THE GLOBE 250

NORM ROTHERY OFFERS HIS TOP STOCK PICKS BASED ON BOTH VALUE AND MOMENTUM

FROM B1

Stocks are ranked for their value and momentum appeal. But the rankings are based entirely on the numbers. The number of stars does not reflect the character of a company, its management or its employees. The stock of a very meritorious business may get a low number of momentum stars if that company and its sector are in a temporary downtrend.

We believe our star system offers an objective take on the largest 250 common stocks on the TSX with at least 12 months worth of trading history. We also try to skip over firms that are in the process of being purchased by another company, such as Shaw Communications Inc. this year, because they are usually in the purview of merger arbitrageurs.

We hope you enjoy this year's Megastars and you can learn about the star system below.

AWARDING VALUE STARS

Value investors are bargain hunters at heart. Our analysis starts with a company's bottom line by rewarding stocks that have low price-to-earnings ratios (P/E). It's a classic value-investing approach that identifies profitable firms trading at relatively low prices.

Bargain hunters also like solid stocks selling at low prices relative to their net worth. That's why we favour companies with low price-to-book-value ratios (P/B). This ratio compares a firm's market value to the amount it could theoretically raise by selling its assets at their balance-sheet values and paying off its debts. A low P/B ratio provides some assurance you're buying a company at a discount.

In addition, we want to make sure that companies use their capital wisely. So, we track each stock's return on equity (ROE), which measures how much a firm is earning compared to the amount its shareholders have invested. ROE is a common measure of business quality.

We also appreciate companies that have enough money to buy back their own shares and that have cut their share counts significantly over the past four quarters. After all, a well-executed repurchase program can add a huge amount of value when firms trade at bargain prices.

The value factors are combined to determine each stock's value star grade, and the top 10 per cent (or 25 stocks) get a full five out of five stars.

In a back-test, the five-star value portfolio gained an average of 15.6 per cent annually from the end of 1999 through to the end of November, 2022, when an equal-dollar amount was put into each stock and the portfolio rebalanced monthly. And the portfolio posted a hefty 23-per-cent gain over the past 12 months.

In comparison, the S&P/TSX Composite Index (a reasonable proxy for the Canadian stock market) gained an average of 6.7 per cent annually over the 1999 to 2022 period. (Our data comes from Bloomberg. All the returns include dividend reinvestment, but not fund fees, taxes, inflation, commissions and other trading costs.)

Value stocks can usually be held for months – and sometimes years. When rebalanced annually, the five-star value portfolio gained an average of 16.1 per cent annually from the end of 1999 to the end of 2021. The market index climbed by an average of 7 per cent a year.

GAINING MOMENTUM STARS

Momentum investors love to buy stocks on the upswing because they have a habit of continuing to climb. Early this year, for example, the oil and gas sector did well for months. Conversely, stocks on the decline tend to continue to slide, at least in the short term.

While it might seem to be overly simplistic, buying based on momentum has been profitable in nearly every stock market in the world for decades, and in some cases centuries.

We take a blended approach with momentum, and combine results from several different periods. We favour stocks that have performed well, compared to their peers, over the past three, six and 12 months.

In addition, we prefer steady returns and shy away from highly-volatile stocks. The idea is to avoid stocks that might act like lottery tickets, because they often fail to compensate investors for the risks they involve.

The momentum factors are blended to determine a star grade for each stock, with the top 10 per cent (or 25 stocks) getting a full five out of five stars.

The five-star momentum portfolio gained an average of 15.8 per cent annually from the end of 1999 through to the end of November, 2022 when an equal-dollar amount was put into each stock and the portfolio rebalanced monthly. In comparison, the S&P/TSX Composite Index gained an average of 6.7 per cent a year.

Momentum stocks often fare well with short holding periods and the five-star momentum portfolio was no exception. It gained an average of 12 per cent annually from the end of 1999 to the end of 2021 when it was rebalanced annually instead of monthly. In comparison, the market index climbed by an average of 7 per cent a year.

The portfolio's gain over the past 12 months has been even larger: 39 per cent.

THE MEGASTAR TEAM

There are several different ways to merge value with momentum. One way is to split a portfolio in half and put one part into the five-star value stocks and the other into the five-star momentum stocks. But keeping up with a 50-stock portfolio can be overwhelming. We focus instead on the 20 stocks with the best blend of value and momentum characteristics, which form our Megastar team.

The 20-stock Megastar portfolio provided average annual returns of 14.3 per cent from the end of 1999 to the end of November, 2022, when an equal-dollar amount was put into each stock and the portfolio rebalanced monthly. It gained an average of 13.1 per cent from the end of 1999 to the end of 2021 when rebalanced annually.

