



C-A-N-S-L-I-M: A Growth Approach Using Technical and Fundamental Data

By Maria Crawford Scott

Investment approaches are often classified as being either “value-based” or “growth-based” strategies that focus on fundamental company characteristics. But not all approaches fit easily into these definitions.

One interesting approach that combines both fundamental and technical factors was devised by William J. O’Neil.

O’Neil began his career on Wall Street and eventually founded an investment research firm, William O’Neil & Co., which publishes, among other things, Daily Graphs (a daily chart service), and Investor’s Business Daily (a daily financial newspaper). The latter publication was started in 1983 and was designed by O’Neil to provide more investment information than was then contained in daily financial newspapers. As a result, Investor’s Business Daily includes in its daily stock price tables information that pertains to his investment approach.

O’Neil discusses his approach in “How to Make Money in Stocks: A Winning System in Good Times and Bad” (published by McGraw-Hill; \$10.95), which is now in its second edition, and this book served as the primary source for this article on William O’Neil’s approach.

C-A-N-S-L-I-M: The Philosophy

William O’Neil is a strong believer in the sustained long-term growth of the American economy due to the freedoms and opportunities available, which he says have made the U.S. a “prime success model” worldwide and a leader in high-growth, innovative entrepreneurial companies. The ultimate goal of investing in stocks, he believes, is to participate in that long-term growth.

With that basic outlook in mind, O’Neil starts with the entire universe of stocks—those listed on the major exchanges, including Nasdaq, but he favors the stocks of smaller firms, since most innovations and new products come from smaller and

medium-sized companies. His system can best be described as a growth stock approach that seeks companies whose stock prices are poised to rise due to favorable fundamental factors within the firm and industry, such as increased earnings due to new products and services, as well as favorable technical factors regarding price trends and the supply and demand for the stock.

In his book, O’Neil says that his approach to investing stems from an analysis covering 40 years of market data, which examined each year’s stocks with the largest percentage price increase to find the common characteristics of the “most successful stocks.” These common characteristics include both fundamental factors, inherent in the nature of the firm and industry, and technical factors from observing the price patterns of the stocks.

The approach he ultimately devised he refers to by the acronym C-A-N-S-L-I-M, which is supposed to help investors remember the seven key factors of these successful stocks (see Table 1).

Increasing Earnings Currently and Historically

O’Neil believes that increases in earnings per share are the single most important elements of stock selection. In fact, he devotes two whole letters of his acronym to earnings—C (current earnings growth) and A (annual earnings growth for the past five years). And it is the presence of both factors, indicating both past and current growth, that he feels is significant.

In terms of current (most recently reported) earnings per share, O’Neil suggests that investors seek firms showing a major percentage increase of at least 18% to 20% over the same quarter’s earnings one year prior. Comparing same-quarter earnings is important to eliminate seasonal earnings fluctuations. O’Neil also warns against meaningless mathematical increases, such as those produced by comparing current earnings with non-existent earnings for the prior year, which would produce a large percentage increase, and those produced by

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Table 1.
The C-A-N-S-L-I-M Criteria and Data Available from Investor's Business Daily

O'Neil's Criteria		Relevant Data in Investor's Business Daily Stock Listings
C	Current Quarterly Earnings Per Share: Should show an increase of at least 18% to 20% above the same quarter one year prior.	EPS Rank: Relative performance in terms of earnings per share growth in the last two quarters compared to one year prior, growth over the last five years, and stability. Earnings rankings are relative to all firms in the tables, with an 80 or above indicating superior earnings records.
A	Annual Earnings Per Share: Should show meaningful growth over the last five years, and should show consistency, with increases each year over the prior year.	
N	New Products, New Management, New Highs: There should be new products or services being sold, or new management offering innovation; stock prices should be reaching new highs.	52-Week High Low: Shows high and low stock price in last 52 weeks; NH indicates New Highs; 52-week high boldfaced if closing price is within 10% of a new high.
S	Supply and Demand: There should be a small or reasonable number of shares outstanding to create buying pressure; and there should be volume increases when a stock begins to move up.	Acc.Dis: An Accumulation-distribution rating that takes into account the percentage change in a stock's daily price and its volume. Vol % Chg: Daily trading volume as percentage change above or below its average for last 50 days, which indicates abnormal volume. % Owned by Management: Shows the percentage of shares outstanding owned by management.
L	Leaders: Buy industry and market leaders, avoid laggards.	Relative Price Strength: Measures each stock's relative price change over the last 12 months compared to all other stocks; stocks below 70 indicate laggard relative price performance. Industry Group Relative Strength: Compares the 6-month price performance of the stock's industry group with 196 other groups.
I	Institutional Sponsorship: Buy stocks with a small number of institutional owners who have good performance records.	Sponsorship Rank: Averages the three-year performance rank of all mutual funds owning the stock.
M	Market: The general direction of the market should be positive.	Daily general market indexes (price and volume changes): Within the general pages of Investor's Business Daily.

