



A simple system that trounces the FTSE

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Positioned at the farm end of the half-mile track leading into John Mulligan's Cotswold home is a rain gauge. Every day for the past thirty years, he has recorded the rain that falls on his 70 acres. It is important because his water comes from a spring, but it is also typical. Mr Mulligan is a professional stock screener and former investment manager. The routine of collecting, recording and analysing data is second nature.

Last month I reviewed 'The Little Book that Beats the Market'. Its author, Professor Joel Greenblatt, described a convincing screening system that identifies shares in good companies selling cheaply. The lure of [Star](#), John Mulligan's system, is that unlike the Professor's 'Magic Formula' Mr Mulligan designed it for British stocks. Like the Professor, he has back tested the system exhaustively, but he has also used it since 1988.

Stock screens automate stock picking by allowing investors to fish for companies that meet certain, usually financial, criteria. Most financial websites, including Interactive Investor, offer [screens with the most common criteria](#). Beyond those, investors must crunch the numbers themselves, or subscribe to a system like Star. Happily, Mr Mulligan has agreed to show me how Star works.

"I wanted to look ahead, and see how one could select companies that were likely to do well in the future," he says. So, instead of using historical numbers plucked from financial statements, he buys analyst's two-year profit forecasts, in the form of earnings per share. "One year is a bit too short and three years is too inaccurate," says Mr Mulligan.

By dividing the current price of a share by the earnings forecast, he derives a prospective price earnings ratio for the largest 300 companies on the London Stock Exchange. A low pe ratio indicates a share is cheap relative to the profits analysts predict. By sorting the spreadsheet, low pe to high pe, he gets a list in rank-order. The bottom 30 or so are most 'expensive', and form his sell-list.

Then he takes the top 75 companies (the cheapest) and re-ranks them, this time according to their prospective two-year growth rates. He looks at earnings revisions, where analysts have changed their minds and reduced their forecasts. If expectations have fallen more than 20%, or by more than 10% for two consecutive months, Mr Mulligan usually adds them to the sell list. Of the remaining companies, the top 20, those with the highest growth rates, are all buys. The rest are holds.

For two frenetic days every month Mr Mulligan and a colleague check the data, rank the shares and write up the Star newsletter. Once subscribers have invested in portfolios of ten or twenty stocks, all that remains is to scan the sell list each month for shares they own. If they find one, Mr Mulligan says they should sell it and pick the top company on the buy list, provided they do not already own two companies from the same sector.

As with all money-making schemes, it is easy to be incredulous, and some investors will have their doubts.

Analysts' estimates are notoriously unreliable yet Mr Mulligan's system relies on them: "I think they are useful," says Mr Mulligan. He researched the accuracy of estimates for the Financial Times in 2004 and

found them to be within about 10% of the results achieved by large companies. It is not a magic bullet, but it is enough to give you an edge, he says.

Screening systems look for anomalies, companies that are cheap in relation to profits, or assets, but anomalies are more plentiful among the smaller companies Star ignores. Mr Mulligan agrees, but says the anomalies exist because there are fewer analysts covering smaller companies and the estimates are just too inaccurate.

There have been bad times. Mr Mulligan says he probably thought about abandoning Star during a grim three-year period between 1996 and 1998, when it failed to keep up with the market, but: "I reckoned it had value in it. I had been at it long enough to know the thing worked."

Ultimately, the proof is in the performance and, since 1999, Star's ten share portfolio has outgrown the FTSE All-Share by an average of 1.6% a month. It adds up. If you had put £10,000 into it on 11 January 1999, it would be worth £36,500 today (excluding costs). Going back further, Mr Mulligan's testing shows that £10,000 invested in Star in 1985 would have been worth £319,400 twenty years later. The same investment in the FTSE All-Share would have returned you £38,300. Just put those numbers together side-by-side; £38,000 and £319,000. That is the difference between an index, and a Star.