces a cost of capital of 10% in perpetuity. You can estimate the economic value added each year by using these inputs:

Economic Value Added = \$ 15 million - .10* \$ 100 million = \$ 5 million

The value of the firm can be estimated from these inputs by first estimating the present value of expected economic value added over time. Since the \$ 5 million in EVA is expected to last forever and the cost of capital is 10%, the present value is:

Present value of economic value added = $5 / .10 = \$ 50$ million

Adding this on to the existing capital invested in the firm of \$ 100 million generates a firm value of \$ 150 million.

Value of firm = Capital Invested + PV of Economic Value Added
 $= 100 + 50 = \$ 150$ million

The calculations become a little more complicated when you expect the firm to take projects in the future that will generate excess returns but the basic structure of the valuation will remain intact. The key insight, though, should be that the way you create value as a firm is by generating returns in excess of your cost of capital. Thus, a firm that grows at a substantial rate by taking investments on which it earns its cost of capital will become a larger but not necessarily a more valuable firm. Another way of presenting these results is in terms of Market Value Added (MVA). The market value added, in this case, is the difference between the firm value of \$150 million and the capital invested of \$100 million, which yields \$50 million. This value will be positive only if the return on capital is greater than the cost of capital and will be an increasing function of the spread between the two numbers. Conversely, the number will be negative if the return on capital is less than the cost of capital.

If you conclude that the ultimate payoff to having better management or a superior product or a more effective board of directors is in a higher and more sustainable excess

return, you can see that the value of a firm with these characteristics will be higher than the value of an otherwise similar firm without these characteristics.

Looking at the Evidence

Given the many and often divergent definitions of a good company, it should not be surprising that the evidence also has to be categorized based upon the definition used. You will begin this section by looking at the evidence on the relationship between the excess returns earned on projects by firms and returns earned on the stocks of these firms. You will follow up by examining whether stronger corporate governance or social consciousness translates into higher stock returns for investors. You will close the section by examining how services that rank companies based upon quality, presumably using a combination of factors, do when it comes to finding good investments.

Project Quality and Stock Returns

Will increasing economic value added cause market value to increase? While an increase in economic value added will generally lead to an increase in firm value, it may or may not increase the stock price. This is because the market has built into its expectations of future economic value added. Thus, a firm like Microsoft is priced on the assumption that it will earn large and increasing economic value added over time. Whether a firm's market value increases or decreases on the announcement of higher economic value added will depend in large part on what the expected change in economic value added was. For mature firms, where the market might have expected no increase or even a decrease in economic value added, the announcement of an increase will be good news and cause the market value to increase. For firms that are perceived to have good growth opportunities and are expected to report an increase in economic value added, the market value will decline if the announced increase in economic value added does not measure up to expectations. This should be no surprise to investors, who have recognized this phenomenon with earnings per share for decades; the earnings announcements of firms are judged against expectations and the earnings surprise is what drives prices.

You would therefore not expect any correlation between the magnitude of the economic value added and stock returns or even between the change in economic value added and stock returns. Stocks that report the biggest increases in economic value added should not necessarily earn high returns for their stockholders.¹ These hypotheses are

¹ Kramer, J.R. and G. Pushner, 1997, *An Empirical Analysis of Economic Value Added as a proxy for Market Value Added*, Financial Practice and Education, v7, 41-49. This study found that differences in operating income (NOPAT) explained differences in market value better than differences in EVA. In 1996,

confirmed by a study done by Richard Bernstein at Merrill Lynch, who examined the relationship between EVA and stock returns.

- A portfolio of the 50 firms which had the highest absolute levels of economic value added earned an annual return on 12.9% between February 1987 and February 1997, while the S&P index returned 13.1% a year over the same period.²
- A portfolio of the 50 firms that had the highest growth rates in economic value added over the previous year earned an annual return of 12.8% over the same time period.³

In short, investing in companies just because they earned large excess returns last year or increased their excess returns the most in the last year is not a winning strategy.

The Payoff to Corporate Governance

Are companies with stronger boards of directors and corporate governance principles better investments than firms without these characteristics? While the overall evidence on this question is mixed, it is quite clear that stock prices generally go up when firms move to give their stockholders more power.

Consider first the evidence on the link between the board of directors and value. Research indicates that firms with smaller and more activist boards trade at higher values, relative to companies with larger and passive boards. Price and Waterhouse, in an examination of corporate governance across countries, conclude that firms in countries with stronger corporate governance trade at a significant premium over companies in countries without weak governance.⁴ However, there is little supportive evidence for the proposition that buying stock in companies with stronger corporate governance generates higher returns.

The studies that provide the most promising leads for a strategy of investing in companies based upon corporate governance principles are the ones that look at actions that strengthen or weaken corporate governance and the consequence for stock prices. For instance, the stock prices of companies go down when they adopt strict new anti-takeover amendments or change the voting rights on shares to give incumbent managers more voting power, both actions that weaken corporate governance. In contrast, stock prices tend to go up when managers are replaced or when a proxy fight is announced, actions that strengthen corporate governance.

O"Byrne, S.F (*EVA and Market Value*, Journal of Applied Corporate Finance, v9(1), 116-125), however, found that changes in EVA explained more than 55% of changes in market value over 5-year periods.

² See Quantitative Viewpoint, Merrill Lynch, December 19, 1997.

³ See Quantitative Viewpoint, Merrill Lynch, February 3, 1998.

⁴ Price Waterhouse, *The Opacity Index*, www.pricewaterhouse.com.

The Payoff to Social Responsibility

In the last decade, a large number of funds have been created to cater to investors who want to avoid companies that they deem socially irresponsible. While the definition of social responsibility varies from fund to fund, the managers of these funds all argue that investing in “ethical” companies will generate higher returns in the long term. Arrayed against them are others who believe that constraining your investment choices will result in lower returns, not higher.