The Megastar portfolio is roughly a fifth less volatile, on average, than either the five-star momentum or five-star value portfolios in the back-tests. We believe most investors benefit by exchanging slightly lower expected returns for much lower volatility. With a little luck, the Megastar team will deliver strong results while allowing investors to sleep better.

The results over the past 12 months have been astonishing. The portfolio has posted a 52-per-cent gain.

SENSE AND SENSIBILITY

While the Megastars and our full ranking represent a great starting point for further research, you should improve your understanding of each company by studying it and its industry in more detail.

Watch your step, as well, with stocks that trade infrequently, and those with very low share prices, because they may be difficult to buy or sell in a cost-effective manner.

Before dashing off to the market also recognize the built-in limitations of quantitative methods such as ours, because less tangible factors can be important. The quality of a company's management can sometimes help – or hinder – a business.

And while we hope our portfolios achieve similar returns to those in the back-tests, the market isn't that predictable. Even in the best circumstances, we expect results to be bumpy and some individual stocks will disappoint. We would be pleased indeed for the portfolios to outperform the market index by an average of a few percentage points a year over the next couple of decades. (For the sake of disclosure, the author owns many of the stocks mentioned herein.)

Enjoy looking up the facts and figures that mean the most to you. After all, the purpose of our star system is to help guide you through the market to stocks you might want for your portfolio.

THE MEGASTAR TEAM

The Top 20 Canadian stocks on the TSX

Megastar Stocks

These 20 stocks offer the best blend of value and momentum.

Name	3-month return (%)	6-month return (%)	12-month return (%)	P/E	P/B	ROE (%)
Advantage Energy (AAV)	4.9%	4.1%	73.9%	6.21	1.37	44.0%
Cdn. Natural Resources (CNQ)	14.5	-2.0	67.0	7.85	2.34	32.5
Celestica (CLS)	17.4	7.6	19.0	9.61	0.88	8.9
Clairvest Group (CVG)	2.4	31.4	23.8	3.56	0.93	29.9
Crew Energy (CR)	8.3	2.6	130.7	6.93	0.91	24.6
Element Fleet Mgmt. (EFN)	21.2	39.6	62.0	21.47	2.39	12.0
Enerplus (ERF)	22.1	26.1	104.4	4.51	4.42	102.6
Fairfax Financial (FFH)	20.6	10.8	40.2	20.93	1.01	0.4
Frontera Energy (FEC)	1.9	-22.3	66.4	2.13	0.51	69.2
George Weston (WN)	12.2	12.7	29.3	18.40	3.66	33.1
iA Financial (IAG)	13.4	19.0	16.5	3.18	1.23	12.2
Imperial Oil (IMO)	21.4	8.5	84.8	8.05	2.07	29.5
Manulife Financial (MFC)	10.3	7.2	11.5	2.75	0.94	14.6
Mullen Group (MTL)	12.2	26.2	42.7	14.44	1.54	12.9
NuVista Energy (NVA)	30.1	2.1	120.8	5.37	1.63	36.8
Restaurant Brands (QSR)	15.1	38.5	32.9	24.58	8.78	39.7
Royal Bank (RY)	11.6	3.8	11.3	12.19	1.85	16.1
Stelco (STLC)	40.2	15.8	23.6	2.19	1.54	106.1
Stella-Jones (SJ)	21.9	35.3	21.0	13.16	1.93	14.9
Teck Resources (TECK.B)	20.2	-4.9	54.7	5.19	1.03	19.4

THE GLOBE AND MAIL, SOURCE: BLOOMBERG AS OF DECEMBER 1, 2022

Advantage Energy (AAV) is a Calgary-based oil and gas company with operations focused in the Alberta portion of the Montney formation. Advantage slashed its share count by 4.8 per cent over the past four quarters and it is currently conducting a substantial issuer bid to buy back more. Advantage trades at near six times earnings (trailing 12 months, unless otherwise noted) after its shares surged 74 per cent over the past 12 months.

Canadian Natural Resources (CNQ) is a large oil and gas producer based in Calgary, with a mix of assets in North America, the U.K. North Sea and offshore Africa. The company maintained its dividend during the COVID-19 crash, unlike some of its competitors. It offers a 4.2-per-cent yield after recently announcing a 13-per-cent boost to its quarterly dividend.

Celestica (CLS) manufactures a range of electronics products and offers related supply chain services through its operations in North America, Europe and Asia. The Toronto-based company trades at 88 per cent of book value and six times forward 12-month earnings.

