94/06-The Second Half Effect

Not only is this the right point in the business cycle to look at quality growth stocks, it's also the right time of year.

By Peter Lynch

In the seasons of the stockpicker, late in the year is when a small stock often loses its value, only to revive in January. Thus, aficionados of small stocks do their bargain hunting in November and December, then await the January Effect, when the small stocks come out of their holes. There's a different season for the quality growth stocks, though fewer people know about it. Spring to early summer is the best time to shop for potential bargains in great companies such as Home Depot, Johnson & Johnson , PepsiCo, Abbott Labs, and Gillette.

These big-name issues and others like them tend to bloom in the second half of the year, when the smaller stocks are starting to wilt. This Second-Half Effect is caused by portfolio managers who bid up the prices for quality growth stocks in the third and fourth quarters. I'll explain why in a minute.

This is a timely subject, because right now we're in the bargain phase before the Second-Half Effect takes hold in the market. What makes it even more interesting is that quality growth stocks have done poorly of late. While other kinds of stocks scored big gains from 1991 to 1993, as a group the quality growth issues went nowhere.

A representative list of these recent underachievers in the market appears at the end of this file. PepsiCo has been flat; Gillette, dull; H&R; Block, a brick; Rubbermaid, a stiff; Home Depot, nothing to write home about. McDonald's, the star performer of the lot, has outgained the S&P; 500, but that's the notable exception. Out of this dreary dozen, seven stocks are selling for near or less than their 1991 prices.

If this was your entire portfolio in 1991, you missed two years of excellent advances, particularly the run-up in cyclicals. As a group, the cyclicals shown gained 37 percent while the growth group gained only 3 percent.

If Home Depot, Johnson & Johnson, etc., had lost their knack for making money, I wouldn't be touting them now. But there is nothing fundamentally wrong with them. Over the long haul, these have been terrific investments. Their earnings go up every year. They have a habit of raising their dividends continually. The only problem is that their stocks have been overpriced.

In early 1991, I noticed this situation and issued a warning: Avoid expensive growth stocks. But don't give me the swami award for this call. I saw it coming on the charts. The technical mumbo jumbo that usually goes along with chart reading is beyond me, but there's a simple exercise that I've found to be invaluable. You can do it yourself. In fact, once you've digested the next two paragraphs, you'll be as capable as I am of sounding the alarm the next time the growth group gets overextended.

If you were to examine a chart showing Johnson & Johnson's annual earnings per share going back more than 15 years, you would see a steady, straight line of earnings growth. This is the typical footprint of a quality growth company: steady increases in earnings with only the occasional bobble.

A line showing Johnson & Johnson's stock price over the same period would looks like it was drawn with a shaky hand. The stock hit a high of $58 in late 1991, and it's been mostly downhill since. On such a chart, the price line and the earnings line, taken together, serve as an important reminder of what we're buying when we buy a stock: a share of the earnings. A glance at these two lines gives us a visual history of the price-to-earnings ratio of the company--what investors have been paying for the earnings along the way.

When the price line strays far above the earnings line, as it did for Johnson & Johnson in 1991, it means the stock is very expensive, and people are paying an unusually high price for owning Johnson & Johnson. I found similar gaps up and down the quality-growth list.

That's what told me three years ago that it wasn't the time to be adding Home Depot and Wal-Mart to a portfolio.

Such charts are found in books published by the Securities Research Co., but there's no need for the casual investor to subscribe. Most brokerage houses carry chart books in their libraries, and brokers will readily lend out their copies. For my purposes, charts don't need to be reviewed very often. It's a good idea to consult them before you buy a stock, then every six months or so thereafter.

While quality growth stocks were lagging the market from 1991 to '93, the cyclicals had a great run. Cyclicals came into vogue as Wall Street's portfolio jockeys anticipated an upswing in the economy. Investors who were savvy to this change in market leadership doubled their money in Bethlehem Steel and Deere & Co., and did better than that in Owens-Corning and Caterpillar .

