Today's lesson: less is more

Ivey school professor George Athanassakos teaches his pupils lesser-known stocks can pay big returns

Jan 17, 2008 04:30 AM

NAOMI CARNIOL
SPECIAL TO THE STAR

Call it the anti-Bay Street method. Instead of favouring stocks followed by many analysts, George Athanassakos prefers stocks touted by few.

As a professor at the University of Western Ontario's Richard Ivey School of Business, Athanassakos encounters students who are skeptical about his stock theory. But their doubts tend to vanish when he shows them his research.

Athanassakos, the director of Ivey's Ben Graham Centre for Value Investing, observed two groups of stocks for 19 years to illustrate the potential benefits of stocks favoured by few analysts – ones that had low price-to-earnings ratios. (A price-to-earnings ratio is the share price divided by the company's earnings per share).

Athanassakos started his research in 1986 with more than 700 Canadian stocks. He then screened out stocks using several factors including:

Stocks with prices below $1;

Companies with year-ends not in December.

He then divided the remaining stocks into so-called quarterlies. One quarterlie consisted of about 15 stocks with low price-to-earnings ratios. At the other end, a quarterlie of about 15 stocks had high price-to-earnings ratios and were favoured by many analysts.

Athanassakos monitored both stock groups from 1986 until 2005. He found that in 70 per cent of the years, the group of stocks with low price-to-earnings ratios actually outperformed the highly favoured stocks.

From 1987 to 2005, on average, the group of stocks covered by few analysts exceeded the returns of the favoured group by 24.71 per cent.

In Athanassakos's view, just because a stock isn't followed by many analysts doesn't mean it's a poor investment. Institutional investors like stocks followed by numerous analysts "because they can always blame the analysts if something goes wrong," says Athanassakos.

The stocks institutional investors shy away from tend to be more undervalued than other popular stocks because "the institutional investors don't buy these stocks and ... beat the prices up."

That's music to a value investor's ears.

According to Athanassakos, value investors want to buy stocks on sale.

"They feel that they have a greater chance of finding this type of investment by looking at stocks that are small, obscure and not followed by analysts."

While Athanassakos prefers stocks followed by less than three analysts, he cautions that just because a stock is covered by few analysts "doesn't necessarily mean it's undervalued." It means the potential is there, he says.

Checking if a small number of analysts follow a stock is only the first step, he says. The next step involves taking a closer look at the stock.

"Let's actually value the stock and see if this is truly undervalued. ..."

When you value a stock, "you find the intrinsic value and then you say, `okay, if the stock price right now is trading well below the intrinsic value, then it's truly undervalued and I'm going to buy it.'"

Determining if a tiny number of analysts follow a stock doesn't prevent value investors from doing any homework, but it reduces their workload.

"There are 2,000 stocks out there. I don't have the time as a value investor to value 2,000 stocks so what I do is put in some screening mechanisms which allow me to narrow down the sample from 2,000 to 100."

Looking for stocks covered by a few analysts is one helpful screening mechanism, Athanassakos says. Others include searching for smaller size stocks and stocks with low price-to-earnings ratios.

These screening mechanisms are useful when combined with a long-term perspective, Athanassakos adds. Value investors "know that the future is uncertain. No one will be able to outperform every year. As long as, on average, in the long run you outperform by a significant amount, then you come out ahead."