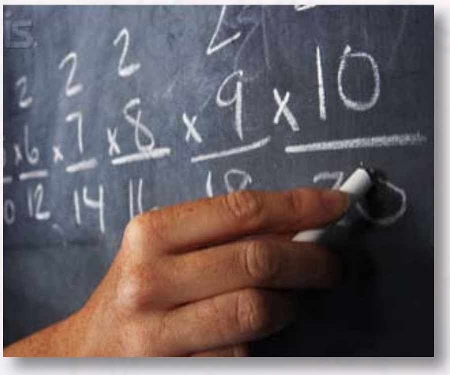

The F factor

Finding cheap shares is easy, but picking the ones that will recover most strongly is the trick. This is where the F score – a measure of financial strength gleaned from company accounts – comes in, says **Richard Beddard**

Since its peak in June 2007, the FTSE All-Share index has fallen 44 per cent. It has dropped 33 per cent since the start of 2008 and 22 per cent since the first Share Sleuth article, on Haynes Publishing, in July. Given this background, you might be thinking that it is not a good time to be a share sleuth, but it is.

Shares are cheap. To work out just how cheap, we can compare the price of companies with their profits. Since profits fund dividends and company growth, they are a measure of the reward investors can expect for owning a share. However, the problem with profits is that they rise and fall.

Last year's profits, or City analysts' forecasts, are not a reliable guide to the future. That is especially apparent as we slip into recession after 16 years of growth. In a recession, the economy shrinks and profits suffer, yet analysts expect the general level of earnings to grow by more than 10 per cent next year.

THE LONG-TERM PICTURE

Fortunately, there is an alternative. Benjamin Graham, often credited with founding the discipline of security analysis, championed the average of five, or better still 10, years of profits as a measure of a company's earning power. The average is a conservative measure because it includes bad years as well as good.

Using nine years of profits, including slowdowns in 2002 and 2005 but no full-blown recessions, I reckon the average price/earnings ratio for UK companies is about 10. At the start of 2008, it was 20. For every £1 you invest now, companies earn 10p per share in a typical year – a yield of 10 per cent. For every £1 you had invested at the start of 2008, companies earn 5p in a typical year – a yield of just 5 per cent.

Key stat: clues in the figures

One way to judge whether a company is getting into trouble or pulling itself out of it is to use the F score – a measure of financial strength. To calculate the F score tot up nine variables from a company's financial statement relating to profitability, liquidity and debt. It sounds complicated, but once you have found the information it requires only basic addition – one of the reasons I like it. For a full explanation see http://blog.iii.co.uk/piotroski/

Shares seem cheap compared with any year since the recession in 1981. They also seem to offer good returns compared with alternatives such as cash deposits or government bonds.

> To back a company others are selling, you need a reason to believe it will recover when other companies might not

Recognising that shares in general are cheap is one thing, but picking individual companies is another. That is because there is safety in numbers. Academic research shows that as a group, cheap companies are safe, rewarding investors because the minority of companies that recover strongly over, say, a two-year period more than make up for the majority that continue to deteriorate.

That is fine if you own shares in 20 or 30 companies, or a fund, but not reassuring if you are a share sleuth picking individual companies. To back a company other investors are selling, you need a reason to believe it will recover when other companies might not. It is unlikely to be a particularly newsworthy reason, such as a giant contract or blockbuster product, or other investors would know about it. You are more likely to find it buried in financial statements.

Professor Joseph Piotroski, of the University of Chicago, realised financially strong companies might recover best. He devised the F score to measure financial strength from information in company accounts. He demonstrated that companies with high F scores not only produce higher returns, but are five times less likely to fail completely than those with low F scores.

High F score companies are perfect Share Sleuth stocks because they are usually small and always out of fashion. But there is a problem: companies are still reporting last year's results, including figures that predate the onset of recession. How those companies score this year and next is likely to be even more revealing and perhaps profitable.

Update: previous picks

Although it is far too early to judge the performance of Haynes (Share Sleuth, July 2008), Education Development International (August), Optare (September) or Games Workshop (October), only Optare has fallen markedly. Perhaps that is not surprising, as it is new to the stock exchange and with limited information – no F score, for example – it is likely to be the most speculative. Haynes and EDI score a comfortable six out of nine variables and Games Workshop an even better seven out of nine.

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