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Lessons from my TFSA: Putting a company to the test

By Fred Kirby, Special to Financial Post

Fred Kirby: Buying financially sound but overlooked companies can give small investors a big advantage. Here's how to make sure the fundamentals stand...

Individual investors have advantages over professionals because we can act independently and are not tied down by investment committees, superiors or other competing demands.

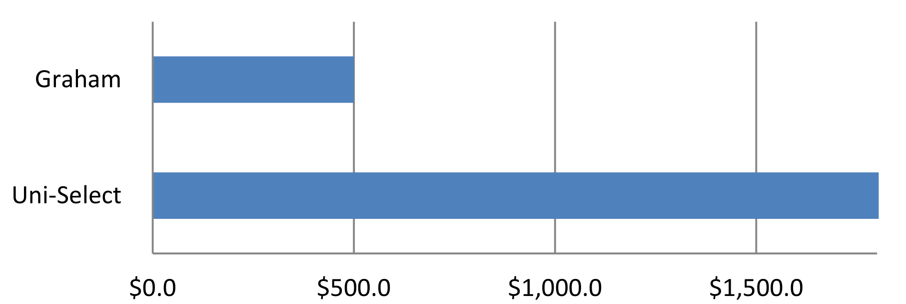
We also can look for profitable investment opportunities in overlooked areas such as small under-followed companies that are too small for larger fund managers to pay attention to.

I bought one such company for our household TFSAs at the end of February; Uni-Select Inc., trading on the TSX under the symbol UNS. Uni-Select, headquartered in Quebec, is a North American distributor of replacement parts, paint products and body shop accessories.

It could be a poster stock for a defensive investor that Benjamin Graham described in his seminal book on value investing *The Intelligent Investor*.

In this book, written in 1949 and acclaimed by Warren Buffett as the best book on investing ever written, Graham lists seven criteria for a good stock. Here we compare his standard with Uniselect's performance.

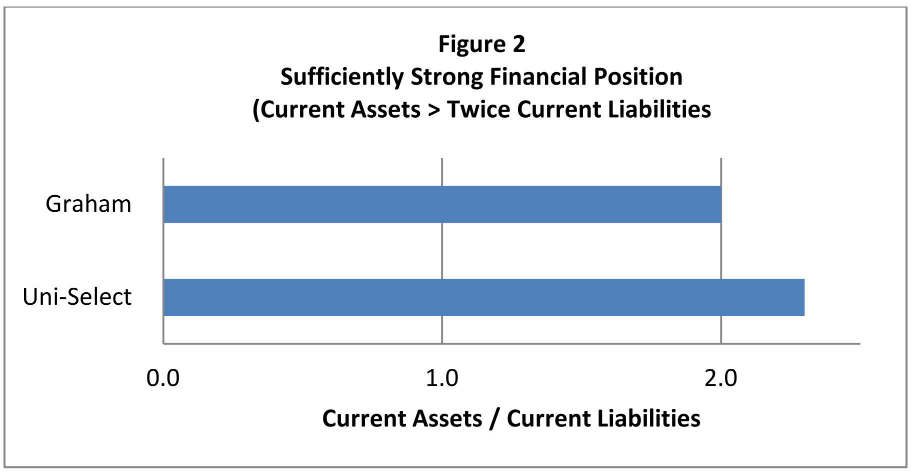
Figure 1
Adequate Size of the Enterprise
Sales > $500 Million
(dollar amounts in millions)



1. Adequate size of the enterprise

After adjusting Benjamin Graham's 1973 edition of the Intelligent Investor's $100-million minimum sales requirement to $500-million for inflation, Uni-Select's sales of $1,821-million in 2012 easily surpassed the size test.

