SmartTrust®

The World According to GARP

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Growth at a reasonable price ("GARP") investment strategies are nothing new on Wall Street. Legendary investors such as Peter Lynch, who was the former portfolio manager of the Fidelity Magellan mutual fund, and Warren Buffet, the well-known Chairman and CEO of investment conglomerate Berkshire Hathaway, have both employed GARP techniques as a part for their stock selection criteria. However, the ways in which GARP strategies are implemented vary greatly and it is these variances that can cause wide differences in investment results. In other words, the inputs greatly impact the outputs in the world of GARP investment strategies.

As there is some confusion about what GARP is and what GARP is not, I believe that it would be helpful to define how we view GARP at SmartTrust®. Following a GARP stock selection approach, we generally look for companies that have been growing their earnings, not their stock price, and are trading at a reasonable price relative to these earnings. Some may suggest that this is a value based investment approach. While it can be argued that the employment of GARP screening criteria helps to identify the stocks of companies that offer a "good value" based on their current stock price and their sustainable growth potential, investors often associate the term "value" with stock dividends, which aren't necessarily a primary component of many GARP investment strategies. Hence, calling it a value based investment approach may be misleading to some. As a result, I would suggest that GARP is more of a hybrid investment approach blending principles of growth and value together.

Source: *www.Investopedia.com, January 2015*

There are several metrics that GARP-oriented investment managers generally look to when identifying stocks for their portfolio strategies. These include, but are not necessarily limited to, the following:

- **P/E Ratio –** is the ratio of a stock's current share price to its earnings per share (EPS). Value oriented investors and GARP advocates tend to prefer stock's with lower relative P/E ratios whereas Growth oriented investors generally lean more towards stocks with higher relative P/E ratios. To gauge the relative value of a P/E ratio, it may be helpful to put it in a historical context. According to Bespoke Investment Group, the average reading of the P/E ratio of the S&P 500 index for the time period starting in 1989 and ending in 2014 was 18.90. Looking at a shorter timeframe, the P/E ratio of the S&P 500 index for the time period starting in 2004 and ending in 2014 was 16.95. Interestingly, the S&P 500 closed the year of 2014 at 2,059 with a consensus earnings estimate for 2014 of 117.02. This equates to a P/E of 17.6, just slightly above the 10 year average of 16.95 but below the 25 year average of 18.9. In this regard, a GARP strategist might consider stocks with a P/E ratio of somewhere between 10 and 20, while generally looking to stay away from stocks with a P/E ratio above 20.

- **P/B Ratio –** is the ratio of a stock's book value per share to its total number of outstanding shares, where book value is determined by subtracting total liabilities from total assets. Companies that have a lower relative P/B ratio are deemed to be undervalued with the potential for price appreciation once the market realizes the degree that the stock is undervalued. As a result, GARP strategists would be attracted to stocks with lower P/B ratios.

- **PEG Ratio –** is the ratio of the P/E ratio itself to the projected growth in earnings. This ratio allows an investor to understand how a stock is currently trading relative to its earnings per share but also how it is trading relative to its projected future earnings growth rate. What determines the projected future growth rate here is critical and is often a distinguishing characteristic of different GARP-based investment strategies. Most projected future earnings growth forecasts use between 3 – 5 years of historical earnings data to calculate expected earnings per share estimates for the next full year (or business cycle). PEG ratios can also be based on either current year P/E ratios or next year P/E ratios. GARP strategists tend to prefer a PEG ratio near 1 and generally below 2 although PEG ratios that are too low (Ex. Below 0.5) may be risky on their own merit due to potential overly optimistic growth projections.

  I found some historical evidence of the potential importance of lower PEG ratios to investment performance. In a study concluded in 1998, Morgan Stanley found that a strategy of buying stocks with low PEG ratios yielded returns that were significantly higher than the S&P 500 index. Morgan came to this conclusion by looking at the 1,000 largest stocks on the U.S. and Canadian exchanges each year from January 1986 through March 1998, and categorizing them based upon their PEG ratios. They found that the 100 stocks with the lowest PEG ratio earned an annual return of 18.7% during the period, higher than the market return of about 16.8% over the same period. While this study represented a relatively short (and older) period of time, and understanding that past performance does not guarantee future results, the results of this study, nonetheless should not be completely ignored.

- **ROE –** is a measure of company's profitability and is calculated by determining the amount of net income returned as a percentage of shareholder equity. For ROE calculations, net income is typically calculated for a full year and does not include dividends paid to common stock holders but does include dividends paid to preferred stock holders. In addition, shareholder equity does not include preferred shares. GARP strategists tend to prefer the stocks of companies with a relatively high and/or increasing ROE relatively to their peer group of the market as whole.

