High ROIC Stocks Are The Best For Your Portfolio

What do toy company Hasbro (HAS), retail giant Wal-Mart (WMT), tax preparer H&R Block (HRB), auto parts store AutoZone (AZO), and biotech companies Gilead (GILD), Amgen (AMGN), and Celgene (CELG) all have in common?

They are the only surviving S&P 500 stocks to rise 10% or more in 2008. In the midst of a collapsing market and the subsequent damage, these seven stocks made good money for investors.

What other trait do they share? They all earn a consistently high return on invested capital (ROIC). Six out of these seven companies have earned a double digit ROIC in every year for the past decade, and the one exception, CELG, has managed it in nine out of ten.

Figure 1: S&P 500 Stocks That Made Big Money In 2008

Company	Ticker	Performance in 2008	ROIC 2007	Post-Crash Performance	ROIC 2015	Current Rating
Amgen	AMGN	24%	16%	195%	15%	Neutral
H&R Block	HRB	22%	19%	94%	19%	Neutral
Celgene	CELG	20%	28%	352%	23%	Neutral
Wal-Mart	WMT	18%	13%	16%	11%	Attractive
AutoZone	AZO	16%	20%	383%	24%	Attractive
Hasbro	HAS	14%	15%	235%	14%	Neutral
Gilead	GILD	11%	35%	359%	75%	Very Attractive

Sources: New Constructs, LLC and company filings.

Figure 1 shows that all seven companies earned a high ROIC going into the disastrous year of 2008. CELG struggled to a 5% ROIC in 2008 before quickly rebounding, while all of the other companies continued their strong profitability even in a poor economy.

The success of these stocks can't be credited solely to their industries either. HAS competitor Mattel (MAT) dropped 16% on the year. AZO competitor Pep Boys (PBY) actually did worse than the broader market and fell over 60% in 2008.

Strong In A Bull Market Too

Not only did these stocks thrive during the market crash, they've done incredibly well in the recovery too. All except HRB and WMT have outperformed the S&P 500, and an equal weight bundle of these seven stocks would have returned 233% since the recovery began, 35% better than the S&P 500.

For those who wonder why we put so much work into adjusting the income statement and balance sheet to get ROIC, here is your answer. Empirical research shows that ROIC, not P/E is the most important driver of valuation. Long-term, companies that can earn superior returns on capital are the ones that outperform, regardless of the market climate.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

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Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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