The Motley Fool's Foolish 8 method for investing in small caps looks for profitable and rapidly growing companies with strong price momentum. It is based partly on the premise that the lack of coverage in small-caps presents an opportunity to locate undiscovered attractive investment candidates.

**FOOLISH 8 FILTERS**

The Foolish 8 screen is designed to flag potential growth companies as opposed to growth stocks. It is based upon a combination of market- and business-related factors. Four are business-related filters, which are used to identify potentially good businesses:

- Earnings and sales growth of at least 25%,
- Net profit margin of at least 7%,
- Positive operating cash flow, and
- Insider ownership of at least 10%.

The next three Foolish 8 screens narrow the universe of stocks from which the top companies may be located. These market-related factors are:

- Stocks with daily dollar trading volume of between $1 million and $25 million,
- Stocks with a share price of at least $7, and
- Stocks with a relative strength of greater than 90%.

Finally, the final Foolish 8 screen caps a company's annual sales at $500 million, which is used as a measure of firm size.

This article walks you through the steps of the Foolish 8 stock screen as it is outlined in the Small Cap Foolish 8 area of the Motley Fool Web site (found under Investing Strategies), using AAII's fundamental stock screening and database program Stock Investor Pro. Stock Investor Pro covers a universe of approximately 8,600 NYSE, Amex, and Nasdaq National Market, Nasdaq Small Cap, and over-the-counter bulletin board or pink sheet stocks.

Table 1 is a listing of the eight companies that passed the Foolish 8 small-cap screen.

---

Wayne A. Thorp, CFA, is associate financial analyst at AAII.
SMALL COMPANIES

The most common method of analyzing companies based upon size is market capitalization—current price per share times the number of shares outstanding for the company.

However, for the Foolish 8 small-cap screen, small companies are defined as those that have annual sales of $500 million or less. This screen is designed not only to separate the small from the large, but also to orient the investor’s mind toward purchasing a company, rather than a small-cap stock. However, since sales are an industry-specific element, this screen will tend to eliminate companies in traditionally high sales, low-margin industries such as grocery stores.

Requiring companies to have sales over the last four quarters (trailing 12 months), using Stock Investor Pro with data as of October 4, 2002, narrowed the initial database of 8,685 companies down to 5,720 firms.

Of the eight companies that passed the final Foolish 8 screen, Chico’s FAS has the highest level of sales over the last 12 months at $451 million, while Royal Gold, with sales of $12.3 million, was at the other end of the spectrum.

GROWTH

One advantage of focusing on smaller companies is that they tend to have a greater potential for high growth. It is much easier for a smaller company to grow earnings and sales. No company can sustain a high growth rate indefinitely—eventually its size begins to weigh it down.

The Foolish 8 methodology looks for a minimum level of year-on-year growth in both sales and earnings of at least 25%. The screen is looking for quality small companies, and instituting such a high growth requirement is one way of achieving that goal.

Looking at the growth in both sales and earnings from continuing operations—which excludes extraordinary items and discontinued operations—over the last 12 months, versus over 12 months one year ago, a total of 3,120 and 1,246 companies, respectively, had growth rates in excess of 25%. When these two screens are combined, only 651 firms passed, and the list of passing companies for the entire Foolish 8 screen is lowered to 542.

For those companies that ultimately passed the Foolish 8 screen, New Century Financial had the highest growth rate in sales over the last 12 months, at 140.5%. What makes this number even more impressive is that New Century is second on the list of passing companies in Table 1 in terms of sales over the last 12 months at $433.8 million. The lowest sales growth rate in the group of passing companies comes from Glamis Gold, at 25.9%.

On the earnings side, Royal Gold had the highest growth rate over the last 12 months, at 757.1%. However, when using growth rates as part of a screening methodology, it is important to examine the raw numbers once you have completed the screen. In the case of Royal Gold, earnings grew from $0.07 a share to the current trailing 12-month figure of $0.60. When the base figures used in growth calculations are close to zero, as is the case here, any growth in earnings per share on a percentage basis can be very high. The other consideration is whether the historical growth is sustainable going forward.

Chico’s FAS had the lowest 12-month growth rate in earnings per share from continuing operations at 42.6%.