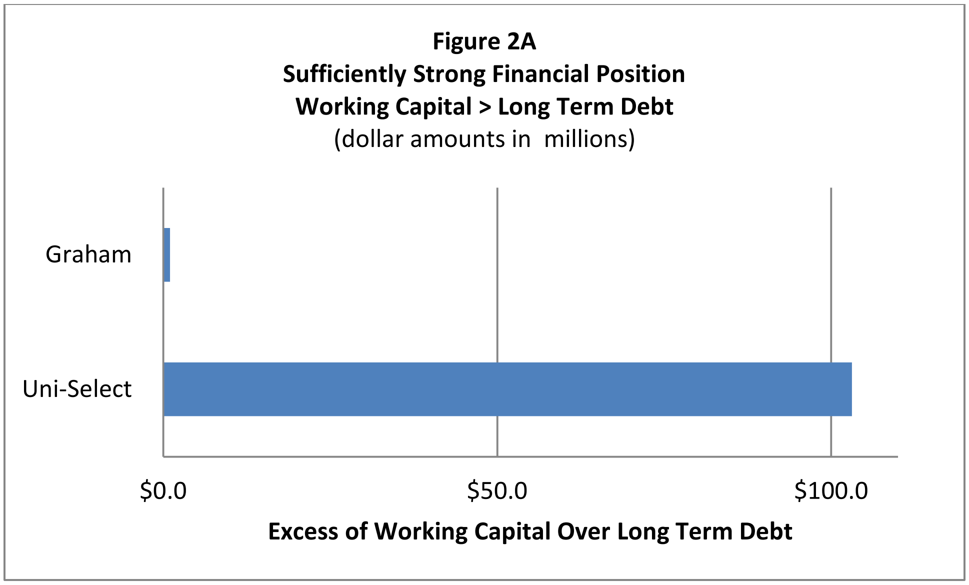
Score: Uni-Select 1 out of 1.



2. A sufficiently strong financial position

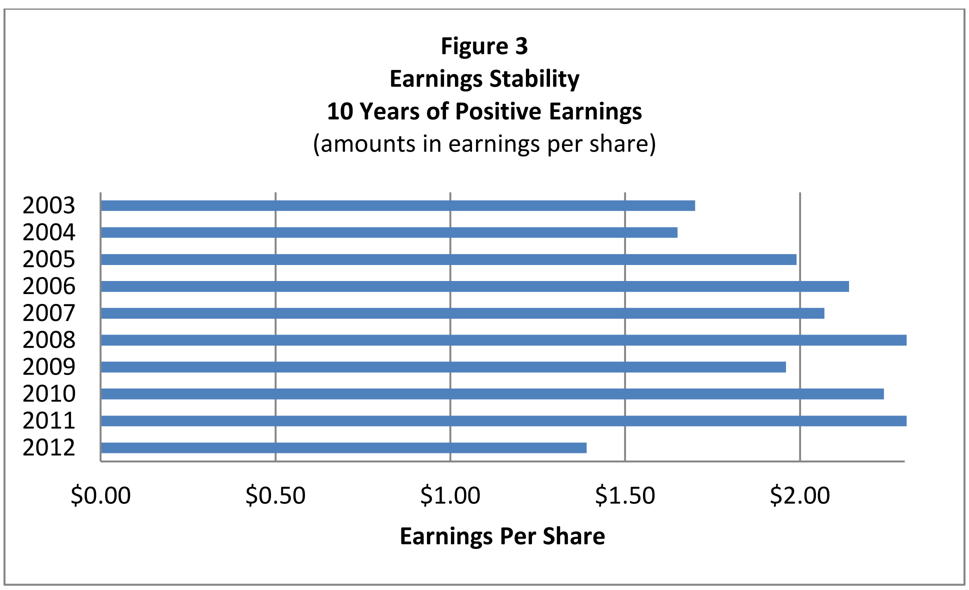
According to this criterion, industrial companies require a ratio of at least 2:0 for their current assets divided by current liabilities (also called working capital). Uni-Select's has a 2.3 ratio.

Score: Uni-Select 2 out of 2



The second test for financial strength is that the company's working capital (current assets minus current liabilities) be more than its long term debt obligations. Uni-Select handily exceeds that requirement.