In a finding that is bound to leave both groups dissatisfied, an examination of 103 ethical funds in the United States, UK and Germany from 1990 to 2001 found no significant differences in excess returns between these funds and conventional funds.⁵ That is bad news for those investors who had invested in these funds, expecting a economic payoff to social responsibility. It is, however, good news for those investors who invested in these funds for altruistic reasons, fully expecting to pay a price for their social commitment.

Broader Definitions of Good Companies

All of the research quoted above can be faulted for taking too narrow a view of what comprises a good company, i.e., that good companies earn excess returns or that they have more effective boards or are more socially responsible. You can argue that good companies may have all of these characteristics and that using a richer definition of good companies may yield better results for investors.

Investing in Excellent Companies

Tom Peters, in his widely read book on excellent companies a few years ago, outlined some of the qualities that he felt separated excellent companies from the rest of the market.⁶ Without contesting his standards, Michelle Clayman went through the perverse exercise of finding companies that failed on each of the criteria for excellence – a group of unexcellent companies and contrasting them with a group of excellent companies. Table 6.4 below provides summary statistics for both groups:⁷

Table 6.4: Excellent versus Unexcellent Companies – Financial Comparison

	<i>Excellent companies</i>	<i>Unexcellent companies</i>
Growth in assets	10.74%	4.77%

⁵ Bauer, R., K. Koedijk and R. Otten, 2002, *International Evidence on Ethical Mutual Fund Performance and Investment Style*, Working paper, SSRN.

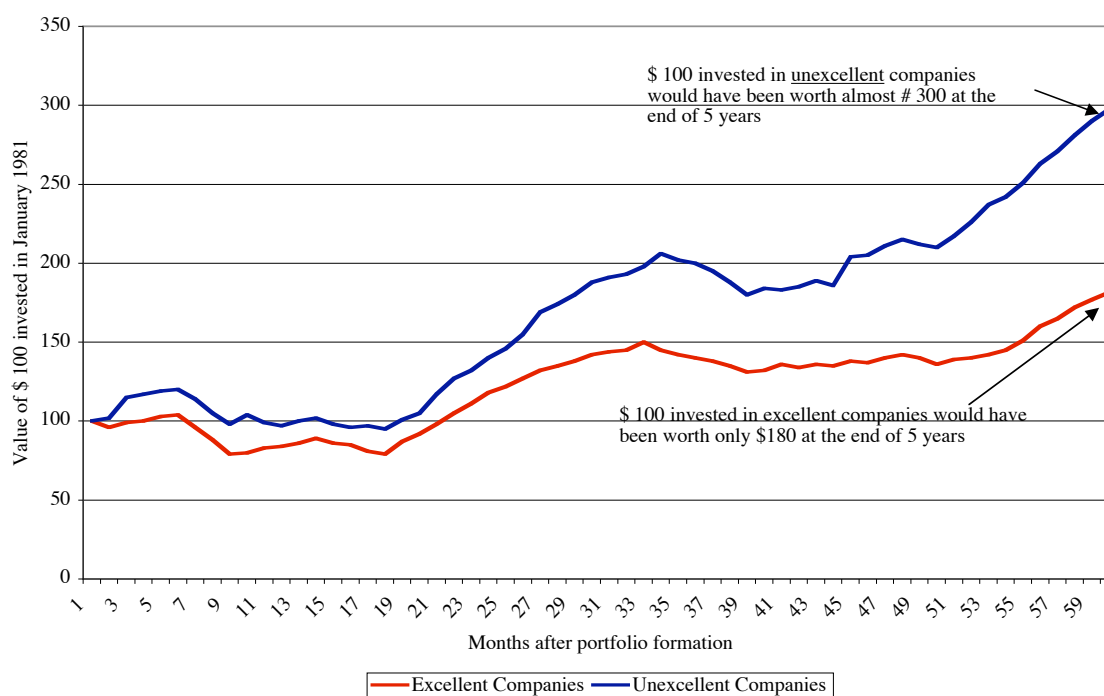
⁶ Peters, T.. 1988, *In Search of Excellence: Lessons form America’s Best Run Companies*, Warner Books.

⁷ Clayman, Michelle, *Excellence revisited*, Financial Analysts Journal, May/June 1994, pg 61-66.

Growth in equity	9.37%	3.91%
Return on Capital	10.65%	1.68%
Return on Equity	12.92%	-15.96%
Net Margin	6.40%	1.35%

The excellent companies clearly are in much better financial shape and are more profitable than the unexcellent companies, but are they better investments? Figure 6.1 contrasts the returns would have made on these companies versus the excellent ones.