NET PROFIT MARGIN

Net margin, the focus of the next Foolish 8 small-cap screen, is the bottom line profit margin that indicates how well management has been able to turn sales into earnings available for shareholders. It is computed by dividing net income by sales for the same period. Here, the

**TABLE 1. STOCKS PASSING THE FOOLISH 8 SCREEN**

<table>
<thead>
<tr>
<th>Company Name (Exchange: Ticker)</th>
<th>Sales 12m ($ mil)</th>
<th>Sales Grth 12m (%)</th>
<th>EPS Cont 12m ($ shr)</th>
<th>EPS Cont 12m (%)</th>
<th>Net Margin 12m (%)</th>
<th>Ind Net Margin 12m (%)</th>
<th>Avg Trading Vol ($000s)</th>
<th>Insider Owner (%)</th>
<th>% Rank Rel Strtg</th>
<th>52wk</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Gold (M: RGLD)</td>
<td>12.3</td>
<td>108.5</td>
<td>757.1</td>
<td>0.60</td>
<td>87.8</td>
<td>-8.4</td>
<td>8,253</td>
<td>24.9</td>
<td>99</td>
<td>99</td>
<td>Gold properties</td>
</tr>
<tr>
<td>Glamis Gold (N: GLG)</td>
<td>73.9</td>
<td>25.9</td>
<td>121.0</td>
<td>0.13</td>
<td>13.5</td>
<td>-8.4</td>
<td>8,091</td>
<td>10.0</td>
<td>97</td>
<td>97</td>
<td>Precious metals</td>
</tr>
<tr>
<td>Meridian Medical Tech (M: MTEC)</td>
<td>82.4</td>
<td>34.0</td>
<td>156.7</td>
<td>2.31</td>
<td>10.8</td>
<td>-0.5</td>
<td>3,737</td>
<td>36.0</td>
<td>94</td>
<td>94</td>
<td>Health care devices</td>
</tr>
<tr>
<td>Friedman, Billings, Ramsey (N: FBR)</td>
<td>210.9</td>
<td>41.7</td>
<td>190.9</td>
<td>0.32</td>
<td>7.8</td>
<td>2.8</td>
<td>1,067</td>
<td>51.3</td>
<td>94</td>
<td>94</td>
<td>Financial services</td>
</tr>
<tr>
<td>New Century Financial (M: NCEN)</td>
<td>433.8</td>
<td>140.5</td>
<td>581.4</td>
<td>5.44</td>
<td>25.8</td>
<td>6.9</td>
<td>14,516</td>
<td>17.9</td>
<td>93</td>
<td>93</td>
<td>Mortgage loans</td>
</tr>
<tr>
<td>Multimedia Games (M: MGAM)</td>
<td>261.3</td>
<td>133.5</td>
<td>235.8</td>
<td>1.78</td>
<td>8.4</td>
<td>2.5</td>
<td>6,535</td>
<td>16.5</td>
<td>93</td>
<td>93</td>
<td>Video games</td>
</tr>
<tr>
<td>Hilb, Rogal &amp; Hamilton (N: HRH)</td>
<td>370.2</td>
<td>28.3</td>
<td>61.2</td>
<td>1.58</td>
<td>13.1</td>
<td>3.4</td>
<td>7,932</td>
<td>10.1</td>
<td>93</td>
<td>93</td>
<td>Insurance</td>
</tr>
<tr>
<td>Chico’s FAS (N: CHS)</td>
<td>451.0</td>
<td>38.9</td>
<td>42.6</td>
<td>0.67</td>
<td>12.2</td>
<td>3.0</td>
<td>22,251</td>
<td>10.3</td>
<td>91</td>
<td>91</td>
<td>Clothing retailer</td>
</tr>
<tr>
<td>Median—All Companies</td>
<td>97.3</td>
<td>-1.6</td>
<td>6.7</td>
<td>-0.01</td>
<td>-0.4</td>
<td></td>
<td>65</td>
<td>26.2</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Data as of October 4, 2002.
Source: AAII’s Stock Investor Pro/Market Guide Inc.

