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Setting the Standard

By MICHAEL SANTOLI

The Barron's 400, based on stock-selection criteria that stress soundness and growth, has beaten most other major indexes since its inception. On the way: a tradable version.

WITH HINDSIGHT, SEPTEMBER 2007 might not have been the most propitious time to launch a stock index based on strong individual-company fundamentals. A bear market worse than any in decades was about to strike—one in which global credit contagion and macroeconomic distress would swamp companies sound and dodgy alike.

Yet the Barron's 400—unveiled three years ago and designed to beat the broad market with a disciplined selection process based on company growth and value factors—has fared well through the collapse and rebound.

The index has handily outpaced the senior U.S. stock indexes since its inception. Through Thursday, it was down less than 15% since Aug. 31, 2007, compared with 24% for the Standard & Poor's 500 and 21% for the Dow Jones Industrial Average. Crucially, it also did better than the Dow Jones U.S. Total Stock Market index (off about 21%), from which the Barron's 400 components are picked.

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Scott Pollack for Barron's

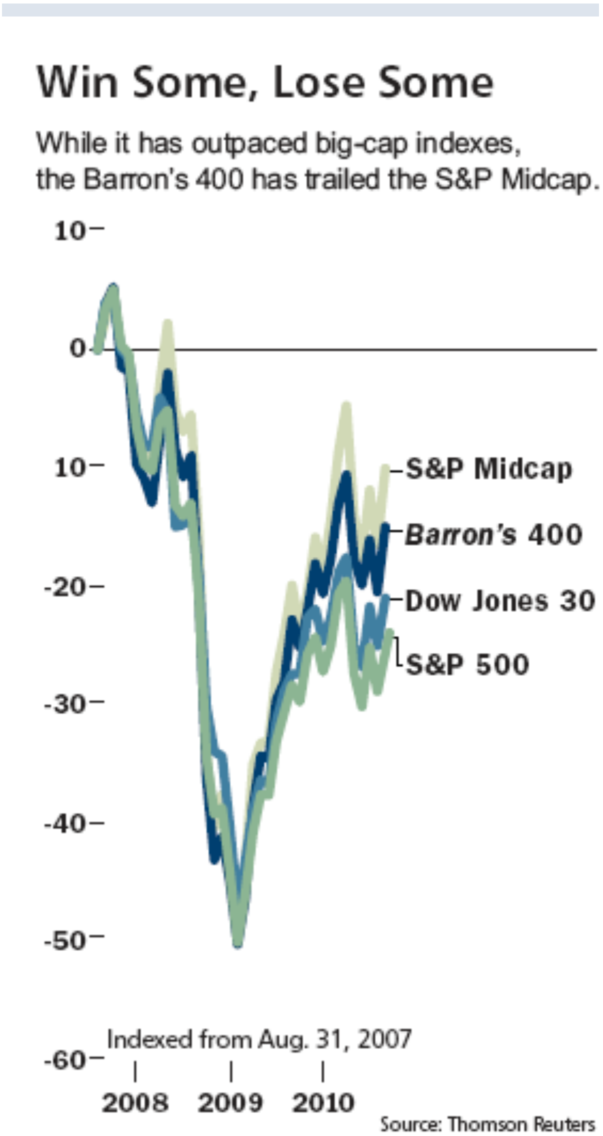
The Barron's 400's approach could have helped investors beat the bear and make money in the "lost decade."

The B400 has somewhat trailed the S&P 400 Midcap index and the Nasdaq Composite, though it offers greater diversification than either in terms of sectors and company size. Including back-tested data using the same index-construction method, the Barron's 400 emerged nicely from the "lost decade"—from Dec. 31, 1999, through Dec. 31, 2009— gaining an annualized 6.76%, while the S&P fell 2.7%, excluding dividends.

Designed as a "stockpicker's index," the B400 isn't intended as a benchmark of overall market performance. Rather, it uses fundamental criteria to choose companies of all sizes that combine certain growth and value characteristics, which generally reflect the kinds of names that Barron's writers seek when searching for stocks to feature favorably.

As such, it is useful as a hunting ground for stocks, and as an indicator of which sectors look promising, as the index is rejiggered twice a year. The Barron's 400 was just rebalanced, as of the close of trading Friday. It currently favors very large, quality companies, somewhat reducing its exposure to smaller names.

While no fund tracks the Barron's 400, one may be developed in the future.



A refresher on how the index is built: All components of the DJ U.S. TSM index—which covers nearly all investable U.S. stocks—are analyzed by MarketGrader, an investment research firm in Coral Gables, Fla., for fundamental strength in growth, value, profitability and cash flow.

Candidates for the index are graded in each category, based on six factors. To gauge growth characteristics, the MarketGrader computers consider a company's earnings-surprise record, revenue-growth rate, short- and long-term sales and earnings-growth rates, and the stock's relative strength versus the market.

There's also a unique take on earnings momentum. In MarketGrader's system, this isn't about how fast earnings or earnings forecasts are rising. Rather, MarketGrader president Carlos Diez explained in 2007, the computers measure the stock's reaction to the latest earnings reports. The aim is to gauge a company's tendency to surprise the Street and the degree to which a stock might be unjustly neglected by analysts.

The value test involves measures of a company's capital structure (such as debt versus equity); price-to-book, price-to-cash-flow and price-to-sales ratios; overall market capitalization, and a price/earnings analysis.