Clairvest Group (CVG) is a private equity-management firm based in Toronto that trades at 93 per cent of book value. Clairvest likes to invest $25-million to $100-million in companies with EBITDA (earnings before interest, taxes, depreciation and amortization) between $10-million and $50-million. While Clairvest's shares are thinly traded, they're up 31 per cent over the past six months.

Crew Energy (CR) is a natural gas producer with operations primarily in the Montney formation in northeast British Columbia. The Calgary-based company's shares climbed 131 per cent over the past 12 months, and now trade near seven times earnings and three times cash flow.

Element Fleet Management (EFN) is an automotive fleet manager with operations across North America, Australia and New Zealand. The Toronto-based company pays a 2.1-per-cent dividend yield after recently raising its quarterly dividend by 29 per cent to 10 cents a share.

Enerplus (ERF) is an oil and gas company headquartered in Calgary. It focuses mainly on light oil assets in the Bakken formation in North Dakota, and it has a position in the Marcellus shale natural gas region in northeast Pennsylvania. Its shares climbed by more than 100 per cent over the past 12 months, yet still trade at five times earnings. Enerplus also cut its share count by 11 per cent over the past four quarters.

Fairfax Financial (FFH) is an insurance-focused conglomerate based in Toronto. Damaging storms this fall will likely allow Fairfax's property and casualty insurance businesses to boost premiums. The company trades near book value and seven times forward 12-month earnings.

Frontera Energy (FEC) is an oil and gas company with operations in South America. Calgary-based Frontera trades near two times earnings, 51 per cent of book value and has cut its share count by 9.5 per cent over the past four quarters.

George Weston (WN) is the parent company of huge food and drug retailer Loblaw (L) and Choice Properties REIT (CHP.UN). Toronto-based George Weston has grown its revenues by 8 per cent over the past four quarters and boosted its operating income by 31 per cent.

iA Financial (IAG) is a Quebec City-based insurance and wealth-management company. Its stock trades near 1.2 times book value and pays a 3.5-per-cent dividend yield. iA also has a habit of boosting its quarterly dividend, which has climbed from 38 cents a share to 67.5 cents over the past five years.

Imperial Oil (IMO) is a large integrated oil and gas company based in Calgary that pays a 2.3-per-cent yield. Imperial cut its share count by about 12.1 per cent over the past four quarters and continues to buy back stock, with a substantial issuer bid that was due to be completed on Dec. 9. The company is a subsidiary of U.S. oil giant ExxonMobil, which owns about 69.6 per cent of Imperial's stock.

Manulife Financial (MFC) provides life insurance and wealth management to individuals and institutions, primarily in Asia, Canada and the U.S. The Toronto-based company trades just below book value. It also offers a generous 5.4-per-cent yield and reduced its share count by 2.1 per cent over the past four quarters.

Mullen Group (MTL) is a large trucking and logistics provider headquartered in Okotoks, Alta., that operates across the U.S. and Canada. It supports the energy, mining, forestry and construction industries in Western Canada. Mullen pays a 4.7-per-cent yield and trades near 11 times forward 12-month earnings.

NuVista Energy (NVA) is an oil and gas company that focuses on the Montney formation in Alberta. The Calgary-based firm's shares climbed 121 per cent over the past year and now trade at five times earnings.

Restaurant Brands (QSR) is a quick-service restaurant conglomerate with brands that include Tim Hortons, Burger King and Popeyes. The Toronto-based company offers a 3.3-per-cent dividend yield and, as of its December payment, it will have grown its dividend at an average annual rate of 21 per cent over the past five years.

Royal Bank (RY) is the largest bank in Canada and the largest stock on the TSX by market capitalization. Toronto-based RBC recently boosted its quarterly dividend by 3 per cent and now offers a yield of 3.9 per cent. Factoring in the boost, the bank's five-year dividend-per-share growth rate is a healthy 7.7 per cent.

Stelco (STLC) is a steelmaker based in Hamilton that has earned huge profits over the past couple of years. The company trades just above two times earnings and pays a 3.7-per-cent dividend yield (after a 40-per-cent boost to its regular quarterly payments that does not include a $3-a-share special dividend paid on Dec. 1). Stelco also reduced its share count by a whopping 29 per cent since the start of 2022 after completing a recent substantial issuer bid.

Stella-Jones (SJ) makes pressure-treated wood products. The company, based in Saint-Laurent, Que., offers a 1.7-per-cent yield and has grown its dividend each year, from 32 cents a share in 2015 to 80 cents a share in 2022.

Teck Resources (TECK.B) is a mining company with operations and projects in Canada, the U.S., Chile and Peru. Vancouver-based Teck trades at five times earnings and nine times forward 12-month earnings. After a 55-per-cent price climb over the past 12 months, its shares aren't too far away from their all-time highs.