Exchange Key: N = New York Stock Exchange
M = Nasdaq National Market

24 AAII Journal/November 2002
screen looks for companies with a net margin of 7% or greater for the trailing 12 months.

Screening just for companies with a net margin of 7% or greater returned 2,017 companies. To this point, the Foolish 8 screen’s list of passing companies stands at 168.

Among those companies that passed the screen, Royal Gold again led the way with a net margin of 87.8%, meaning that 87.8 cents of every dollar of sales generated by the company is net income. Royal Gold’s revenue primarily comes from royalty interest in gold properties, not mining or exploration. In contrast, Glamis Gold is involved in the exploration, development, and mining of gold and has a much lower net margin.

Since profit margins are in part affected by the industry in which a company operates, it is common to compare the margins of a company to those of its underlying industry or sector. For this reason, we also provide the median industry net margin for each of the passing companies in Table 1. For the most part, all the companies have net margins that far exceed their industry’s median value.

CASH FLOW

The next Foolish 8 small-cap screen deals with cash flow, specifically cash flow from operations, and requires that a company’s be positive.

Cash flow from operations is found on the statement of cash flows, and includes adjustments to net income, such as adding non-cash expenses (depreciation, amortization, etc.) and changes in working capital accounts such as accounts payable, accounts receivable, and inventory. For rapidly growing small companies, their ability to control their working capital accounts often determines whether they live or die. In order for small companies to continue growing, they need to find ways to fund inventories (a cash outflow that lowers operating cash flows) and collect on accounts receivable (increasing accounts receivable also lowers operating cash flows). While it is more common to hear of companies failing because there is not a market for their products, companies can also grow themselves to death.

Within the Stock Investor Pro database, 5,217 out of 8,685 companies have cash from operations for the trailing 12 months (last four quarters) that is greater than zero (positive).

Adding the cash flow filter to the Foolish 8 screen narrowed down the universe of companies to 140.

LOW LIQUIDITY

One risk of investing in smaller companies is that their shares tend to be illiquid—the trading volume of the shares is low, and the spread between the stock’s bid and ask prices is high. If you own an illiquid stock and wish to sell it, you may have to discount the price to attract a buyer. Common screening strategies to avoid illiquid shares include requiring a minimum level of trading volume or a minimum level of shares outstanding.

The Foolish 8 screen, on the other hand, actively seeks companies that the Motley Fool considers to be relatively illiquid. In doing so, it forces would-be investors into taking the extra time that is required to analyze small companies. Since low liquidity makes it more difficult and expensive for investors to “trade out of mistakes,” this screen requires caution and discipline in the analysis process. Lastly, since it may be difficult to sell an illiquid stock during bad times, an individual must have a longer-term investment horizon.

As a proxy for liquidity, the Foolish 8 screens makes use of average daily dollar trading volume. Volume is the total number of shares transacted. The daily average can be calculated using various time periods, but a daily average based on three months’ trading is common. Average daily dollar volume reflects the current price of a stock multiplied by its average daily volume. In order for a company to pass the Foolish 8 screen, its average daily dollar volume must be between $1 million and $25 million.

For this particular filter, a custom field was created in Stock Investor Pro by multiplying the average monthly trading volume over the last three months—which was divided by 20 to approximate the average daily trading volume—by the current stock price. In Stock Investor Pro, 2,348 companies had an average daily dollar trading volume greater than or equal to $1 million, and 8,142 companies (94% of the database) had an average daily dollar trading volume of $25 million or less. Combined, these two filters isolated 1,855 companies and after adding the average dollar trading volume constraints to the overall Foolish 8 screen, 49 companies were left.

The average daily dollar trading volume shown on Table 1 is in thousand dollar units. Chico’s FAS has the highest average daily dollar trading volume at $22.25 million while Friedman, Billings, Ramsey just cleared the hurdle with an average daily dollar trading volume of $1.07 million.

INSIDER HOLDINGS

For the Foolish 8 screen, the Motley Fool looks for companies where insiders own at least 10% of their company’s stock. This requirement allows investors to see whether the interests of “insider” shareholders are aligned with those of “outsider” shareholders. They are, however, more interested in the issue of insider ownership and not the level of insider ownership.

