

STREET SAVVY

Merrill Quant Models Way Around Value Traps

By SPENCER JAKAB

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NEW YORK -- By focusing on stocks that seem to be selling well below their intrinsic value, contrarian investors are often drawn to companies and industries that have fallen far out of favor with Wall Street.

Sifting through the bargain bin can yield winners, but it also can lure even savvy portfolio managers into buying a dud that creates a drag on their performance. Stocks that are cheap and likely to stay cheap for an inordinate amount of time are called "value traps."

Is it possible to get better at picking a stock's turning point? A report by Merrill Lynch quantitative analyst Savita Subramanian highlights a model called the Earnings Expectation Life Cycle that can identify those stocks likely to represent dead money. The note contends that over the past 11 years, industries retroactively identified by their model as value traps either stagnated or deteriorated further 67% of the time.

"Value managers often like to say that they will buy stocks early, but they'll be there at the bottom," writes Subramanian. "Although that sounds encouraging, the route to value fund underperformance is to buy early too many times."

Current value trap industries, according to Merrill Lynch, are semiconductors, biotechnology, IT services, industrial conglomerates and independent power producers. Some of the stocks cited are Intel (INTC), Automatic Data Processing (ADP), General Electric (GE), Tyco (TYC), Apollo Group Inc. (APO), and Amgen (AMGN).

Timing Isn't Everything

Value managers concede that the conventional wisdom isn't always wrong, but they attach far less importance to timing than the Merrill report. To them, value traps in their portfolios are just stocks that they misjudged.

Jim Clarke, a portfolio manager at value specialist Clarke Bennett, said his main concern is making a good call when he picks a stock, even if it takes a few years to be reflected in the price. A model is no substitute for doing your homework, veteran investors say.

"The essence of any stock pick is you're looking for something that's undervalued, something the market's overlooked," said Dawn Bennett, president of advisory firm Bennett Financial Group. "The reality is that you need to look on the flip side, and sometimes it takes something more than just reading a research report."

To be fair, Merrill's model is about timing rather than sorting out those hopeless companies that are unlikely ever to rebound. It outlines a circular series of events that begins with negative earnings surprises, estimate revisions and outright market neglect before contrarians should consider buying a stock.

The model separates the phases of the stock's life into four quadrants: bad growth, bad value, good value and good growth. The worst time to buy is the bad growth stage, when a high price is paid for poor performance, while the bad value stage is what lures investors in to a stock that is unlikely to see a catalyst any time soon for a revaluation.

Merrill's thesis is a sophisticated way of saying that timing is everything, and this is certainly a

consideration for funds whose investors may not have the patience for a long-term strategy. Take the hugely successful value investor Joel Greenblatt, who said that adopting an automated value approach that he calls a "magic formula" would have returned an average of 30.2% between 1988 and 2005 versus just 12% for the S&P 500. Despite such stellar returns, there would have been two nonconsecutive periods of 46 and 39 months when this portfolio would have underperformed the broader market.

Value Is What You Get

Ardent devotees of value investing -- those in the mold of Benjamin Graham or Warren Buffett -- would say Merrill's suggestion that investors should try to buy just before a sector or a stock is on the cusp of coming back into favor is music to their ears. Such impatience by others is the key to the consistent market outperformance of value investors. Greenblatt calls it "time arbitrage."

Shai Dardashti, a young portfolio manager who has idolized Buffett since his teens, has set up his own investment partnership, Dardashti Capital Management, that seeks to benefit from the same focus on value and patience.

"If my time horizon is three years, and it hasn't moved after a year, that's OK," he said, echoing Graham's dictum that the stock market is a voting machine in the short run but a weighing machine of value in the long run.

Clarke and Dardashti both point out that buying an out of favor, slumping company that may not have an immediate catalyst isn't a problem as long as the investor has made a good call on the long-term prospects and hasn't bought something likely to get into financial distress before the turnaround. Clarke points to the steel industry, which saw a big rebound, but not before some players went bust.

"For years, that was the definition of a value trap," Clarke said. "But as long as you avoided the ones with bad balance sheets, you did great."

Dardashti said that even a rebound in earnings isn't necessary. Consciously buying an industry in obvious long-term decline -- examples he cites are wireless paging, video rental, photographic film and newspapers -- can yield nice returns.

"Even if it's a dying industry, if you pay a cheap enough price for it, you might be OK," he said. "Price is what you pay. Value is what you get."

(Spencer Jakab, a columnist who provides insightful and unique takes on the stock market, previously wrote about the energy market.)

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