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WEEKEND INVESTOR

Amid Record Rally, Stock Picker Keeps Focus on the Basics

Sam Eisenstadt, a Pioneer at Value Line, Remains Bullish

By MARK HULBERT

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Sam Eisenstadt, who devised Value Line's much-admired stock-selection system, at home with his wife, Edith. *Adrienne Grunwald for The Wall Street Journal*

Few people listen to Sam Eisenstadt anymore. And that is a shame, since—even at 91—he still has a lot to say.

Until he was fired four years ago, he had for more than two decades been head of research at Value Line, the research firm founded in 1931 that pioneered individual stock analysis. Mr. Eisenstadt remains a close student of the markets, often emailing institutional investors and journalists to report the latest results of his research. (Value Line didn't respond to requests for comment.)

He currently is bullish on stocks. His market-timing model projects the S&P 500 will gain 8% over the next six months—even after a 29% rise so far in 2013.

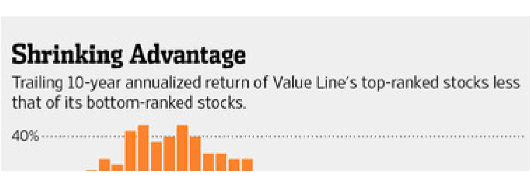
In a telephone interview from his apartment in Queens, N.Y., where he and his wife have lived since 1952, Mr. Eisenstadt exhibited no signs of easing up in retirement. He continues to hold himself to the same high standard that he kept for the 63 years he worked at Value Line: "Subject all beliefs about investing to mathematical verification." Unfortunately, he says, "most advisers fail to live up to that standard."

The famous Value Line stock-ranking system, which Mr. Eisenstadt was instrumental in creating in the mid-1960s, has struggled in recent years. But he says "there are compelling reasons to expect it once again to perform much better."

Value Line continues to maintain his stock-ranking system. It rates 1,700 of the stocks with the largest market capitalizations according to their performance prospects over the next 12 months.

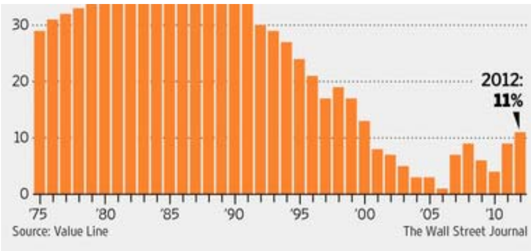
The 100 deemed to have the greatest potential are placed in Value Line's "Group 1," while the 100 with the worst prospects are placed in Group 5. The rest are placed in Groups 2 through 4.

Though the system is proprietary, its two primary factors are known as "price momentum" and "earnings momentum." A stock is ranked higher to the extent its performance over the trailing year has been good and its earnings growth has accelerated. Despite the name "Value Line," the stocks it favors fall closer to the "growth" end of the spectrum.



Focusing on these factors represented a breakthrough. Mr. Eisenstadt says he "is unaware of any firm that, prior to Value Line, had systematically been picking stocks based on either of them."

The system has been phenomenally successful over the past five decades. From 1965 through 2012, according to data on Value Line's website, Group 1 stocks on



average have gained an annualized 12.9%, before dividends. That's nearly seven percentage points per year better than the S&P 500's 6.1% annualized return over the same period, and more than 22 percentage points ahead of the minus 9.8% return for Group 5.

This record led some big academic names to fawn over Value Line. Perhaps the most famous to do so was the late Fischer Black, at the time a University of Chicago professor.

In a 1971 Financial Analysts Journal article titled "Yes, Virginia, There Is Hope," Mr. Black concluded his analysis of the Value Line record by declaring that "most investment management organizations would improve their performance if they fired all but one of their security analysts and then provided the remaining analyst with the Value Line service."

In recent years, however, the Value Line system has struggled. The advantage enjoyed by Group 1 over Group 5 has narrowed considerably. Over the past decade, it has been just 11 percentage points a year, on annualized basis; in the 1970s, for example, it was three times as great.

Samuel and Edith Eisenstadt at their home in New York *Adrienne Grunwald for The Wall Street Journal*

Yet its recent performance is still impressive, according to David Aronson, a former finance professor at Baruch College and currently president of Hood River Research, a quantitative-analysis firm in New York. "Indeed, quants on Wall Street often celebrate when they discover a stock-selection system that can identify a performance differential of just a few percentage points between different groups of stocks," he says.

Mr. Eisenstadt says that, given the initial success of his system, it was inevitable there would be at least some narrowing of Group 1's advantage over Group 5. "A successful strategy typically weakens as more and more investors start following it," he says.

This is only part of the reason for the system's recent challenges, however, Mr. Eisenstadt adds. He says there are also some temporary factors that have contributed.

The biggest, in his opinion, is the market's recent preference for lower-quality stocks. He is referring to those of companies whose very survival is in question, as indicated by traits such as high debt and highly variable year-to-year profitability. Mr. Eisenstadt says the Value Line ranking system performs best when higher-quality stocks with strong relative earnings, are "beating out junk."

Consider the performance of the various quality rankings compiled by San Diego-based Ford Equity Research, based on factors such as debt and earnings volatility. Over the past decade, the stocks that Ford rated lowest for financial quality gained an annualized 14.2%, compared with 6.7% for the stocks rated strongest. Over the previous three decades, according to Ford, it was the highest-quality stocks that did better.

Mr. Eisenstadt says there are many reasons for this recent preference for junk—such as the Federal Reserve's aggressive monetary stimulus, which has encouraged risk-taking. But, in any case, he says he is "confident the situation can't last, since otherwise the market would become increasingly irrational."

And when the situation rights itself, he predicts that the Value Line ranking system will recover some of its lost glory. For now, he counsels patience and discipline. No system, no matter how good, works equally well during all phases of the market cycle.

Here are the stocks that have recently been added to Value Line's Group 1: steelmaker AK Steel ; three petroleum companies: BP, Marathon Oil and Ultra Petroleum ; two natural-gas firms: Chesapeake Energy and Devon Energy ; two auto-parts suppliers: Federal Mogul and Superior Industries ; Canon, the electronics giant; and entertainment technology company Rovi.

At the other end of the spectrum are the stocks most recently added to Value Line's Group 5: Cepheid, a biotech firm; Cullen/Frost Bankers, a bank-holding company; Federal Realty Investment Trust, a real-estate investment trust; pharmaceutical firm Medicines; Quiksilver, an apparel company; and brokerage firm TD Ameritrade.

—Mark Hulbert is editor of the Hulbert Financial Digest, which is owned by MarketWatch/Dow Jones.

Corrections & Amplifications

The gap between stocks that a ranking system from Value Line, a research firm, says have the most potential and those the system says have the least potential was three times as great in the 1970s as it has been over the past decade. An earlier version of this article incorrectly said the gap was three times greater, which would equate to four times as great.

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