As a general rule it is better that a company have some level of insider ownership than not. Who else would better know the future prospects of the company and how this may affect future stock price movement? Insiders are privy to information...
regarding new products, competition, and operating environment—oftentimes long before the companies become large.

The Securities Exchange Act of 1934 defines an insider as an officer or director of a public company, or an individual or an entity owning 10% or more of any class of a company's shares. Thus, the term “insider” refers to a wide-ranging group including large shareholders, directors, and officers.

Although large shareholders are insiders in a legal sense, they are not privy to the same kind of information that top-level employees of the company have access to. Directors, as one may guess, are members of the board of directors of a company. Officers are those individuals at a company occupying the highest positions: CEO, chief financial officer, president, vice president, and others.

In Stock Investor Pro, the percentage of insider ownership is defined as the percentage of common stock held by all officers and directors as a group, and beneficial owners who own more than 5% of the subject company's stock as disclosed in the most recent proxy statement. The database contains 6,527 companies where insiders or beneficial owners hold at least 10% of the company's outstanding shares. Integrating this criterion into the Foolish 8 screen drops the list of passing companies down to 35. For those companies that passed Friedman, Billings, Ramsey has the highest level of insider ownership at 51.3% while Glamis Gold exactly met the minimum requirement of 10.0%.

PRICE & PERFORMANCE

While the Foolish 8 small-cap screen is looking for attractive small companies, it does not want these companies to have a price that is too low. As a rule, the Motley Fool shies away from so-called penny stocks, which they term as stocks with a price per share of under $5. These companies, historically, have been prone to manipulation, as well as a lack of financial data.

In recent years, moves by The National Association of Securities Dealers (NASD) to require companies traded on the Over-the-Counter Bulletin Board (OTCBB) market to be current in their SEC filings before their shares can be quoted have made the OTCBB more reputable. However, the Foolish method of investing avoids these stocks.

For this reason, the AAII Foolish 8 screen eliminates companies that are traded over-the-counter, which leaves us with 6,249 companies. As a component of the overall Foolish screen, this requirement does not eliminate any additional companies, leaving us with a roster of 35 passing companies.

In looking at share price, the Foolish 8 screen raises the price requirement to $7 a share or greater. The Motley Fool believes that prices reflect fundamental aspects of a company. If, after implementing all of the filters of the Foolish 8 screens, a company does not have a share price of $7 or greater, they believe it may be a sign of some underlying fundamental problem with the company.

In Stock Investor Pro, 3,676 companies have a per-share stock price of $7 or greater and adding it to the Foolish 8 screen eliminates only four companies, leaving 31. Just as price reflects certain fundamental aspects of a company, so too does relative price strength. High price performance relative to the stock universe tends to show that the market is recognizing the company's value and is driving up the price of the stock at a rate better than that of a majority of other stocks. In this case, the Foolish 8 screen looks for companies whose stock price has outperformed 90% of the stock universe.

The most common time frame in examining relative strength is one year, or 52 weeks. Therefore, AAII's version of the Foolish 8 screen requires that a company's relative strength 52-week percentage rank value is 90% or greater. In other words, over the last 52 weeks the stock has performed in the top 10% of the entire Stock Investor database.

In Stock Investor Pro, 888 companies have a 52-week relative strength that ranked in the top 10% of the database. Adding this final requirement to the Foolish 8 screen isolated the final eight companies, with Royal Gold ranking the highest in relative strength over the last 52 weeks at 99% and Chico's FAS registering the lowest at 91%.

Check the Stock Screens area at AAII's Web site (www.aaii.com) for a monthly update of companies passing this screen, as well as a chart tracking the screen's performance over time. The Stock Screens area updates and tracks over 30 screens based on popular stock strategies.

CONCLUSION

Stock screening such as this is a useful way of identifying potential investment candidates. However, the Motley Fool stresses that the final list of companies passing its Foolish 8 screen—or any list of passing companies you generate—is by no means a buy list. It is up to you to perform your own due diligence to see whether the companies truly warrant your investment dollars.

This is especially the case when dealing with small companies, where the price of making a mistake tends to be greater than when dealing with larger firms. ✦