- **Cash Flow** – often a measure of the financial soundness of a company, cash flow can help to provide investors with an understanding of any excess cash that a company is generating that could potentially be redeployed elsewhere. These redeployments could take the form of any of the following:

    - Raising the company's dividend
    - Buying back shares of the company's stock
    - Acquiring other companies or divisions of other companies
    - Hiring additional employees
    - Expanding the company's operations
    - Paying down existing debt

    All of these potential deployments are generally good for the company, and can be good for shareholders as well. As a result, GARP strategists tend to prefer companies with positive cash flow. One such measure to look at is trailing twelve month free cash flow ("TTM FCF"). This measure is typically calculated by adding free cash flow totals for the four most recent quarters, where free cash flow is comprised of the cash flow from operating activities minus total capital expenditures. According to Bloomberg, free cash flow represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.

Using some combination of these statistics, and perhaps additional ones, GARP strategies attempt to select stocks that are believed to be associated with companies that are;

1. well-run with a healthy balance sheet,
2. growing their earnings, and
3. trading at a reasonable price or are presently undervalued

While applying these criteria to any selection process may result in an attractive and timely investment portfolio, it does not ensure a profit in up markets nor does it prevent a potential loss in down markets. Different market factors can influence the price of a stock regardless of the strength of their balance sheets, their history of earnings growth, their expected future rate of earnings growth and their current valuations. Regardless, applying these criteria to any stock selection process, in most market cycles, is certainly worthy of consideration.

<u>SmartTrust® GARP-focused UIT Solution</u>

At SmartTrust®, we provide a GARP investing solution through our partnership with Zacks Investment Management. Zacks is the Portfolio Consultant to the *SmartTrust®, Zacks GARP Composite 35 Trust* series. Zacks is a leading expert on earnings and using earnings estimates in the investment process. Zacks Investment Management ("ZIM") is a wholly owned subsidiary of parent company, Zacks Investment Research, one of the largest providers of independent research in the United States. Zacks specializes in managing equity and fixed income portfolios for individual investors using a unique combination of Zacks independent research and Zacks proprietary quantitative models.

Our GARP investing solution is provided through a Unit Investment Trust ("UIT"). For those of you who may not be aware, UITs are a fixed portfolio of stocks, bonds or other securities. These types of portfolios allow investors to know what securities are held within a UIT as of the date of deposit, as well as the mandatory termination date of the trust. While it is not common, a trust may terminate early as described in the prospectus. UITs offer an attractive opportunity for investors to own a portfolio of securities via a low minimum, typically liquid investment. As a point of contrast, while many actively managed funds continually buy and sell securities, thereby changing their investment mix, the securities held in a UIT generally remain fixed. Some UIT securities are chosen according to a quantitative selection process determined by a sponsor while some are based on an index. Other UITs are chosen by experienced analysts or portfolio managers, who research the securities and screen them for various characteristics, according to specific objectives. Once securities are selected, the UIT portfolios are then supervised accordingly throughout the life of the trust.

For the *Zacks GARP Composite 35 Trust*, after ranking all publicly traded common stocks listed on the New York Stock Exchange or the NASDAQ Stock Market by market capitalization and liquidity (*using three-month average daily trading volume data*), the following security selection screens are employed for this 15 month UIT series to help arrive at the 35 stocks in the final portfolio:

- Stocks are ranked by the **PEG ratio**, which is defined for these purposes as the stock's market price-to-earnings ratio divided by the stock's 12-month earnings per share ("EPS") growth rate of the <u>last 5 years</u>

- Stocks are then ranked by **Share Buyback** data, which is defined for these purposes as the number of shares outstanding one year prior to the Security Selection Date divided by the current number of shares outstanding

- Stocks are then ranked by the **CFO-to-price** ratio, which is defined for these purposes as the issuing company's trailing 12-month cash flow from operations divided by the stock's market price

- Stocks are then ranked by **Earnings Surprise** data, which is defined for these purposes as the issuing company's actual earnings per share from the last completed fiscal quarter minus the issuing company's mean earnings per share consensus estimate for the completed fiscal quarter reported by industry analysts, divided by the issuing company's actual earnings per share from the last completed fiscal quarter

Visually, this GARP-based decision tree looks like the following:

Hence, our GARP-focused investment solution incorporates traditional GARP measures such as P/E ratios, PEG ratios (using 5 years of actual 12-month EPS growth rates), and cash flows but also includes more innovative criteria such as share buyback information and earnings surprise data to help arrive at its final portfolio that is constructed with an objective to provide investors with the possibility of above-average total return (i.e. a total return that exceeds that of the S&P 500 index over the life of the Trust). It should be noted that total return may include capital appreciation and dividend income, which is why some GARP-based investment strategies may include dividend screens as well.

Conclusion

GARP-based investing is not easy and its success is not guaranteed and requires extensive research and an understanding of the various data points that GARP strategists rely upon. As a result, individual investors may want to consider utilizing an investment solution or a money manager with extensive GARP-focused investment experience. GARP has been a part of Wall Street lexicon for decades and will likely be a part of certain Wall Street investment strategies for decades to come.

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