Predictors of Stock Performance

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When you invest in the American stock market, you are looking to make a profit, build up savings for retirement, avoid loss, and grow your wealth. Whether you are investing in individual stocks or an ETF that tracks the market, two values are important. What can you buy a stock for today and what will it be worth at a future date. Since the current stock or ETF price is readily available, what you need are predictors of stock performance going into the medium to distant future.

How Do You Predict if a Stock Will Go Up?

In regard to stock price performance, the first thing we have is past price action. Stocks and the market follow trends. So, trend following can work, at least for a while, in predicting that a stock will keep going up or keep going down. Unfortunately, stocks correct and crash when they have gone too high either due to internal factors in the company or problems in the overall economy. And, when stocks start to fall they usually don't fall forever. Many successful long term investors pick up bargains by purchasing stocks at the bottom of a trough. How can they do this?

Intrinsic Stock Value Is One of Best Predictors of Stock Performance

While market sentiment data can be an excellent guide to short term price changes, accurate prediction of longer term stock prices comes from accurate predictions of future earnings. Intrinsic stock value is a predictor of the forward looking earnings of a company. It was first suggested in the days after the 1929 stock market crash and beginning days of the Great Depression. Benjamin Graham suggested this approach as an alternative to "playing the market." Most famously, his protégé, Warren Buffet has used this approach for decades on the way to becoming on the richest people in the world.

Formula for Calculating Intrinsic Stock Value

Here is the formula that Graham provided in 1962.

- V = EPS x (8.5 + 2g)
- V is the intrinsic stock value
- EPS is the trailing 12 months earnings per share
- 8.5 was the P/E ratio at the time for a "zero-growth" stock
- g is the company's long term rate of growth

The solution to the formula, (V), is compared to the current market price of a stock. When V is less than one, the stock is overpriced and when (V) is more than one, it is underpriced. Nobody suggests that an investor blindly apply this formula but rather learn what a company does to earn money and how that plan will continue to work into the future. Then, using intrinsic value as a guide, long term investors can get out of overpriced stocks in the last days of a bull market and pick up bargains as a bear market bottoms out. The key to this approach is to be able to pick companies able to make money for decades instead of just for months or years.

P/E Ratio versus CAPE Ratio as Predictors of Stock Performance

A similar approach for assessing the value of a stock is to look at the price to earnings ratio (P/E ratio) when compared to other stocks in its market niche. The CAPE ratio is a variation of this approach what seeks to average out the P/E ratio over a decade. CAPE is an acronym for cyclically-adjusted P/E ratio and it acts like a long term moving average indicator by averaging out fluctuations in the P/E ratio over a decade.

Value Investing for Long Term Investment Success

The US stock market is a long-term money-making machine. However, to reliably profit one needs to stay invested for five to ten years after picking sound investments with tools like the P/E ratio, CAPE ratio, or intrinsic value calculation. The conclusion of successful long term investors like Buffett is that it is too difficult for the average investor to time the market with individual stocks and that buying shares of an ETF that tracks the S&P 500 is a better idea. Using a dollar cost averaging approach the investor avoids buying too much at high prices and buys for shares at low prices thus mimicking the intrinsic value approach.

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