Ignore the 2017 TSX Trend and Buy Low-Debt Stocks

Description

Governments may rectify economic problems by issuing bonds or printing money, whereas companies gain financial leverage mainly through corporate bonds. Increasing debt is one strategy, but it is a careful balance, because a company with high debt may be swinging above its weight class.

Banking companies borrow money and then lend it out at a higher interest rate. Utilities are also heavy borrowers to pay for infrastructure costs. In an increasing interest rate environment, however, it is important to have a watchful eye on over loaded debt.

A key measure is the debt-to-equity ratio (D/E), which, according to Investopedia, “is a debt ratio used to measure a company’s financial leverage, calculated by dividing a company’s total liabilities by its stockholders’ equity. The D/E ratio indicates how much debt a company is using to finance its assets relative to the amount of value represented in shareholders’ equity.”

There are two ways to drive this ratio down: pay down debts or drive up the value of the company. The D/E is a way to screen for financial leverage.
It may come as a surprise, but, year over year, among 258 TSX companies, 68 stocks with D/E above one actually outperformed 190 stocks with D/E less than one. That’s right. Heavier-in-debt stocks are up 17% for the year. Lighter-debt stocks rose 6.7%, which is underperforming the TSX market as a whole by 230 basis points.

	D/E ratio	
	Greater than 1	Less than 1
Number of TSX companies	68	190
52-weeks average performance (%)	+17%	+6.7%

Information accessed from TD waterhouse

Could this trend continue? Maybe, but it’s not likely and certainly not across the board.

Heavier debt didn’t slow these stocks down

Kudos to investors who have held this small-cap stock: **StorageVault Canada Inc.** (TSXV:SVI) trades on the TSX venture exchange and has a D/E of 1.4. This stock is up 97% for the year.

Tucows Inc. (TSX:TC)(NASDAQ:TCX) is a diversified internet service company that has been a heavy-hitting stock and can handle the high leverage with a D/E of 1.7. This stock up 75% for the year; it tends to double (yes, double) in value each year.

Getting even lighter on debt

The D/E peaked for **Saputo Inc.** (TSX:SAP) at 0.6 in recent years, but it has now been chopped in half. The earnings per share (EPS), now at $1.91 per share, have more than doubled over the last 10 years. This is a nice combination for a company that has steady revenue from solid footing in the global cheese market.

The information services company **Thomson Reuters Corp.** (TSX:TRI)(NYSE:TRI) is another example of low D/E that is pushed down even lower as of late, while profit margins are tilting upward again.

Moving from heavier to lighter debt

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) has clawed back on D/E, while the EPS continue to climb. Dropping D/E below one would be a strategy to keep financial leverage to within historic levels, which would make this transportation stock even more attractive.

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