Figure 6.1: Excellent versus Unexcellent Companies

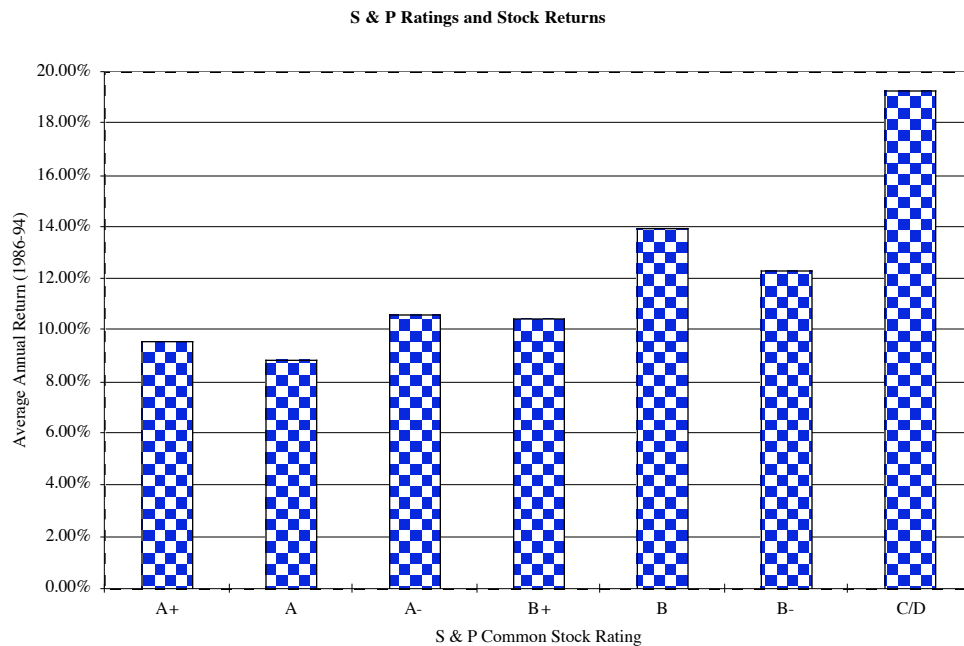


Data from study by Clayman. The figure graphs the value of \$ 100 invested in excellent and unexcellent companies in the 60 months after categorization.

The excellent companies may be in better shape financially but the unexcellent companies would have been much better investments at least over the time period considered (1981-1985). An investment of \$ 100 in unexcellent companies in 1981 would have grown to \$ 298 by 1986, whereas \$ 100 invested in excellent companies would have grown to only \$ 182. While this study did not control for risk, it does present some evidence that good companies are not necessarily good investments, whereas bad companies can sometimes be excellent investments.

S&P Stock Ratings

Standard and Poor's, the ratings agency, assigns quality ratings to stocks that resemble its bond ratings. Thus, an A rated stock, according to S&P, is a higher quality stock than a B+ rated stock, and the ratings are based upon financial measures (such as profitability ratios and financial leverage) as well as S&P's subjective ratings of the company. Figure 6.2 summarizes the returns earned by stocks in different ratings classes; the lowest rated stocks had the highest returns and the highest rated stocks had the lowest returns.



Data on ratings from S&P. The annual returns are reported for stocks in each ratings class.

Again, these findings are not definitive because the higher returns for lower rated companies may well reflect the higher perceived risk in these companies, but it indicates that investors who bought the highest ranked stocks, expecting to earn higher returns, would have been sorely disappointed.

Fortune Rankings

An earlier section described how Fortune magazine comes up with its list of most admired companies each year. In the process, Fortune also reports on the scores (based upon the survey of executives and analysts) for 500 companies. A study looked at the returns that you would have made investing in the 50 most admired and the 50 least admired firms on the Fortune list each year from 1983 to 1995. The results are promising. The most

admired firms earn a return of 125% in the 5 years after the portfolios are created in contrast the return of 80% earned by the least admired firms. These differences persist even after you adjust for risk and the differences in firm characteristics. The most admired portfolio did better than the least admired portfolio in 8 out of the 11 years in the sample.

These results are in contrast to those obtained from looking at excellent and S&P rated companies. One possible explanation is that Fortune does incorporate more qualitative factors in its rankings, through its survey. These qualitative inputs may be the source of the added value. Whatever the explanation, it does offer hope for investors in high quality firm that coming up with a composite measure of quality may provide a payoff in terms of higher returns.

Crunching the Numbers

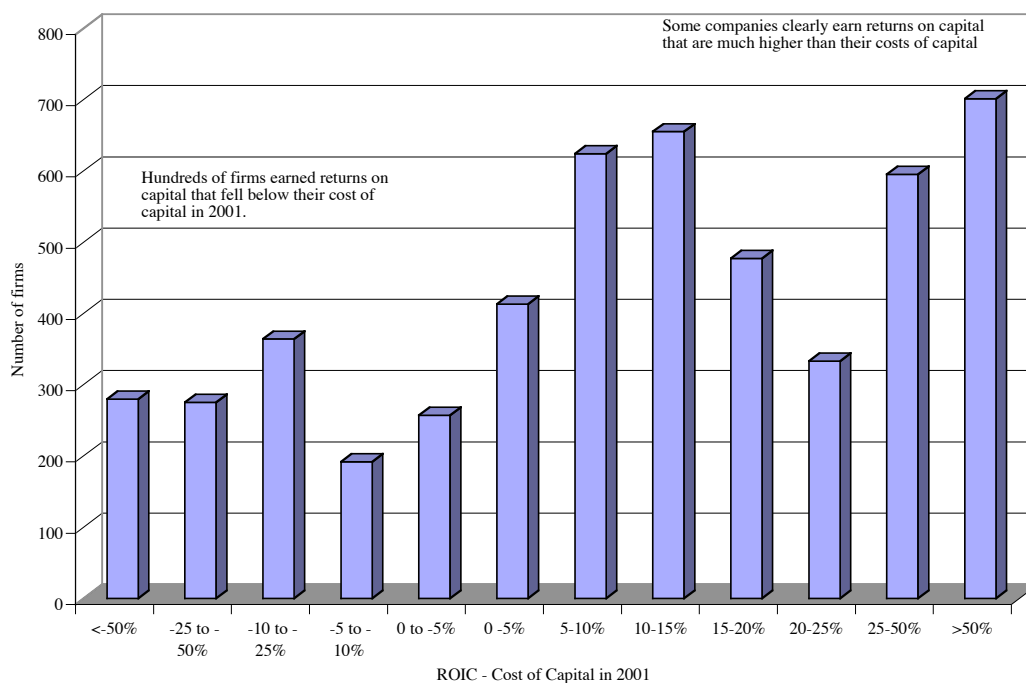
Looking at how companies vary across the market when it comes to excess returns may provide you with insight into what characterizes good companies. You will begin by looking at the distribution of excess returns and economic value added across companies in the United States. You will then consider alternate measures of company quality and the companies that make the list with each measure.

Across the Market

The financial indicator that is most closely tied to the quality of a company's management is excess return earned by the company on its investments, i.e., the difference between the return on invested capital and the cost of raising that capital. Embedded in this measure are all of the aspects of management. The capacity to take good investments is reflected in the return on capital and the optimal use of the different sources of capital should result in a lower cost of capital.