one-time extraordinary gains such as the profit from the sale of a plant (such gains should be omitted from earnings per share figures).

Other positive indicators include quarterly earnings per share that have accelerated over the past 2½ years (in other words, the earnings growth rates are increasing each quarter). On the other hand, decelerating quarterly earnings (declining growth rates) are a bad sign.

In terms of annual earnings per share, O'Neil looks for "meaningful" growth rates of between 25% to 50% annually for the last five years. He also prefers firms that show stability and consistency in annual earnings per share, with annual figures that don't deviate significantly from the five-year average.

What about price-earnings ratios?

O'Neil says that markets are seldom wrong, and thus most stocks are correctly priced, with low price-earnings ratios indicating (correctly) low growth prospects. The best investments, according to O'Neil, are growth stocks in which one must be willing to pay for earnings growth.

Growth Prospects

Earnings growth is one important indicator of a growth company. Also important, according to O'Neil, is the timing factor, indicating whether a stock's price is poised to advance. For that, O'Neil suggests investors seek "new" factors: firms that are developing new products or services, or that have new managements that are able to provide innovations or changes that can

The William O'Neil Approach in Brief

Philosophy and style

Investment in companies whose stock prices are poised to rise due to favorable fundamental factors within the firm and industry, such as increased earnings due to new products and services, as well as favorable technical factors regarding price trends and the supply and demand for the stock.

Universe of stocks

No restrictions—the entire universe of stocks including those listed on the major exchanges, including Nasdaq. However, stocks of smaller firms are favored, since most innovations and new products come from smaller and medium-sized companies.

Criteria for initial consideration

- Current quarterly earnings per share that are 18% to 20% above earnings per share for the same quarter one year prior.
- Meaningful growth in annual earnings per share over the last five years (25% to 50% annually).
- New products or services, or new management offering innovation; and share prices that are reaching new highs.
- Small or reasonable number of shares outstanding to create buying pressure; and there should be volume increases when a stock begins to move up.
- Stock should show high price strength relative to other stocks.
- Stock should have a small number of institutional owners with good performance records.

Secondary characteristics

- Quarterly earnings per share that are accelerating. Conversely, decelerating quarterly earnings per share are a bad sign.
- Consistency and stability in annual earnings per share, with few deviations from the long-term average trend.
- Two or three other top stocks within same industry to serve as confirmation of growth.
- Companies that are buying back their own stock in the open market implies expectations by management of improved sales and earnings.
- Low amount of long-term debt to equity.
- A large percentage of stock held by top management.
- Avoid companies that are “overowned” by institutions.
- Avoid companies with no institutional ownership and with low capitalization because of lack of liquidity.

Stock monitoring and when to sell

Monitor stocks quarterly by examining the percentage price increase over the prior quarter, focusing on relative price performance among stocks. When selling, sell worst-performing stocks and let the better-performing stocks ‘run.’

To limit losses, sell if a stock’s price drops 7% to 8% below the purchase price. Take profits when a stock has a 20% gain, unless the outlook is particularly favorable for further growth, both for the stock itself and the overall stock market.

lead to sustained earnings growth. Equally favorable would be new changes within the entire industry that could lead earnings to accelerate.

New highs in stock prices are also important. While these firms are often viewed as too high-priced and risky, O’Neil says that these stocks are the ones whose prices advance. Thus, stocks that are reaching new highs after undergoing a price correction, and particularly those that are accompanied by a big increase in trading volume, usually go higher—what O’Neil characterizes as the “stock market’s great paradox.”