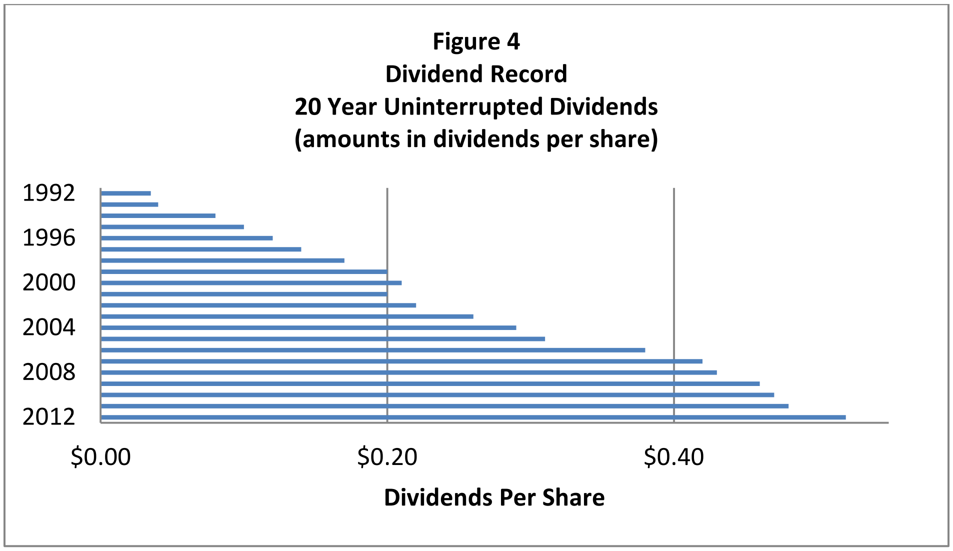
Score: Uni-Select 3 out of 3.



3. Earnings stability

There should be positive earnings in each of the past 10 years. Uni-Select not only has accomplished that, it has had uninterrupted positive earning for more than two decades.

Score: Uni-Select 4 out of 4.



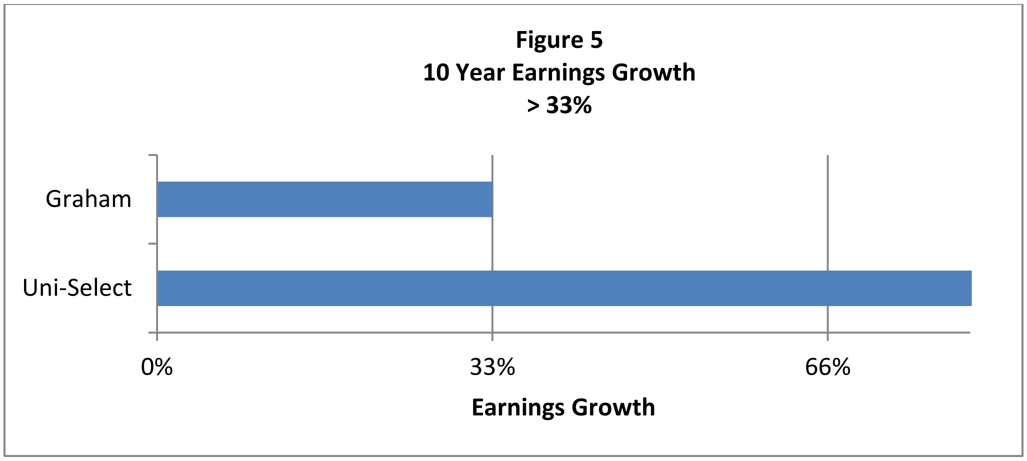
4. Dividend record

The fourth Graham criterion for a defensive investor is an uninterrupted dividend payments for 20 years. Uni-Select increased its dividend almost every single year for 20 years.

However while there is no doubt the company will pay a dividend in the coming year, its management will have to decide whether to maintain an almost unblemished record of annual dividend increases or to abide by its stated dividend policy of "declaring a dividend at a rate of approximately 20% of the previous year's net earnings."

If they abide by that policy, its dividend per share will be significantly reduced from last year's $0.52. Regardless of the decision, a 20-year record of uninterrupted dividends will not be in jeopardy.