While a return on capital that exceeds the cost of capital will generate a positive excess return, there are firms that earn huge premiums over the cost of capital. At the other extreme, there are also firms that earn very large negative returns on capital while facing high costs of capital. Figure 6.3 presents the distribution of excess returns earned in 2001 by firms in the United States.

Figure 6.3: Excess Return: Distribution across U.S. Stocks - October 2002



Data from Value Line. The excess return is the different between the return on capital (book value) and the cost of capital during the most recent year.

You should note that this represents one year's numbers; the year in this graph is 2001. In this case, the recession during the year affected the earnings (and returns on capital) of many cyclical firms, resulting in negative excess returns for those firms. Notwithstanding this limitation, the divergence between firms in terms of excess returns is striking.

There are also wide differences in excess returns across sectors. Table 6.5 lists the sectors that generated the most positive and the most negative excess returns in 2001.

Table 6.5 Highest and Lowest Excess Return Sectors

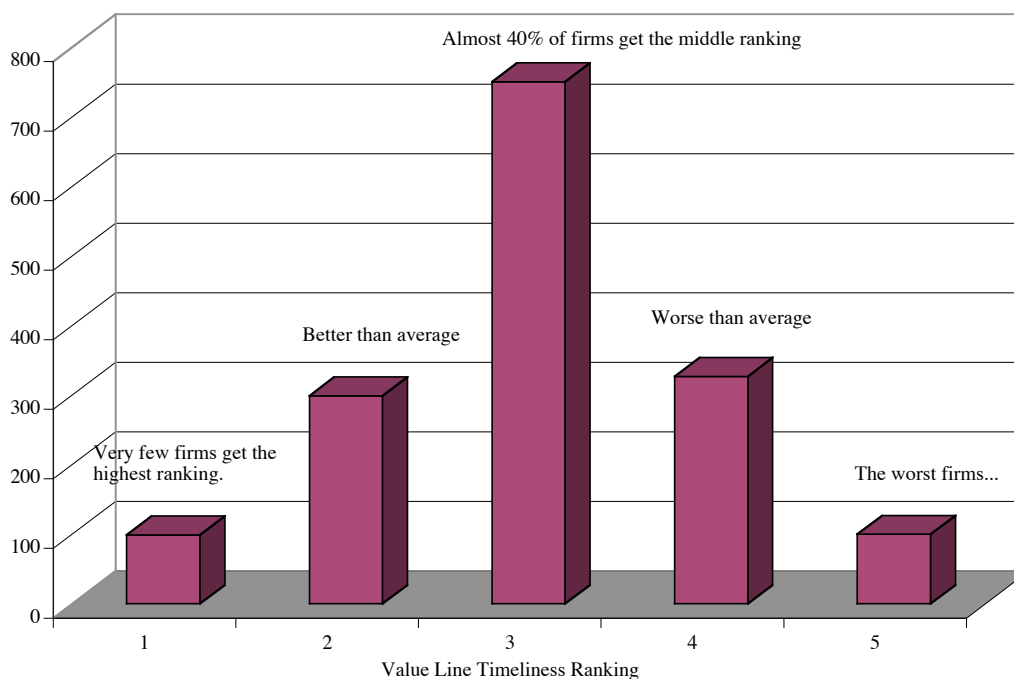
<i>Industry</i>	<i>ROC - Cost of Capital</i>	<i>Industry</i>	<i>ROC - Cost of Capital</i>
Internet	-32.76%	Beverage (Soft Drink)	13.94%
E-Commerce	-17.78%	Home Appliance	14.10%
Wireless Networking	-11.80%	Medical Supplies	15.42%
Entertainment Tech	-8.07%	Electrical Equipment	15.79%
Telecom. Equipment	-8.00%	Semiconductor Cap Eq	16.33%
Insurance (Prop/Casualty)	-7.11%	Beverage (Alcoholic)	17.12%
Investment Co. (Foreign)	-6.85%	Petroleum (Integrated)	17.46%

Healthcare Info Systems	-3.77%	Household Products	19.53%
Entertainment	-2.46%	Petroleum (Producing)	19.92%
Manuf. Housing/Rec Veh	-1.28%	Toiletries/Cosmetics	20.30%
R.E.I.T.	-1.04%	Tobacco	24.47%
Cable TV	-0.63%	Drug	24.93%

A closer look at these sectors provides clues on both the biases and the limitations of the excess return measure. Younger sectors, where firms are early in the life cycle, such as e-commerce and wireless networking tend to have very negative excess returns whereas sectors with significant barriers to entry – brand names with beverages and household products, and patents with drugs, for instance – have the most positive excess returns.

To counterbalance the bias created by looking at excess returns in the most recent year alone, you can look at more qualitative measures of good companies. Many widely publicized ranking measures such as *Fortune's* most admired companies were considered and rejected because they cover only a limited number of firms; *Fortune*, for example, ranks only 500 companies. In contrast, the measure chosen, which is Value Line's Timeliness Ranking, covers approximately 1700 companies and has been around for more than three decades. In fact, it has been widely researched and has proven to be exceptionally successful as a predictor of stock returns over that period. Value Line analysts considers a variety of factors including profitability, earnings growth and earnings momentum in coming up with its timeliness ranks which go from 1 for the best (most timely) stocks to 5 for the worst (least timely) stocks. Figure 6.4 presents the number of firms in the Value Line sample that made each ranking.

Figure 6.4: Value Line Timeliness Ranks



Data from Value Line: This table represents the number of firms that Value Line categorizes in each timeliness class – 1 is best and 5 is worst.

As you can see from Figure 6.4, roughly half the firms that Value Line follows are categorized as average, having a timeliness ranking of 3. Less than 100 firms are assigned the top ranking of 1 and an equivalent number are assigned the worst ranking.

