

Isolate the Positive by Eliminating the Negative?

ISSUE

Most equity research focuses on identifying attractive purchase candidates, usually by searching for companies where "good things are happening". A research process that looks for positive attributes is sensible, but suffers from one potential weakness. Often just a single negative factor or perception can outweigh many positives and keep a stock from outperforming. Is it possible to find good "buy ideas" using the alternative approach of eliminating stocks with any attribute investors might perceive as "negative"? Can a research process that focuses on negative factors also be useful as a sell discipline?

RESEARCH METHODOLOGY

We decided to use a simple screening-oriented approach for this study. We chose ten specific screening factors and "cutoff values" as representative (not optimal or all-inclusive) criteria investors might use to exclude stocks from purchase consideration. Our logic was that stocks with one or more of the following characteristics would be viewed as unattractive by some significant portion of equity investors: high valuation, poor historical growth, declining profitability, falling earnings expectations, weak stock and industry price performance. Our research database consisted of approximately the top 2000 market cap companies (including non-survivors) at each point in time for the ten year period 1984-1993.

RESULTS

Table 1 summarizes the individual performance of the ten screens we used to find "unattractive" stocks. The top half of the table consists of five screening criteria that long-term, fundamentally-oriented investors might use. The first two screens show that stocks with extremely high P/E ratios underperformed our test universe by a significant margin, while the third screen shows that stocks with recent dividend cuts should be avoided. Note

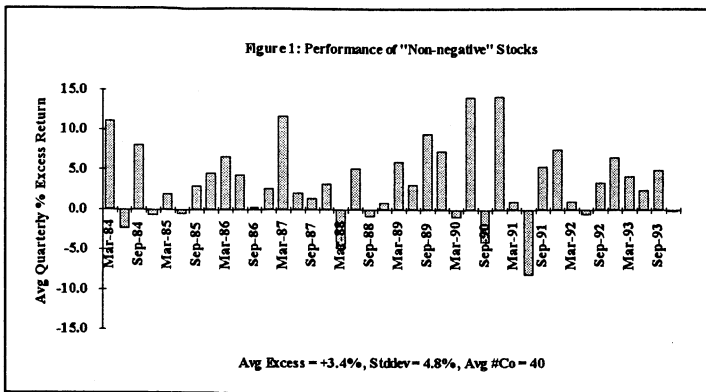
that excluding companies that pass these three screens would still leave numerous potential purchase candidates. Screens 4 and 5 show that companies with declining profitability were poor performers as well.

The bottom half of Table 1 consists of five screening criteria short-term, trading-oriented investors might use. Screens 6, 7, and 8 show that stocks with falling actual EPS and estimated EPS, and those reporting negative earnings surprises all performed poorly. Screens 9 and 10 show stocks with poor stock price performance were also shunned by investors.

Table 1: Performance of "Unattractive" Stocks, 1984-1993

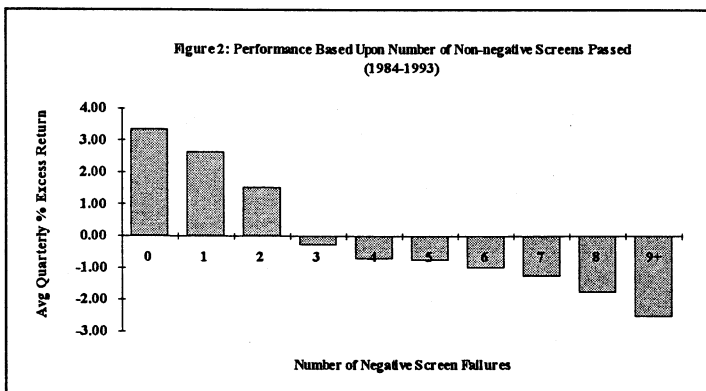
Exclusionary Screen	Avg Qtrly Excess Return%	Avg #Co Passing Screen
<u>Long-term Investment Horizon</u>		
1. P/E >1.5 * S&P500 P/E	-1.46	430
2. P/E >2 * Estd 5Y EPS Gth Rate	-1.56	270
3. 2Y Dividend Gth <0%	-0.77	170
4. 1Y ROE Chg <0%	-0.47	1052
5. 1Y Oper Marg Chg <0%	-0.77	608
<u>Short-term Investment Horizon</u>		
6. Qtrly EPS Gth <0%	-1.34	827
7. 3M Cur Yr EPS Estimate Chg <0%	-1.27	1242
8. Last Rptd EPS Surprise <0%	-1.05	813
9. 12M Stk Price Chg <S&P500 Price Ch	-1.04	1229
10. 12M Industry Price Chg <S&P500 Pric	-0.67	1377

Our next step was to sequentially apply all ten screens to our test universe. For simplicity, we eliminated any company without the data necessary to compute all ten screens. This step reduced our test universe to about 800-1000 stocks at each point in time (operating margin was the most common data deficiency) but did not change our average universe return. We set the direction (> or <) of each screen so that stocks with negative attributes would be eliminated. Therefore, this process of successively applying all ten screening criteria would only yield stocks where no "negatives" were present. We found about 40 stocks passed this screening sequence each quarter. Figure 1 shows the quarterly performance of the resulting "non-negative" stock portfolio.



Eliminating all stocks with one or more negatives produced an outstanding "buy ideas" list. The non-negative stocks outperformed the test universe by 3.4% per quarter and provided positive excess returns 30 of the 40 quarters tested. This performance is exceptional given that our exclusionary process did not even consider positive stock attributes. Remember, we didn't look for undervalued stocks; we just excluded overvalued ones. We didn't look for stocks with rapidly increasing earnings; we just eliminated those with declining earnings. Imagine the performance potential of further screening down this list by focusing back on positive attributes!

Rather than look only at companies with zero negative factors, as a final step we created a simple scoring system by counting the number negative factors for each stock. Figure 2 shows average performance based upon the number of negatives.



The results in Figure 2 are interesting. As might be expected, excess returns decreased as the number of negative factors increased. However, the rate of decrease was not linear. Also note the presence of just three negative factors was enough to drive excess returns below zero. This finding supports our hypothesis that only a few negatives can be enough to keep a stock from performing well.

CONCLUSIONS

With so much investor emphasis on finding the positives, focusing attention on potential negatives appears to be a unique and value-added process. Clearly, eliminating stocks with potential negatives can be an effective method for creating a list of attractive stocks for further research.

The "devil's advocate" approach of focusing on the negatives is helpful in another important respect. Investors often complain about difficulty in making timely and informed sell decisions. Much of this problem can be directly attributed to the conventional research focus on positive factors, a process that inherently provides little guidance for deciding when to sell stocks. Note, by contrast, that each factor in Table 1 could be employed as a potential "sell rule" for evaluating existing portfolio positions. A more comprehensive sell discipline could be based on a scoring system like that presented in Figure 2.

We would like to end by emphasizing the vast potential to enhance the screening process presented in this introductory study. Many alternative screening factors could be used to improve results and/or customize the approach to any firm's investment process. Also, sophisticated decision tree and genetic algorithm techniques could be used to find optimal factor combinations and cutoff values. Happy hunting!