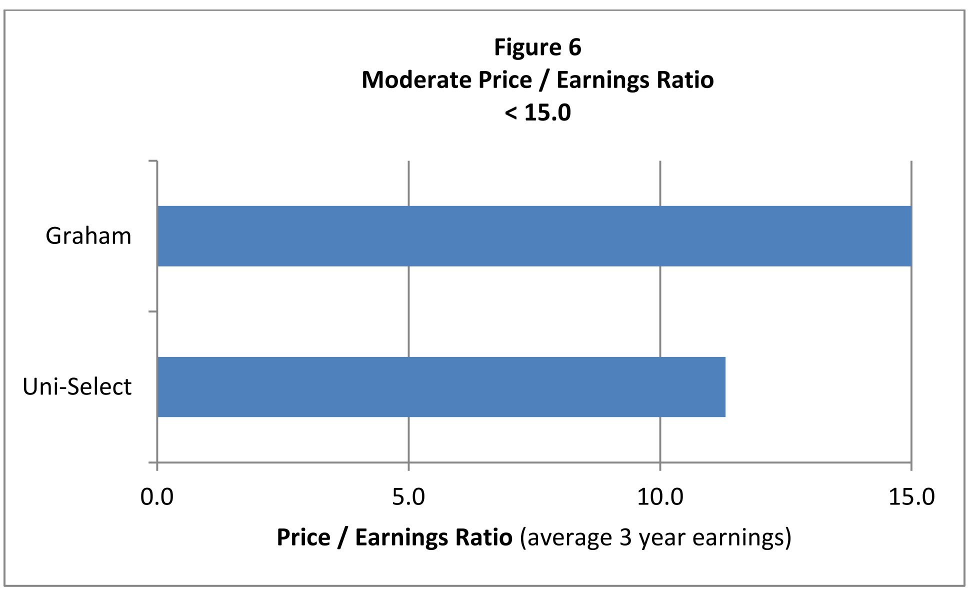
Score: Uni-Select 5 out of 5.



5. Earnings growth

There must be a minimum of at least a one-third increase in earnings per share in the past 10 years using three year averages at the beginning and end. Uni-Select's earnings per share growth has been over double that.

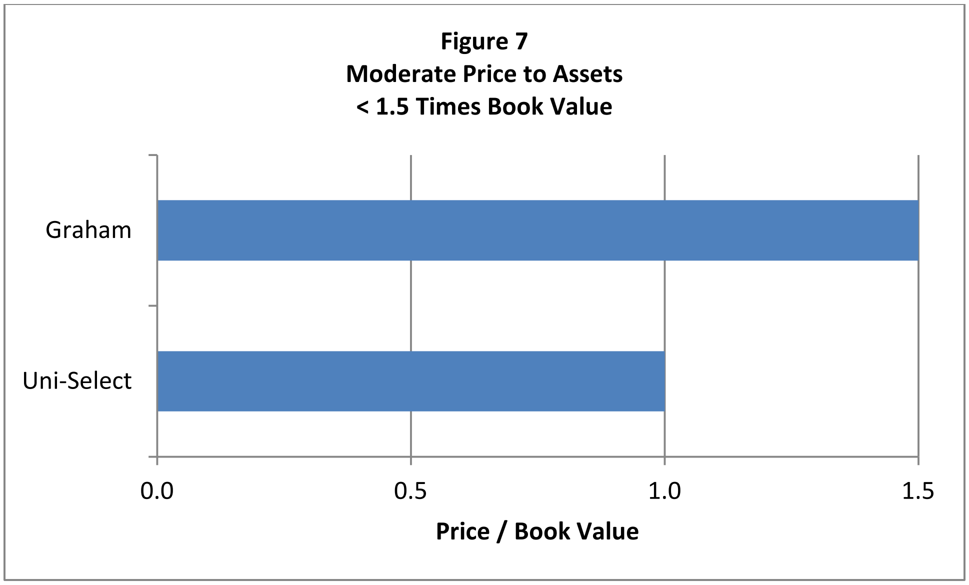
Score: Uni-Select 6 out of 6.



6. Moderate price / earnings ratio

The stock's current price should not be more than 15 times average earnings of the past three years. Using my late February purchase price of $23.01 and dividing by Uni-Select's three year average earnings per share of $2.03 gives a P / E of 11.3, well below 15.0.

