MONTHLY INVESTOR

Combining Value Investing and Trend Following into a single method: ‘Trending Value’

Value and Momentum are two of the most powerful factors that drive stock market returns. My Trending Value method combines the two into a very rigorous method of investment.

Let's look at the two methods of Value Investing and Trend Following independently then consider the merits of combining them.

Value investing has been validated by the successes of Benjamin Graham and some of his students including Warren Buffett. Graham co-authored 'The Intelligent Investor' which is considered a classic exposition of the reasons, methods and benefits of Value investing. Considerable wealth has been built by some users of the methods proposed by Graham. Warren Buffett is arguably the most successful investor of all time and his company Berkshire Hathaway has achieved high double-digit annual growth over many decades. The Value method can be hard to stay with however, because the hidden value in a company may not be recognised by the market for some time. A share price going nowhere or even falling, can test patience to the limit. A purchase may actually be a mistake if the company is a 'value trap'. A low valuation may be signaling that a company or even a whole sector is in trouble. The gains for investors appear only when the share price starts to move upwards, when the value is recognised and validated by buyers, so we like to wait for that signal before committing to purchasing a share no matter how good the perceived value. A share in an uptrend which remains good value is an attractive proposition.

What about Trend Following? There is considerable evidence that shares that are gaining in price continue to gain in price. On average, winners continue to be winners and losers continue to be losers. Academic research has validated this 'momentum' effect, and the investment method known as Trend Following has regularly out-performed the market. But just as Value Investing is not perfect, neither is Trend Following. Its main weakness is that it can be difficult to know whether one is entering a position near the end of a trend. If that happens, we can be whip-sawed out soon afterwards when the trailing stop is triggered. Losses may be small on each position but if this happens over and over for several months the investment account gets whittled away. If we do not sell, the outcome could be even worse. Hence, I always use volatility-based position sizing and trailing stops.

So, both Value Investing and Trend Following have their weakness. But note that combining the two reduces both weakness. Waiting for an uptrend to appear before buying a 'value' share helps us to avoid value traps. And adding Value criteria to Trend Following improves the probability that a share selected for purchase could have considerable upside before the trend runs out of steam. That thinking was the origin of my Trending Value method.

Many financial asset classes (e.g. precious metals, commodities, real estate etc) cannot be valued by these methods and so I concentrate my Trending Value portfolio on shares quoted on the major stock market exchanges. My first choice is always UK shares to remove currency exchange rate factors, though USA and European shares can form part of the portfolio if currency exchange rate factors are minimal or in my favour.

It is actually very hard to find shares that meet my rigorous criteria and the portfolio generally holds only 5-10 shares and often less during the weak summer season. But they are usually the best performers in my investment portfolios.

Listed below are some of the criteria I use.

Value criteria:

- PEG: Price-Earnings to Growth ratio. I am seeking companies with a PE that is low relative to the rate of growth of those earnings in the 'E' part of PE. PEG was a key criterion used by Jim Slater and Peter Lynch. We are looking for a PEG value in the range 0.3 -1.5.
- ROC: Return on Capital illustrates the efficiency with which company managers are using the resources at their disposal. We look for a value above 12, maintained over several years.
- Magic Formula: Assessment can also be based on Joel Greenblatt's Magic Formula (Return on Capital + Earnings Yield) which combines features of both PEG and ROC in a slightly different way. We look for consistency of message across all three.

Trend of price gains:

- The share may be good value, but if that value is not recognised by others then I won't make capital gains. So, I want to see a good rise in price in recent months. Gains over 1-3 month or 1-6 month must be above 30% annualised rate.
- I also want to see a relatively smooth trend in the price chart. I don't want big fluctuations in value of the shares I hold, and I want to detect if a trend changes so I can decide whether to sell. A smooth price movement helps with both these objectives.

Safety criteria:

- Bankruptcy risk: Altman Z-score must be above 3, the higher the better.
- Financial strength: Piotroski's F-value must be between 5 and 9, the higher the better.
- Free Cash Flow conversion: To guard against management 'fiddling the books' when reporting profits, I look for strong generation of cash. Profits can be 'adjusted' but cash flow is much more difficult to manipulate. I

compare Free Cash Flow (FCF) with profit expressed as Earnings Per Share (EPS) to see how much of the profit arrives in cash. I are looking for >90%. We want to see that figure of >90% maintained over the past years too.