A Superior Company List

The competing measures of company quality make it difficult to construct a portfolio of good companies. You could go with the companies that generated the highest percentage excess returns last year, but you run the risk of creating a portfolio of tiny companies (with substantial risk); note that it is easier for a small firm to earn a 50% return on capital than it is a larger firm. To counter this, you could go with a portfolio of companies with the highest EVA. Since EVA is a dollar value, this will bias you towards very large companies that generate excess return and there is the danger that you are putting all your weight on financial performance in one year and ignoring qualitative factors.

You can meld the quantitative and the qualitative measures by looking for firms that generated economic value added of at least \$ 50 million in the most recent financial year (which is 2001) while generating excess returns of at least 5% and maintaining a Value Line timeliness ranking of 1. Table 6.6 contains a listing of the companies that met both criteria

and it is the “good company” portfolio that will be put under the microscope in the next section.

Table 6.6: Firms with EVA > \$50 million and Timeliness = 1

<i>Company Name</i>	<i>Excess Return</i>	<i>EVA</i>	<i>Company Name</i>	<i>Excess Return</i>	<i>EVA</i>
Dean Foods	5.55%	\$280.10	eBay Inc.	24.27%	\$178.11
MGM Mirage	7.82%	\$610.87	Charles River	24.67%	\$95.65
Coca-Cola Ent.	8.14%	\$1,197.72	ITT Industries	24.72%	\$550.82
Walter Inds.	9.36%	\$240.59	Reebok Int'l	25.64%	\$171.71
AnnTaylor Stores	10.24%	\$71.85	IDEXX Labs.	26.40%	\$60.88
Nissan ADR	10.73%	\$4,323.34	Winn-Dixie	26.94%	\$373.02
KB Home	11.04%	\$277.90	Moore Corp.	27.10%	\$114.28
Jo-Ann Stores	11.56%	\$50.32	Lincare Holdings	27.41%	\$261.41
PepsiAmericas	11.76%	\$317.98	Education Mgmt.	28.13%	\$81.27
Dentsply Int'l	12.03%	\$157.27	Bio-Rad Labs. 'A'	28.63%	\$124.57
Mandalay Resort	12.22%	\$410.25	Anheuser-Busch	29.97%	\$2,962.04
Moog Inc. 'A'	12.48%	\$74.22	Procter & Gamble	30.04%	\$7,514.72
Constellation Brands	12.92%	\$307.04	Williams-Sonoma	32.92%	\$160.95
Harrah's	13.10%	\$620.06	Fossil Inc.	33.43%	\$69.25
STERIS Corp.	13.22%	\$78.21	First Health	35.85%	\$186.59
SICOR Inc.	14.10%	\$58.11	Patterson Dental	36.28%	\$132.71
Hovnanian	14.23%	\$125.55	Dial Corp.	37.71%	\$187.70
Quanex Corp.	14.53%	\$68.36	Sysco Corp.	38.59%	\$1,218.96
Stericycle Inc.	15.95%	\$79.68	Forest Labs.	40.90%	\$414.55
Watts Inds. 'A'	16.05%	\$58.44	Int'l Game Tech.	42.40%	\$386.49
Alliant Techsys	16.12%	\$228.99	Techne Corp.	43.04%	\$54.87
Schein (Henry)	16.71%	\$125.08	UnitedHealth	43.14%	\$1,581.15
PETsMART Inc.	18.66%	\$98.89	Block (H&R)	45.45%	\$845.93
RARE Hospitality	19.39%	\$50.68	Winnebago	47.29%	\$53.76
Universal Health	19.39%	\$292.11	Varian Medical	47.66%	\$111.58
Career Education	19.90%	\$70.97	Electronic Arts	51.68%	\$227.13
Amer. Axle	20.10%	\$281.46	Ross Stores	53.03%	\$267.33
Ball Corp.	20.12%	\$298.84	Humana Inc.	63.67%	\$334.55
Lennar Corp.	20.52%	\$622.60	CDW Computer	64.59%	\$248.20
Fisher Scientific	21.89%	\$214.53	Chico's FAS	69.61%	\$68.17
Dollar General	22.09%	\$315.66	Right Mgmt.	74.04%	\$51.89

Michaels Stores	22.45%	\$186.67	Polaris Inds.	76.33%	\$165.18
AutoZone Inc.	23.06%	\$480.64	NVR Inc.	79.42%	\$356.98
Tenet Healthcare	23.14%	\$2,197.94	Apollo Group `A'	171.27%	\$183.58
Whole Foods	23.18%	\$153.96			
Fortune Brands	23.18%	\$705.54			
Express Scripts	23.62%	\$236.32			