Now consider what you would see on a chart for Bethlehem Steel, a company on our cyclical list. You would notice that the earnings-per- share line wanders all over the place. As any Wall Street Boy Scout can tell you, this is the footprint of a cyclical. Cyclical companies produce or sell big-ticket items such as tractors or cars, which people will buy in good times and put off buying in bad times. That's why the earnings are so streaky.

Quality-growth companies, on the other hand, sell small-ticket items such as hamburgers or shaving cream or necessities such as pharmaceuticals. People won't stop buying Tylenol and Band-Aids no matter what shape the economy is in. That's why Johnson & Johnson's earnings line is so beautifully straight.

I'll buy almost any company at some price, and whereas two years ago the growth group was overpriced and the cyclicals were cheap, now it's the reverse. Let's go back to the chart of Johnson & Johnson. The stock price has fallen and the earnings have risen to the point that the troublesome gap is almost closed. Other quality growth stocks are beginning to close their gaps as well.

This doesn't mean you can shut your eyes and pick a growth stock. Sometimes, a stock is cheap for good reason - the company has troubles. With every company, there is something to worry about, but the question is, which worries are valid and which are not?

You may have noticed I omitted Quaker Oats, Gerber Products, Kellogg , and other food companies from our list of 12. These are solid growth companies, but at the moment their stocks are not cheap. The cereal and baby-food business has become highly competitive, with everybody fighting for market share by cutting prices. Price wars are not good for earnings, so this is a valid worry.

A less valid worry is the one that says U.S. health care reform with price controls on drugs would ruin Johnson & Johnson. My research tells me that Johnson & Johnson gets only one third of its revenues from pharmaceuticals. And more than half of those come from overseas, where price controls on drugs have existed for years. So whatever happens in the U.S. political arena won't affect J&J; as much as people think.

This brings us back to the Second-Half Effect. One of the natural tendencies of fund managers is to start the year dwelling in the present, but then to begin to anticipate the future as soon as the snow melts. In the winter months of 1994, they were thinking about 1994 earnings. For instance, McDonald's is expected to earn $3.36 this year. But when summer rolls around, analysts begin to think about 1995 earnings, when McDonald's is expected to earn $3.83. On the basis of 1995 earnings, McDonald's stock suddenly looks cheap. So a lot of people buy it, and the price goes up. Nothing has changed, except a page has turned on the calendar.

The Second-Half Effect does not apply to cyclicals. Their earnings are too unstable. Is Alcoa cheap on 1995 earnings? Who can say? What Alcoa will make in 1995 is anybody's guess. What it will make in 1994 is anybody's guess. It all depends on the price of aluminum, and you do need a swami to predict that.

I can't say enough about the fact that earnings are the key to success in investing in stocks. No matter what happens to the market, the earnings will determine the results. In 30 years, Johnson & Johnson's earnings are up 70-fold, and the stock is up 70-fold. Bethlehem Steel earns less today than it did 30 years ago, and guess what? The stock sells for less than it did 30 years ago.

In a bear market, the Johnson & Johnsons will suffer right along with the Bethlehems (although perhaps not as much), and nobody will be happy. But between Bethlehem with its spotty record and Johnson & Johnson doubling its earnings every six or seven years and raising its dividend like clockwork, which would you like to have in your portfolio a decade from now? --------------- Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan fund, the best performing of all mutual funds over a 15-year period, and he is vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

TABLE: GROWTH STOCKS Abbott Labs (ABT) Genuine Parts (GPC) Gillette (G) H&R; Block (HRB) Home Depot (HD) Johnson & Johnson (JNJ) McDonald's (MCD) PepsiCo (PEP) Rubbermaid (RBD) Toys 'R' Us (TOY) Wal-Mart Stores (WMT) Warner-Lambert (WLA)

TABLE: CYCLICALS Alcoa (AA) AMR (AMR) Armstrong World Industries (ACK) Bethlehem Steel (BS) Caterpillar (CAT) Cincinnati Milacron(CMZ) CSX (CSX) Dana (DCN) Deere (DE) Dow Chemical (DOW) International Paper (IP) Owens-Corning (OCF)

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