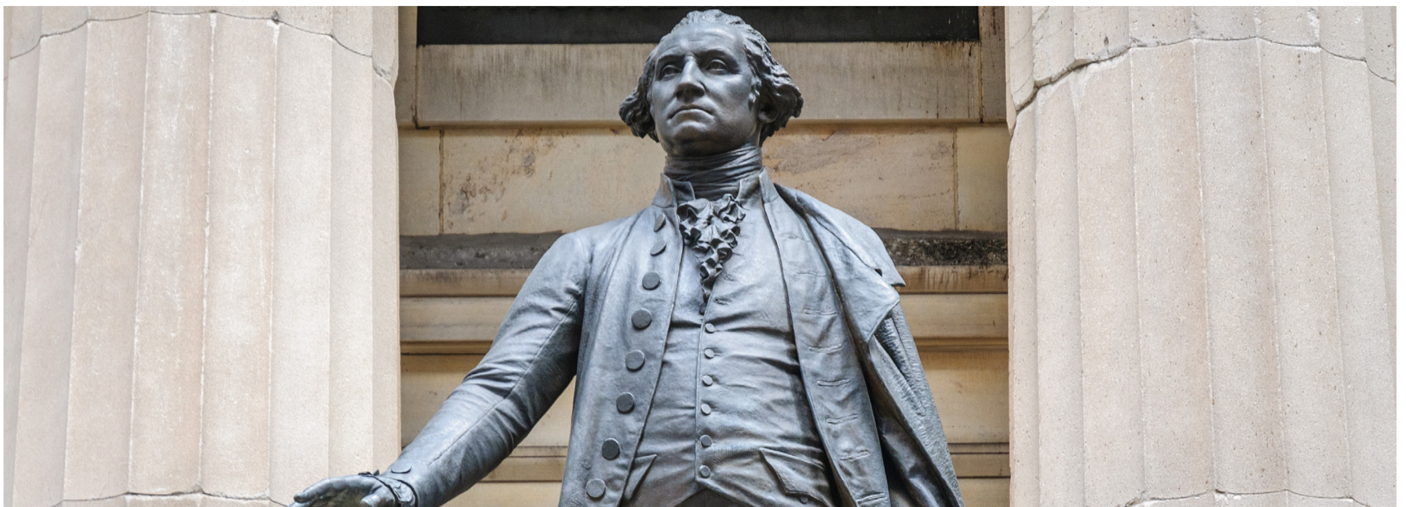
MARKET COMMENTARY

WCA'S UNIQUE APPROACH TO QUALITY



Many managers use textbook financial ratios such as return on equity, debt to equity, and earnings per share variability to evaluate the quality and value of a company. However, these metrics can be easily manipulated by a company's management and misused by index providers and rating agencies. For example, the return on equity ratio can be increased overnight by issuing debt and using it to buy back stock rather than investing in the business to promote growth. This can create an illusion of higher profitability without actually improving the company's business operations.

DISTORTIONS CAUSED BY SHARE BUYBACKS

To better understand this concept, let's take a look at Acme, Inc., a fictional firm, which generates $1,000,000 in net income and has $5,000,000 in shareholder's equity for a 20% return on equity ($1,000,000 / $5,000,000 = 20%). If Acme's management team issues $2,000,000 in debt at 5% and buys back shares worth $2,000,000, the ROE ratio increases to 30% from 20% (see table on page 3). However, this strategy does not contribute to the company's profitability and can even have negative effects. The addition of debt reduces net income by the interest expense and increases the leverage on the company's balance sheet.

EFFECT ON BENCHMARK INDICES

The widespread use of share repurchases not only distort measures like ROE (above), but also the price-to-book ratios used to assign stocks to popular growth or value benchmark indices. By extension, investors who manage to these benchmarks should realize they could potentially be misled.

Moreover, this is not a small and obscure accounting issue affecting relatively few firms. The impact of share repurchases on equity measures is a widespread issue and growing in importance.