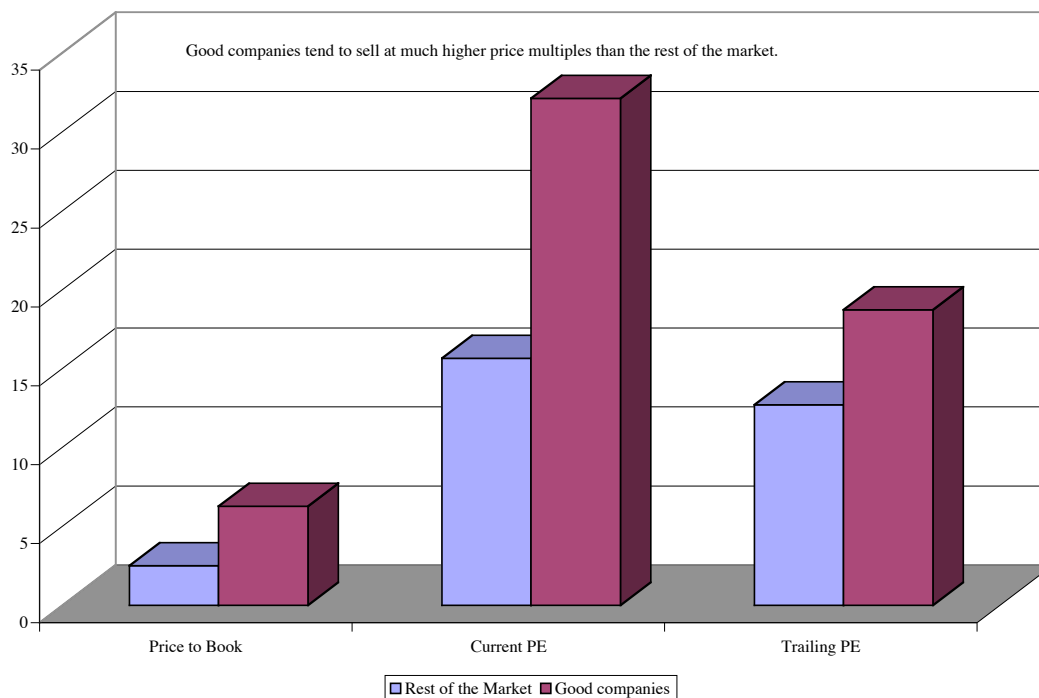
The Rest of the Story

Any investment strategy that is based upon buying well-run, high quality companies and expecting the growth in earnings in these companies to carry prices higher can be dangerous, since the current price of the company may already reflect the quality of the management and the firm. If the current price is right (and the market is paying a premium for quality), the biggest danger is that the firm loses its luster over time, and that the premium paid will dissipate. If the market is exaggerating the value of quality management, this strategy can lead to poor returns even if the firm delivers its expected growth. It is only when markets underestimate the value of firm quality that this strategy stands a chance of making excess returns.

Failing the Expectations Game

A good company can be a bad investment if it is priced too high. The key to understanding this seeming contradiction is to recognize that, while investing, you are playing the expectations game. If investors expect a company to be superbly managed and price it accordingly, they will have to mark it down if the management happens to be only good (and not superb). By looking at the multiple of earnings that you are paying for a company, relative to its peer group, you can measure the expectations that are being built into the price. It is prudent to avoid companies where expectations have been set too high (multiples are high), even if the company is a good company. Figure 6.5 compares the average PE and price to book ratios for the sample of good companies constructed in the last section and the rest of the market.

Figure 6.5: Pricing Differences: Good companies vs Market



Data from Value Line. The average value of each multiple is reported for both the good company portfolio and the rest of the market.

The market is clearly paying a premium for the companies that were categorized as good, with each of the multiples considered. With current PE, good companies trade at about twice the average for the rest of the market and with current price to book ratios, they trade at about two and half times the average for the market. The difference is smaller but still significant with forward PE ratios.

To eliminate companies where the pricing is too rich (high) from your sample of 71 good companies, pricing screens are introduced. If companies with price to book ratios that exceed 4 or current PE ratios of greater than 25 are removed from the sample, the portfolio declines to the 21 companies listed in Table 6.7.

Table 6.7: Good Companies that pass the pricing test

Company Name	Ticker Symbol	Industry	Price to Book	Current PE
KB Home	KBH	HOME BILD	1.67	8.51
Lennar Corp.	LEN	HOME BILD	2.15	8.54
Amer. Axle	AXL	AUTO-OEM	2.05	9.53
Nissan Motor ADR	NSANY	AUTO	2.59	11.26
Walter Inds.	WLT	DIVERSIF	1.16	11.85

Reebok Int'l	RBK	SHOE	2.06	14.41
Moog Inc. 'A'	MOG/A	DEFENSE	1.75	14.76
Watts Inds. 'A'	WTS	MACHINE	1.83	15.16
Winn-Dixie Stores	WIN	GROCERY	2.79	15.46
Constellation Brands	STZ	ALCO-BEV	2.25	15.56
Hovnanian Enterpr. 'A'	HOV	HOMEBUILD	2.78	16.41
Fossil Inc.	FOSL	RETAILSP	3.07	17.42
RARE Hospitality	RARE	RESTRNT	2.19	19.60
Fortune Brands	FO	DIVERSIF	3.51	19.69
Humana Inc.	HUM	MEDSERV	1.56	20.08
Quanex Corp.	NX	STEEL	2.14	20.78
Harrah's Entertain.	HET	HOTELGAM	3.60	20.99
Mandalay Resort Group	MBG	HOTELGAM	2.13	21.13
SICOR Inc.	SCRI	DRUG	3.53	22.74
Bio-Rad Labs. 'A'	BIO	MEDSUPPL	3.66	23.53
MGM Mirage	MGG	HOTELGAM	2.12	24.02
PepsiAmericas Inc.	PAS	BEVERAGE	1.57	24.94

Imposing tighter screens, a price to book screen of 2.5, for example, will reduce the portfolio even further.

Mean Reversion

Even if good companies are fairly priced, given current performance, you have to consider the possibility that companies change over time. In fact, there is a strong tendency on the part of companies to move towards the average over time. This process is called mean reversion and can be damaging for investors in companies that are considered well above average (as is the case with the portfolio of good companies). If these companies tend towards the average, the pricing is bound to follow.

Screening your portfolio for mean reversion is much more difficult to do than screening for over pricing but there are two potential screens. The first is a pricing screen. You could buy good companies only if they are priced like average companies. In practical terms, this would imply that you would buy good companies only when they trade at price earnings or price to book ratios that are lower than the average PE or price to book ratios for the sectors in which they operate. The second is to buy only companies that have sustained their standing for long periods, with the argument that they must possess strengths that do not dissipate easily. In practical terms, using EVA and Value Line timeliness rankings, you

would buy only companies that have maintained a positive EVA exceeding \$ 50 million each year for the last three years and a Value Line timeliness ranking of one in each of these years.

