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In This Overvalued Market, Cut the Chaff, Keep the Wheat

By TIM MELVIN Follow | SEP 25, 2015 | 12:00 PM EDT | 0

Stock quotes in this article: SEAS, CHDN

You can add another voice to the growing chorus of people who think that the stock market may be somewhat overvalued, at current levels. We have heard comments from David Tepper, Sam Zell, Warren Buffett, Carl Icahn and James Montier, over the past year, expressing concerns about the valuation of the stock market. And in the most recent Duke University/*CFO Magazine* poll of chief financial officers, 55% of U.S. CFOs surveyed think the stock market is overvalued, right now. Another 40% think it is correctly valued and just 5% of the CFOs surveyed think that stocks are undervalued. Campbell Harvey, a professor at Duke Fuqua, noted that, "CFOs are very bearish on the U.S. market. Our survey took place during a volatile time, where there was a 10% market correction. Even after this drawdown, 55% of CFOs thought the market was overvalued." They weren't terribly excited about growth prospects, right now, either. David Owens, editorial director for CFO Research, noted, "Finance executives are eager to help their companies start building again, but they feel some drag from continuing uncertainties about government actions and consumer reluctance at home, and about economic conditions overseas -- especially in China."

My crystal ball is still in the shop, and I have no idea when prices might correct to bring valuations back to reality. I do know that it has gone from just hard to ridiculously difficult to find cheap stocks outside of the small-bank sector. Whatever the stock market is, it is not cheap. This is a good time to go through portfolios and make sure you do not own the very worst type of stocks: those that have lofty valuations and are in poor financial condition. You probably should not own these in a good market, but in a bad market you could find yourself holding big losers with limited long-term recovery potential.

The best way to find these overpriced struggling companies is to look for high-multiple stocks that have low Altman Z-scores and Piotroski F-scores. Using these filters produces a list of stocks you don't want in your portfolio, and that traders should be scanning for short setups.

At the top of the list is **Churchill Downs** (CHDN). The simple truth is that, with the exception of a few weeks in May and June, horse racing is a not a vibrant industry in the United States. The company has some casino and slot machine operations, and in 2014 bought Big Fish Games, but they are still heavily dependent on horse racing. At 56x trailing earnings and almost 25x the always optimistic and highly accurate Wall Street Analyst estimates, the stock is clearly overpriced. The numbers tell us that the company is not going to get better any time soon. The F-score is a mediocre 5, and the Z-score of 1.6 tells me the company may not be financially strong enough to weather any economic or market storms that may lie ahead.

Beleaguered **SeaWorld** (SEAS) is another stock where prospects are not that great and the financials are not strong enough to justify owning the stock. SeaWorld has been under fire since the Blackfish documentary was released in 2013. Personally, I think the company is getting a bad rap. Their rescue and conservation efforts have been outstanding, and there are a lot of dolphins and manatees swimming around the Atlantic Ocean and Gulf of Mexico thanks to SeaWorld's efforts, but park visitors have the final say -- and they are not happy. The only worse job, right now, than Speaker of the House and Chair of the Fed is CEO of SeaWorld. Attendance is falling and it will be very difficult for the amusement park operator to reverse the tide. The stock is trading at 67x earnings and the two financial ratios would seem to be indicating it is not getting any better anytime soon. The F-score is just 4 and the Z-score of 1.21 is well below the level that would indicate a financially solid company.

I do not have a clue what the market will do today, next week, or next month. I do know that the market is very pricey, when compared to earnings and asset value, right now, and owning financially challenged companies with poor prospects could lead to a permanent impairment of capital. We cannot control a market pullback dragging our stock prices lower. We can make sure the companies we own have the strength and business quality to rebound when the selling is over. These look like they may not have the characteristics to recover when we do enter a bear market.

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At the time of publication, Melvin had no positions in the stocks mentioned.

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