Rules of Engagement
In an Uncertain Economy

Despite a lack of consensus on whether the U.S. is in a recession or sliding into one, coupled with the media's seeming determination to talk the country into a slump, there is one point of agreement. The stock market has been on a roller coaster ride that shows no evidence of settling into any other pattern.

The market's record-setting volatility – more swings of at least 1 percent in either direction than any other recorded quarter – has investors and non-investors alike wondering where best to put their money.

Norris, Perné & French would suggest that in addition to the return to a position of strength in the bond market, the answer would be to look for publicly held companies with exceptionally strong financial fundamentals.

There no doubt are abundant bargains to be found because so many stocks have significantly fallen from their highs. But as we've witnessed in recent days, what appeared as a sure thing last year, like Bear Stearns, now can resemble little more than a carcass.

What are the fundamentals we're suggesting as primary determinants before the purchase of equities? Strong earnings growth is but one primary consideration. There also are a series of qualifiers that one should assess to determine the strength of a company's financial fundamentals. While the following suggestions would serve as a solid guide in any economic climate, they're of even greater importance in an atmosphere of uncertainty.

First look at the corporate balance sheet for an abundance of cash. Despite the market's softening many large corporations continue to enjoy healthy balance sheets. Cautious investors will seek companies with liquid assets of at least 2.5 times current liabilities. Remember the example set by J.P. Morgan two weeks ago with the Fed-organized acquisition of Bear Stearns: cash reigns in this environment. Market observers have been waiting since last July – or earlier – for J.P. Morgan to take advantage of its significant cash accumulations. Few envisioned the collapse of the nation's fifth largest investment bank as J.P. Morgan's impetus for an acquisition.

Look for those businesses without debt. No debt equals no impending problem. The debt-equity ratio compares corporate debt to shareholders' equity, and those with a ratio of zero are balanced.

Once you've cleared the above qualifiers, look for the company's return on assets (ROA), or profitability. A healthy ROA – or the comparison of net income to total assets – accompanied by positive cash flow is a good indicator of the ability to withstand an economic downturn. Look for several consecutive years of positive earnings, or ROA.

One of Norris, Perné & French's fundamentals, as described earlier, is that earnings growth will drive price change. In an uncertain market, look for those stocks with the opportunity for strong earnings growth – that quality will have the greatest impact upon stock price regardless of the market. One of the leading examples of this is Kalamazoo-based Stryker Corp., which has enjoyed earnings growth of 20 percent annually since the late 1970s. Earnings growth also impacts the next two qualifiers: the fair valuation of the stock based on earnings growth, and investor demand.

Another consideration in picking a stock in an unpredictable time is the minimization of risk. It's easier said than done, but as a rule large companies are safer than small companies. The larger the business' capitalization, the greater the risk reduction. Succinctly put: go big and buy quality.

Investors who currently enjoy some liquidity may be presented with a wide range of attractive opportunities in this current environment. Those in a position to enhance their portfolio should take their time and screen companies for the above characteristics. Look for those corporations which reflect the investor's position of cash, and the stamina to withstand external economic challenges.

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