To screen the portfolio of good companies for mean reversion, companies that traded at current PE ratios that were less than the average current PE for each of their industry groups were eliminated. Table 6.8 applies the industry average current PE test to the sample of 21 firms that made the general pricing screens:

Table 6.8: Industry Average Pricing Tests

<i>Company Name</i>	<i>Ticker Symbol</i>	<i>Industry</i>	<i>Current PE</i>	<i>Industry Average Current PE</i>
KB Home	KBH	HOMEBUILD	8.51	13.84
Lennar Corp.	LEN	HOMEBUILD	8.54	13.84
Amer. Axle	AXL	AUTO-OEM	9.53	16.29
Nissan Motor ADR	NSANY	AUTO	11.26	18.83
Walter Inds.	WLT	DIVERSIF	11.85	16.43
Reebok Int'l	RBK	SHOE	14.41	23.30
Moog Inc. 'A'	MOG/A	DEFENSE	14.76	24.40
Watts Inds. 'A'	WTS	MACHINE	15.16	22.91
Winn-Dixie Stores	WIN	GROCERY	15.46	14.95
Constellation Brands	STZ	ALCO-BEV	15.56	23.97
Hovnanian Enterpr.	HOV	HOMEBUILD	16.41	13.84
Fossil Inc.	FOSL	RETAILSP	17.42	27.63
RARE Hospitality	RARE	RESTRNT	19.60	22.77
Fortune Brands	FO	DIVERSIF	19.69	16.43
Humana Inc.	HUM	MEDSERV	20.08	32.43
Quanex Corp.	NX	STEEL	20.78	52.29
Harrah's Entertain.	HET	HOTELGAM	20.99	23.59
Mandalay Resort Group	MBG	HOTELGAM	21.13	23.59
SICOR Inc.	SCRI	DRUG	22.74	24.20
Bio-Rad Labs. 'A'	BIO	MEDSUPPL	23.53	27.77
MGM Mirage	MGG	HOTELGAM	24.02	23.59
PepsiAmericas Inc.	PAS	BEVERAGE	24.94	34.64

The four firms that fail the test are highlighted, leaving you with a sample of 17 firms that pass both the pricing and the mean reversion tests.

Lessons for Investors

The most succinct description that can be provided for an effective “good company” strategy is that you want to buy good companies that are not being recognized by the market as such. Given that good companies outperform their peers and have superior financial results, how is it possible to keep them a secret? The answer may lie in the market reaction to short term events. First, markets sometimes over react to disappointing news from good companies, even though the news may not have really have significant long term value consequences. For instance, assume that Coca Cola reports lower earnings per share because of foreign currency movements (stronger dollar reduces the value of foreign earnings) while also reporting strong operating results (higher revenues, more units sold etc.). If the market price for Coca Cola drops dramatically, it would represent an over reaction since exchange rate effects tend to smooth out over time. You may be able to buy the stock at a bargain price, before it bounces back up. Second, entire sectors or even markets may be marked down in response to bad news about a few companies in the sector or market. In 2002, for example, all energy companies lost a significant proportion of value because of disastrous happenings at a few of them (Enron and WorldCom). If there are well managed energy companies in the sector, as there inevitably will be, you may be able to get them at a low price when the sector is down. The same can be said for well managed and well run companies in emerging markets that fluctuate as a result of political and economic trouble at the country level. In 2002, for instance, exceptionally well run Brazilian companies lost 40 to 50% of their value because of Brazil’s perceived instability. You could have loaded up your portfolio of these firms and benefited from the bounce back, as investors recognize their mistake.

To create a portfolio of well-managed companies that are trading at bargain prices, a series of screens were imposed:

1. EVA > \$ 50 million in 2001: This screens for companies that meet the financial test of earning excess returns on capital invested in projects.
2. Value Line Timeliness Ranking of 1 or 2 in October 2002: Expanding the ranking to allow firms with a ranking of 2 into the sample is required because only 99 firms have timeliness rankings of 1. This will allow you to make your other screens much more stringent.
3. Price to Book ratio less than 2.5: This eliminates firms that trade at price to book ratios that are substantially higher than the market.
4. PE ratio less than industry average current PE: In addition to finding companies that are reasonably priced, you want to ensure that you have downside protection if your

company starts moving towards the average company in the sector in terms of performance.

The resulting portfolio of 61 companies is provided in the appendix.

Conclusion

Companies that are well managed and well run should be worth more than companies without these characteristics, but that does not necessarily make them good investments. For a company to be a good investment, you need to buy it at the right price. Much of what was said in this chapter is directed towards putting this into practice.

What comprises a good company? Given the many dimensions on which you look at firms – financial performance, corporate governance and social consciousness – it is not surprising that different services and entities have widely divergent lists of quality companies. Assuming that you create a composite measure that weights all these factors and comes up with a list of companies, you will need to follow up and screen these companies for reasonable pricing. You will also need to be aware of the long-term tendency that companies have to move towards the industry average and protect yourself against this phenomenon.

