Seeking Alpha α
Quick Picks & Lists

7 Rocket Stocks With Low-Risk PEG Ratios

Feb. 14, 2011 3:45 PM ET3 comments
by: Kurtis Hemmerling

PE used to be a popular form of analyzing stocks that simply compares price to annual earnings. The difficulty with PE stems from the static view of a stock. To compare the PE to future growth, a couple new ratios were developed.

The forward PE gives you the ratio based on next year's expected earnings. If the forward PE ratio is higher than current, negative growth is generally forecast. If forward PE ratios are lower than current ones, future EPS growth is expected. (An exception is when you are in negative EPS situations as increasing growth can still lead to higher forward PE ratios as the stock is still bleeding, just at a reduced rate) Still, you do not have a clear picture of what a good current-to-forward PE ratio is.

The PEG ratio is another method that attempts to improve upon this. Peter Lynch popularized the concept that future growth and PE ratios should be equivelant. If a stock has a PE of 20, the annualized growth rate should be more than 20% for a bargain. This improves slightly upon the forward PE ratio by giving a rule of thumb; giving a relationship between current PE and expected growth.

Still, both methods do not include a vital component: risk. If two companies are equal in expected growth and current PE ratios, which is the better buy? One method would be to determine which stock has less risk of missing earnings, and a downside fall of share price. (Javier Estrada also considered this topic in a 2003 working paper called Adjusting P/E Ratios by Growth and Risk: The PERG Ratio. While trying to filter in a similar vein of reduced risk PEG stocks, we will not be using his exact methodology.)

Assessing Risk on Equal PEG stocks

Assessing risk is no easy job. We will do so in a few different ways:

- Beta below 1, which lowers our price volatility risk
- High relative strength compared with the S&P 500. Performance for year greater than S&P 500 index
- Fundamental risk is much more difficult to assess. For this I will manually look over the rolling EPS over many years and remove stocks with volatile annual earnings.
- Of course, our scanned list of stocks will all have a PEG below 1.

The Low Risk PEG Stock List

1. (NASDAQ:CSTR) - Coinstar Inc.
2. (NASDAQ:IDCC) - InterDigital, Inc.
3. (NYSE:CLH) - Clean Harbors, Inc.
4. (AGP) - AMERIGROUP Corporation
5. (NASDAQ:ODFL) - Old Dominion Freight Line Inc.
6. (NASDAQ:CRUS) - Cirrus Logic Inc.
7. (NASDAQ:RCII) - Rent-A-Center Inc.
8. (NASDAQ:FELE) - Franklin Electric Co. Inc.
9. (NASDAQ:CYBX) - Cyberonics Inc.
10. (NASDAQ:EZPW) - EZCORP Inc.
11. (LFL) - LAN Airlines S.A.Services
12. (NASDAQ:LABL) - Multi-Color Corp.
13. (QCOR) - Questcor Pharmaceuticals, Inc.
14. (NASDAQ:ATML) - Atmel Corporation
15. (NYSEMKT:AVL) - Avalon Rare Metals Inc.
16. (NYSEMKT:CVU) - CPI Aerostructures Inc.
17. (TCAP) - Triangle Capital Corporation
18. (NASDAQ:NTIC) - Northern Technologies International Corp.
19. (NASDAQ:AFSI) - AmTrust Financial Services, Inc.
20. (NASDAQ:CLCT) - Collectors Universe Inc.
21. (NASDAQ:GAIN) - Gladstone Investment Corporation
22. (CLRS) - Clarus Corp.
23. (NYSE:MIG) - Meadowbrook Insurance Group Inc.
24. (NASDAQ:TLF) - Tandy Leather Factory, Inc.
25. (MDF) - Metropolitan Health Networks Inc.
26. (NASDAQ:SNAK) - Inventure Foods, Inc.

Reducing the 1 Year Growth Risk

PEG is generally calculated using 5 year forward growth and forward P/E with only 1 year. The risk of low PEG stocks also comes in the form of falling 1 year earnings growth. By adding a filter for positive EPS growth next year, and removing stocks with rising forward P/E stocks, we should further reduce our downside risk.

I've left the list above since some may be interested in longer buy and hold periods, are do not mind the negative earnings growth over one year. These multi-year bargain buyers can investigate any of the above 26 stocks.

The list of stocks that make the further restricted reduced risk criteria are:

CSTR, ODFL, CRUS, RCII, FELE, EZPW, LFL, LABL, QCOR, ATML, CVU, NTIC, AFSI

CSTR, ODFL, CRUS, RCII, FELE, EZPW, LFL, LABL, QCOR, ATML, CVU, NTIC, AFSI, MIG, and SNAK.

Stable Earnings

I fully expect that most of these stocks had an earnings dip during the recession. We are more interested in the earnings trend over many years with rolling EPS.

- From 2003 until the middle of 2008, CSTR has dropped in annual earnings. The past couple of years has seen a marked jump. However, the prices have also been quite volatile during 2010 with a 52 week range of $26 - $67. The stock is bouncing off $40 support, and prices are overall up when looking back 12 months.
- FELE alarms me in that earnings are in cyclical waves with the overall trend being down since 2004.
- Because SNAKs annual EPS is so low with the rising trend only beginning in 2008, I give this a higher risk rating of potential annual volatility.
- Stocks with extreme price run-ups also alarm me as the momentum can fall creating a strong downside. CRUS, LFL, EZPW, QCOR (also less historical data), and ATML.

On the short-list we have 7 stocks that made our final cut for low-risk PEG earners:

1. (ODFL)
2. (NTIC)
3. (MIG)
4. (RCII)
5. (LABL)
6. (CVU)
7. (AFSI)

These stocks are at least fairly valued with PEG ratios of less than one (with the range going from high to low in decending order. ODFL is 0.99 and AFSI is 0.76). Some of the downside risk of short-lived earnings events and wild price moves should be removed through our filtering process. (You might also be interested in 8 highly unusual growth stocks found here).

Comments?

Is there another filter that would be useful in lowering risk of missed future earnings? I'd like to hear from other low PEG buyers as well as other current shareholders from these stocks.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.