



Fisher Funds Investor Education Centre

Making investing understandable,
enjoyable & profitable

Building our 2012 toolkit - 5 February 2012

As my daughter headed off to school this week for an introduction to her new computer, I thought about the tools that investors might find useful in the year ahead. While investment markets are random, it makes sense to be prepared for every eventuality.

Markets may go up, down or sideways in the year ahead and if last year is any indication, 2012 will probably feature all three patterns at some stage. The tools required for down markets and sideways markets are similar – diversification and a cash buffer are essential. You can never be truly prepared for a down market except by being out of the market altogether, which is risky because you might miss the up market when it emerges.

Ensuring your portfolio is well diversified across different assets, industries and geographies can protect against the downside as not all investments fall at the same time or to the same extent.

Holding some cash is prudent in an uncertain investing environment as it provides a buffer when markets fall and it allows the selective purchase of undervalued investments on particularly bad days. Opportunities can arise even in sideways markets, so you want some cash to put to use judiciously.

As for up markets, it is easy to think that just by being in the market at the time, you will benefit as the market rises. But in the case of share market investments, not all boats are lifted with a rising tide. Some will rise faster and further than others.

How to identify which stocks to buy is a big discussion in itself, and we have covered many of the key aspects in previous columns – earnings history, competitive advantage, earnings growth potential etc.

How much to pay is just as important a consideration as what to buy.

Many investors use the price-to-earnings ratio to indicate whether a stock is cheap. The P/E ratio shows how many dollars a buyer must pay for each \$1 in annual earnings the company achieves. It is a useful tool, but there are many others that do a similar job.

Two Drexel University professionals recently published the results of a 40 year study of a number of valuation measures. The study looked at how each measure predicted stock returns between 1971 and 2010, and the winner was declared to be the EV/EBITDA.

Now despite it being a fairly ugly acronym, the 20% of stocks with the lowest EV/EBITDA returned 17.7% over the period compared with 15.2% for the lowest P/E ratios, and 13.0% for an equal weight portfolio of all stocks.



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EV stands for enterprise value which is the cost to buy a business in full and take over its debt obligations. EBITDA is earnings before interest, tax, depreciation and amortisation. The EV/EBITDA measures the core profitability of a business' operations and looks at a firm the way a potential acquirer would, by taking debt into account, which a P/E doesn't explicitly.

It's a bit heavy going for the start of the year, but hopefully this tool might prove handy when you dip your toes back in the water.