Appendix: Good Companies with reasonable pricing

<i>Company Name</i>	<i>Ticker Symbol</i>	<i>Industry</i>	<i>EVA</i>	<i>Price to Book</i>	<i>Projected Growth Rate</i>	<i>Current PE</i>	<i>Industry average PE</i>
Omnicare Inc.	OCR	DRUGSTOR	\$154.81	1.71	19.50%	21.99	57.31
Quanex Corp.	NX	STEEL	\$68.36	2.14	11.50%	20.78	52.59
Hercules Inc.	HPC	CHEMSPEC	\$332.42	1.48	8.50%	0.00	23.48
Sunrise Asst. Living	SRZ	MEDSERV	\$84.03	1.14	24.00%	9.87	32.42
Korea Electric ADR	KEP	FGNEUTIL	\$5,046.16	0.57	7.50%	4.22	26.29
Cendant Corp.	CD	FINANCL	\$1,225.77	1.67	16.50%	12.12	34.14
Crown Cork	CCK	PACKAGE	\$528.85	1.07	23.00%	0.00	21.44
ShopKo Stores	SKO	RETAIL	\$122.82	0.52	4.00%	12.78	30.08
US Oncology Inc.	USON	MEDSERV	\$125.38	1.15	14.50%	15.62	32.42
PacifiCare Health	PHSY	MEDSERV	\$171.78	0.44	2.50%	15.85	32.42
Owens-Illinois	OI	PACKAGE	\$636.25	1.02	2.00%	4.88	21.44
AutoNation Inc.	AN	RETAILSP	\$266.62	0.89	17.00%	11.71	27.63
Burlington Coat	BCF	RETAILSP	\$90.90	1.16	8.00%	12.55	27.63
Brown Shoe	BWS	SHOE	\$58.36	1.11	8.00%	10.02	23.30
Russell Corp.	RML	APPAREL	\$91.31	1.02	7.50%	12.75	25.87
Pep Boys	PBY	RETAILSP	\$117.30	0.87	20.00%	14.84	27.63
Humana Inc.	HUM	MEDSERV	\$334.55	1.56	21.50%	20.08	32.42
Dress Barn	DBRN	RETAILSP	\$63.02	1.88	9.00%	15.78	27.63
Norsk Hydro ADR	NHY	CHEMDIV	\$3,107.41	1.16	9.50%	10.98	22.24

PepsiAmericas Inc.	PAS	BEVERAGE	\$317.98	1.57	19.00%	24.94	34.64
Moog Inc. 'A'	MOG/A	DEFENSE	\$74.22	1.75	10.50%	14.76	24.40
IKON Office Solution	IKN	OFFICE	\$142.25	0.75	15.00%	14.36	23.62
Reebok Int'l	RBK	SHOE	\$171.71	2.06	15.00%	14.41	23.30
Global Imaging Sys.	GISX	OFFICE	\$60.35	2.13	16.00%	14.92	23.62
Jones Apparel Group	JNY	APPAREL	\$340.06	2.14	11.00%	17.30	25.87
Constellation Brands	STZ	ALCO-BEV	\$307.04	2.25	16.00%	15.56	23.97
Paxar Corp.	PXR	ELECTRNX	\$52.04	2.05	12.50%	18.01	26.09
Universal Forest	UFPI	BUILDING	\$64.01	1.32	12.00%	9.23	17.01
Watts Inds. 'A'	WTS	MACHINE	\$58.44	1.83	14.00%	15.16	22.91
Republic Services	RSG	ENVIRONM	\$409.77	1.83	11.00%	15.17	22.75
Dillard's Inc.	DDS	RETAIL	\$178.60	0.56	16.50%	22.79	30.08
Centex Corp.	CTX	HOMEBUILD	\$444.67	1.27	17.00%	7.02	13.84
Amer. Axle	AXL	AUTO-OEM	\$281.46	2.05	14.50%	9.53	16.29
Ryland Group	RYL	HOMEBUILD	\$226.34	1.75	15.50%	7.21	13.84
Ralcorp Holdings	RAH	FOODPROC	\$77.16	1.59	15.50%	16.04	21.78
Kerzner Int'l Ltd.	KZL	HOTELGAM	\$60.64	0.98	9.00%	17.96	23.59
Pulte Homes	PHM	HOMEBUILD	\$282.63	1.13	15.00%	8.49	13.84
KB Home	KBH	HOMEBUILD	\$277.90	1.67	15.00%	8.51	13.84
Lennar Corp.	LEN	HOMEBUILD	\$622.60	2.15	18.50%	8.54	13.84
Coors (Adolph) 'B'	RKY	ALCO-BEV	\$250.65	2.36	12.50%	18.74	23.97
Pactiv Corp.	PTV	PACKAGE	\$395.74	1.60	17.00%	16.38	21.44

Walter Inds.	WLT	DIVERSIF	\$240.59	1.16	20.00%	11.85	16.43
Int'l Speedway 'A'	ISCA	RECREATE	\$131.27	1.88	15.50%	22.28	26.84
Honda Motor ADR	HMC	AUTO	\$4,514.05	2.02	11.50%	14.33	18.83
Beazer Homes USA	BZH	HOMEILD	\$116.93	2.20	17.50%	10.22	13.84
Harris Corp.	HRS	ELECTRNX	\$62.91	1.62	15.00%	22.49	26.09
Horton D.R.	DHI	HOMEILD	\$265.60	2.14	17.50%	10.47	13.84
RARE Hospitality	RARE	RESTRNT	\$50.68	2.19	15.50%	19.60	22.77
Exelon Corp.	EXC	UTILEAST	\$4,153.18	1.77	10.50%	9.93	12.99
Manor Care	HCR	MEDSERV	\$323.75	1.94	19.50%	29.60	32.42
BorgWarner	BWA	AUTO-OEM	\$196.46	1.06	8.50%	13.70	16.29
Union Pacific	UNP	RAILROAD	\$2,060.02	1.56	10.00%	15.44	17.93
Mandalay Resort Group	MBG	HOTELGAM	\$410.25	2.13	17.50%	21.13	23.59
Albertson's Inc.	ABS	GROCERY	\$2,200.98	1.72	7.50%	12.81	14.95
Johnson Controls	JCI	AUTO-OEM	\$1,167.42	2.47	11.00%	14.80	16.29
Lear Corp.	LEA	AUTO-OEM	\$759.97	1.53	15.50%	14.87	16.29
Toro Co.	TTC	APPLIANC	\$96.60	2.11	13.00%	14.31	15.58
Teleflex Inc.	TFX	DIVERSIF	\$198.77	2.21	10.50%	15.28	16.43
AnnTaylor Stores	ANN	RETAILSP	\$71.85	1.72	16.00%	26.74	27.63
La-Z-Boy Inc.	LZB	FURNITUR	\$101.50	1.82	10.50%	17.25	17.97
Raytheon Co.	RTN	DEFENSE	\$1,175.28	1.04	21.00%	23.98	24.40