Other Fundamental Factors

There are several other fundamental factors O’Neil suggests investors examine, including:

- Firms that are in growing industries, since these provide

stronger growth prospects. O’Neil also suggests seeking the top two or three firms in a strong industry. Finding several key stocks within a growing industry group additionally serves as a confirmation that you are looking in the “right” area (in terms of growth); conversely, if you can’t find more than one strong company within an industry group, you may have made an error.

- Companies that are buying back their own stock in the open market. Not only does this reduce the number of shares outstanding (a plus, since it increases demand and reduces supply), but more importantly it implies that management most likely expects improved sales and earnings.
- Firms that have a low amount of long-term corporate debt relative to equity outstanding are preferable to firms with larger amounts of debt to equity. Firms that are more highly leveraged have a much greater risk of suffering from problems

in their earnings during periods of high interest rates.

Technical Factors

Supply and demand considerations for the outstanding shares of a stock are important considerations for O'Neil. These factors directly impact the price of a stock, with greater demand and limited supply helping to drive up share prices, according to O'Neil.

O'Neil favors the stocks of smaller firms not only for their growth prospects, but also because of the smaller number of shares outstanding. For these firms, a "reasonable" amount of buying can push up the stock price. On the other hand, he warns that the very same characteristics make these stocks less liquid and more volatile, which are extra risks that investors must consider.

For similar reasons, O'Neil suggests investors examine the "float"—the number of common shares left for possible purchase after subtracting the shares that are closely held by management. Needless to say, stocks with a large percentage of stock held by top management are favorable.

While O'Neil likes a limited number of shares outstanding, he is uncomfortable at the extremes, with little or no liquidity. He warns against owning low-priced stocks with a very low number of shares outstanding and no institutional ownership due to a lack of liquidity and marketability. Thus, O'Neil prefers to see at least some institutional ownership to create demand and thus liquidity and marketability in a stock, and he suggests three to 10 institutional owners as a reasonable number. He also views it as a confirmation of a good purchase. However, if institutional ownership is to be considered as a sign of a good purchase, O'Neil says the institution should have a good performance record. As an example, he suggests ownership by one or two top-performing mutual funds is a positive sign.

On the other hand, stocks that are "overowned" by institutions should be avoided, since it can create too much liquidity and the possibility of large volumes of sales should something go wrong in the short term.

O'Neil also prefers stocks that are market leaders within an industry. By some measures, this could be considered a fundamental criteria, but one way of measuring a leader, according to O'Neil, is by examining a stock's relative strength, which compares a stock's price performance relative to the price

action of the market. A leader is identified as one whose price has outperformed 80% or more of the stocks in the comparison group. In addition, O'Neil suggests that a stock's relative strength should not be trending down.

Lastly, O'Neil is a strong believer in monitoring the stock market, and his book provides a number of guidelines to determine the overall market direction.

Stock Monitoring and When to Sell

O'Neil suggests that investors monitor stock holdings quarterly by computing the percentage change in price from the prior quarter, and then listing the holdings in order of their relative price performance. This places the attention on the relative performance of stock holdings rather than how much a stock has gained or lost from its original purchase price.

O'Neil also suggests that when a stock is purchased, a "profit and loss plan" should be established—one that sets an absolute loss level on the down side, as well as a goal for the upside.

O'Neil recommends that investors sell if a stock drops to 7% or 8% below the purchase price. This level is established to limit an investor's absolute loss, and the level therefore need not be raised as the stock price increases.

O'Neil notes that investors must have patience when holding stock with the expectations of price increases, and he suggests that investors wait at least 13 weeks before concluding that a stock is not advancing properly. He recommends taking profits when a stock has gained 20% unless it is a particularly powerful stock with the possibility for stronger gains, both for the stock itself and during a bull market. "Giant profits" in stocks, he notes, takes one to three years.

O'Neil in Summary

O'Neil's approach has a growth focus, but is nonetheless difficult to categorize since it uses both fundamental and technical factors. The best summary of the approach comes from O'Neil himself:

"We're buying companies with strong fundamentals, large sales and earnings increases resulting from unique new products or services, and trying to time the purchases at a correct point as the company emerges from consolidation periods and before the stock runs up dramatically in price." 