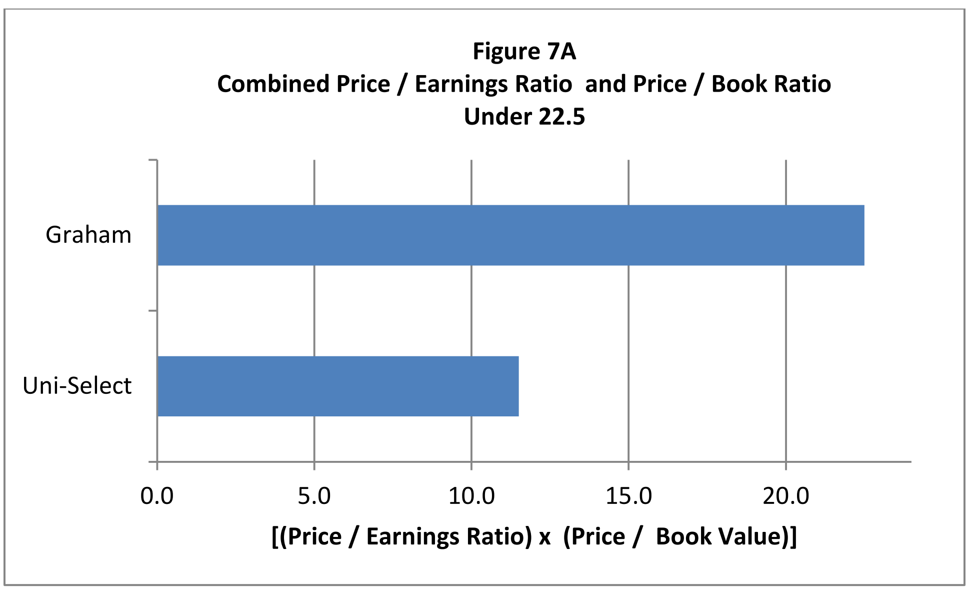
Score: Uni-Select 7 out of 7



7. Moderate price to assets

According to Graham's rules for a defensive investor the current price of the stock should be less than one and a half times its most recent book value. Again even using my higher purchase price of $23.01 and dividing by Uni-Select's most recent book value of $22.47 gives a price to book value of 1.02.

Score: Uni-Select 8 out of 8.



Graham allows an exception to his rule if the product of the Price Earnings Ratio (calculated in rule six) times the Price to Assets (in rule seven) is less than 22.5. We already know that the company passed those measurements from previous calculations, but let's repeat it anyway to make the analysis complete. We calculated that the company's Price to Three Year Average Earnings Ratio is 11.3, multiplying that by its previously calculated Price to Book Value of 1.02 equals 11.5, almost half the maximum 22.5.

Final Score: Uni-Select 9 out of 9.

If Uni-Select met all of the requirements for a defensive investor's stock enumerated in *The Intelligent Investor* when I purchased it over a month ago at $23.01, it is even a better candidate following its requisite decline from my original price (an affliction that seems to plague many of us).

Our household has two TFSA accounts that we treat as one portfolio and holds positions acquired before 2013.

This may limit the size of new positions due to cash availability. However, for the purpose of this series to make this as current, relevant and accessible to as broad an audience as possible, we are starting from scratch in 2013 using one account with an opening balance of $25,500.

Adjusting our combined household TFSAs, the equivalent position for a single $25,500 account would be buying 117 shares of TSX: UNS at $23.01. But I would caution that this is our household TFSA and it is designed to meet our specific purposes that may differ from yours.

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1. Small investors can have an advantage when finding and buying over-looked but financially sound small companies.

2. Make a list of potential candidates and follow them closely.

3. Whatever system you select to screen for financially strong companies, have the patience to wait for your buying criteria to be met and the courage to hold onto to the stock over short term declines.

4. Maintain a cash reserve at the ready to take advantage of exceptional buying opportunities.

5. Sometimes the short term price behaviour of a stock overreacts and bears little resemblance to the more important longer-term financial fundamentals of the company.

Fred Kirby is a fee-only certified financial planner, chartered investment manager and MBA, who writes a financial planning/investment newsletter from the outskirts of Armstrong, B.C.

Note: This is a slightly edited version of the format that appeared in the Financial Post to make it easier to read. The original article can be found here.

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