The First Cut

Companies Surpassing Industry Norms

The First Cut is designed as a starting point for investors. Each issue we list the top stocks that pass relatively simple screens of interest to individual stock pickers. AAII's Stock Investor Pro *screening software is used to generate the First Cut listing.*

This issue's First Cut seeks out companies that are cheaper than their industry peers yet have better margins and lower levels of debt than the median for their industry.

This First Cut relies on a trifecta of valuation ratios to seek out attractively priced stocks—price to sales, price to earnings and price to free cash flow.

The price-to-sales ratio (price divided by sales per share) looks at the top line of the income statement and may identify undervalued firms sooner than the price-earnings approach and avoid some of the accounting complications of the price-earnings and price-to-book ratios.

The price-earnings ratio (price divided by trailing 12-month earnings per share) is tied to bottom-line profitability and is closely linked to company stock price performance.

The price-to-free-cash-flow ratio (price divided by free cash flow per share, where free cash flow is cash from operations minus capital expenditures and cash dividends) is tied to the actual cash generation and usage of the business and not burdened by accrual accounting.

The First Cut requires that a firm's price-to-sales, price-earnings and price-to-free-cash-flow ratios come in below the median for the industry in which the company is classified, highlighting companies that are cheaper than the norm for the industry.

Since profit margins vary by industry, the First Cut also requires that the company's gross margin and operating margin be higher than the industry norm. This type of filter helps to highlight companies that have a competitive advantage. Gross margin (gross profit divided by sales) examines the competitive pricing power of the firm, while operating profit margin (operating income divided by sales) examines the relationship between sales and management-controllable costs.

The First Cut then focuses on financial leverage and strength by requiring that each firm's ratio of total liabilities to assets and ratio of long-term debt to equity both come in below their respective industry medians. Industry comparisons are desired, as companies in more stable industries can safely assume greater levels of debt.

The final First Cut filter requires a positive consensus earnings per share estimate for the current fiscal year and expected growth in earnings over the next fiscal year. This filter is seeking companies with minimum levels of expected future growth in bottom-line profitability.

The stocks passing the First Cut are domestic exchange-listed companies with minimum trading liquidity of $300,000 in average daily dollar amount. This trading liquidity measure reflects the current price of a stock multiplied by its average daily volume over the last three months. The 15 stocks making the First Cut are presented in the table ranked by their 52-week relative price strength. ▲

—John Bajkowski, AAII president

Companies Surpassing Industry Norms: Ranked by 52-Week Relative Price Strength

Company (Ticker)	P/Sales Co. (X)	P/Sales Ind. (X)	P/Earnings Co. (X)	P/Earnings Ind. (X)	P/Free-Cash-Flow Co. (X)	P/Free-Cash-Flow Ind. (X)	Operating Margin Co. (%)	Operating Margin Ind. (%)	Liab to Assets (%)	52-Wk Rel Price Strgth (%)	Share Price (9/14) ($)	Industry
Hibbett Sports, Inc. (HIBB)	0.39	0.42	10.6	18.5	3.9	17.2	5.5	3.7	33.0	85	20.35	Retail (Specialty)
Electro Scientific Ind (ESIO)	1.55	2.29	4.5	20.4	10.3	23.0	26.0	6.6	25.1	84	18.26	Semiconductors
Xcerra Corp. (XCRA)	1.59	2.29	15.4	20.4	15.5	23.0	13.1	6.6	21.3	81	13.70	Semiconductors
MSC Industrial Direct (MSM)	1.58	1.59	18.0	24.3	32.4	34.8	13.2	7.3	38.0	69	87.38	Misc. Capital Goods
MicroStrategy Inc. (MSTR)	3.37	4.51	40.5	42.0	28.7	43.7	7.5	(2.5)	33.1	63	149.13	Software & Progrm'g
Cohu, Inc. (COHU)	1.75	2.29	13.9	20.4	18.4	23.0	10.5	6.6	30.1	62	22.60	Semiconductors
Chico's FAS, Inc. (CHS)	0.48	0.63	13.6	19.1	10.1	18.1	5.3	5.1	39.7	51	8.55	Retail (Apparel)
MKS Instruments (MKSI)	2.14	2.85	11.5	29.1	16.1	36.9	24.2	5.1	30.0	40	83.30	Scientific & Tech Instru
Entravision Comm (EVC)	0.86	1.46	3.1	15.4	2.1	12.1	48.7	13.2	55.1	38	5.30	Broadcst'g & Cable TV
DHI Group Inc. (DHX)	0.51	1.42	6.0	28.9	10.2	26.5	11.9	5.4	45.5	36	1.95	Business Services
Federated Investors (FII)	2.13	2.65	6.6	14.1	11.7	19.8	31.6	25.4	37.4	29	23.64	Investment Services
Nautilus, Inc. (NLS)	1.07	1.31	21.6	21.7	16.4	30.8	7.8	7.6	38.6	28	14.35	Recreational Prods
Cirrus Logic, Inc. (CRUS)	1.66	2.29	15.0	20.4	10.0	23.0	14.3	6.6	17.5	19	39.71	Semiconductors
NutriSystem Inc. (NTRI)	1.49	1.74	19.8	29.2	29.5	31.5	10.7	9.1	30.7	19	35.10	Personal Services
MiMedx Group (MDXG)	1.76	4.07	16.5	37.9	10.8	45.8	11.6	(7.3)	20.3	8	5.00	Medical Equip & Supl

Source: AAII's Stock Investor Pro, *Thomson Reuters. Data as of 9/14/2018.*