The analysis doesn't simply use a raw P/E multiple. Instead, the system calculates each company's earnings-growth rate for the past four quarters, then comes up with an "optimum" P/E for each stock. Comparing the stock's actual multiple with its optimal, or justifiable, multiple helps determine its value score.

Profitability is gauged on a blend of asset utilization, capital utilization, operating margins, relative margins, return on equity and quality of revenues. Finally, the cash-flow ranking is derived from cash-flow growth, cash-flow margin, debt-to-cash-flow ratio, interest-coverage capacity, economic value and cash-retention rate.

The Bottom Line

The Barron's 400, designed as a "stockpicker's index," has fared well through the market's collapse and rebound. It currently favors very large, high-quality companies.

Once all the stocks in the DJ U.S. TSM index are graded, they are ranked. Then a series of screens is applied. Real-estate investment trusts are eliminated. The number of entries from any one industry is capped at 20% of the index. To ensure sufficient liquidity, each selection must have a minimum three-month average daily dollar-trading volume of $2 million. The minimum market-capitalization of a component of the index is $250 million, and at least 25% of the components must have a market value of at least $3 billion.

Once all those tests are satisfied, the highest-ranking 400 stocks become the Barron's 400. Importantly, each stock is initially weighted equally in the index, to prevent a small minority of huge companies from steering the index. Every six months, on the third Friday of March and September, the process is rerun, to incorporate recent financial results and market action, and the index is revised accordingly.

The turnover in the components tends to be high, as MarketGrader's screens incorporate the latest two quarters of earnings releases and share-price action. In the just-completed reshuffling, 44.75% of the 400 stocks were replaced, slightly above the median historical turnover pace of 43.5%.

The Latest 400 Revealed

The tables below show some of the stocks that were added or culled from the Barron's 400 Friday. For a listing of all the stocks now in the index, **click here**.

HIGHEST-RATED INDEX MEMBERS

Company	Ticker	Grade
Deckers Outdoor	DECK	90.45
Impax Labs	IPXL	89.12
Microsoft	MSFT	88.52
Apple	AAPL	87.20
Ariad Pharma	ARIA	86.81
Syntel	SYNT	86.67
Alexion Pharma	ALXN	86.23
InterDigital	IDCC	86.15
Ebix	EBIX	86.03
Intel	INTC	85.93

TOP TEN INDEX ADDITIONS BY MARKET VALUE

Company	Ticker	Mkt Val*
Chevron	CVX	$146,994
Cisco Systems	CSCO	119,395
Merck	MRK	107,416
3M	MMM	52,069
Home Depot	HD	48,202
American Express	AXP	42,300
EMC	EMC	36,819
Union Pacific	UNP	36,436
Medtronic	MDT	35,824
DuPont	DD	35,503

TOP TEN DELETIONS BY MARKET VALUE

Company	Ticker	Mkt Val*
Procter & Gamble	PG	$185,023
Visa	V	63,044
Monsanto	MON	38,818
Emerson Electric	EMR	35,892
Baxter International	BAX	34,442
S1	SONE	327
Almost Family	AFAM	322
Immunomedics	IMMU	290
Sterling Construction	STRL	266
Smith & Wesson	SWHC	252

COMPANIES WITH THE MOST TIME IN THE INDEX

Company	Ticker	Yrs in Index
Microsoft	MSFT	12.0
WalMart Stores	WMT	12.0
Amgen	AMGN	11.5
Johnson & Johnson	JNJ	11.0
PepsiCo	PEP	11.0
Nike	NKE	10.5
Oracle	ORCL	10.5
IBM	IBM	10.5
Home Depot	HD	10.5
Apollo Group	APOL	10.5
Bed Bath & Beyond	BBBY	10.5

*In millions, as of Aug. 30. *Source: Barron's*

As the tables above show, the largest additions to the B400 by market value are quite large indeed, with three stocks above the $100 billion market-value threshold, and a total of seven Dow Industrials members among the biggest 10 incoming stocks. While a few heavy hitters—notably **Procter & Gamble** (ticker: PG) and **Visa** (V)–were ousted, the fact that the largest 10 deletions included five small-caps under $400 million in market value indicates the B400 is holding tight to most of its blue chips.

The MarketGrader process is ratifying the idea that well-capitalized Big Tech stocks are attractively priced at the moment. The tech sector is at its maximum 20% weighting in the index. **Microsoft** (MSFT), **Apple** (AAPL) and **Intel** (INTC) are all among the 10 highest-rated names, and **Cisco Systems** (CSCO) rejoins the index after an absence of several years.

At the moment, the index is largely shunning energy stocks, with just a 4.25% allocation to oil and gas. Utilities, at 2.5%, and telecom, at 1%, are also scantily represented, probably due to the emphasis on growth.

The 10 stocks with the longest streak of uninterrupted membership in the B400 include affordable-luxury retailer **Coach** (COH), which hasn't been out of the index in nine years. Also among the stalwarts are **Western Digital** (WDC), **Pepsico** (PEP), **Diamond Offshore Drilling** (DO), **Aeropostale** (ARO) and Apple. These might be viewed as some of the index's core holdings, which are complemented with a changing roster of companies hitting a sweet spot in their growth paths or suffering a temporary setback that leaves them undervalued.

Investing this way works for some of the top fund managers and should continue to serve the Barron's 400 well, too.

E-mail: editors@barrons.com