According to Yardini Research, S&P 500 companies have repurchased $852 billion in stock in the past year. When stock is repurchased, the sum total of all repurchased shares shows up as an item called "treasury stock" on a firm's balance sheet. This amount is subtracted from retained earnings, which reduces shareholder equity. As of the latest quarter, Bloomberg data shows 125 of the top 500 largest companies in the United States have significant treasury stock (greater than 10% of the market value of outstanding stock) on their books. Moreover, 40 of the 500 largest publicly traded companies in the United States show negative equity on their balance sheet. This creates a major challenge in calculating price-to-shareholder equity ratios, which is the primary tool for forming the ubiquitous value and growth style benchmark indices.

And index providers' method for dealing with negative equity just makes matters worse. One major provider, according to their own index construction methodology, makes no attempt to adjust the misleading accounting measurement of equity value. Instead, they assign a price to equity ratio "proxy" by arbitrarily substituting an average industry or sector ratio in place of the company's actual ratio. This makes little sense to us, which is one more reason why we adjust the data.

A last issue with buybacks is the way it tends to focus on bottom-line per share figures, often obscuring the "bigger picture." The lead story in yesterday morning's *Wall Street Journal*, for example, announces that "Corporate Earnings Estimates Edge Up." The story says S&P 500 profits are expected to be up 0.5% for the third quarter and 1.2% for the whole year. However, what the article misses is that, in aggregate, *total earnings* are not growing. This is because share repurchases have created the illusion of growth that is not really there.

RATING AGENCIES MISFIRE ON "QUALITY"

Many managers rely heavily on rating agencies to assess quality. However, these assessments have been called into question in the past. During the 2008-2009 financial crisis, credit rating agencies were subject to criticism for their failure to accurately and promptly recognize failures at some of the nation's largest financial institutions (Lehman Brothers, AIG, Fannie Mae, and Bear Stearns come to mind). As recently as last year, the Security and Exchange Commission (SEC) charged S&P Global Ratings with conflict of interest violations over ratings for jumbo residential mortgages. And earlier this year, rating agencies again failed to anticipate trouble at formerly investment grade rated Silicon Valley, Signature, and First Republic banks. Within days of the first signs of trouble,

TABLE A | ACME, INC. CALCULATION OF RETURN ON EQUITY (ROE) Source: WCA

	Before Buyback	After Buyback
Gross Income Less: Interest Expense	$1,000,000	$1,000,000 -$100,000*
Net Income	$1,000,000	$900,000
Equity	$5,000,000	$3,000,000**
Return on Equity (ROE) (Net Income / Equity)	20%	30%
Leverage (Debt/Equity)	0%	67%***

* Interest expense on $2,000,000 debt @ 5% = $100,000
** Equity reduced by $2,000,000 debt issuance and share buyback
*** $2,000,000 debt / $3,000,000 equity = 67% debt/equity

these companies' ratings were downgraded to junk and subsequently withdrawn.

Such inconsistency in ratings actions and poor track record calls into question the methodology used by rating agencies when assessing quality. For this reason, we do our own work in assessing quality rather than relying on ratings by credit rating agencies.

A DIFFERENT PERSPECTIVE

At Washington Crossing Advisors, we take a different perspective when measuring quality and value. We evaluate the entire firm and not just easily manipulated bottom-line metrics like return on equity or changes in earnings per share. Instead, we measure total profits (not per share) relative to a firm's assets (not equity), before leverage effects, to ensure a business is profitable and growing. We also measure the consistency of that overall profitability when measuring consistency and predictability. We find changes in earnings *per share* susceptible to manipulation, thereby reducing the usefulness of the measurement. A whole-firm approach, and not an equity-per-share approach, is less prone to mislead investors who seek to better understand quality and value. Therefore, such broad measures are the basis of WCA's approach to measuring fundamentals assessing quality, growth, or value.

Next time we will discuss how we incorporate these measures into a *process* for structuring quality and value oriented equity portfolios. For now, we hope to raise awareness of avoiding the use of overly simple metrics and shortcuts when evaluating quality.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Index Descriptions: WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher-quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees.

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