

Screening for Tomorrow's Stock Market Winners

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Article Highlights

- Based on a study of past winners, potential future winning stocks have nine specific characteristics.
- These characteristics include a low price-to-book ratio and good relative strength.
- This restrictive screen has had strong, but volatile, performance.

For most of us, stock screening is about finding stocks with strong future prospects. In other words, we are trying to find future winners.

The question is, what does it take for a stock to become a winner? The investing landscape is littered with studies that attempt to answer this question. Many of these studies try to pinpoint winning characteristics that can be used to identify future stock market winners.

One of the most well-known stock studies was undertaken by William O'Neil, who analyzed the common traits of the 500 biggest stock market winners dating back to 1953 and formed the basis of the CAN SLIM screening methodology. Due to its strong performance since AAI started testing it in 1998, the CAN SLIM approach has become a favorite among our members. However, this is not the only stock screen we track that focuses on the winning characteristics of stocks.

In the article "Investment Characteristics of Stock Market Winners," from the September 1989 issue of the *AAII Journal*, Marc Reinganum examined the common traits of a group of winning stocks. Based on Reinganum's research, AAI developed the Stock Market Winners screen.

Defining the "Winners"

Reinganum's research stems from a publication by William O'Neil & Co. titled "The Greatest Stock Market Winners: 1970–1983." Reinganum examined 222 stocks highlighted in the publication to establish the characteristics that were



common to these stocks *prior* to their rise to prominence.

Based on his analysis, Reinganum came up with nine trading rules to help identify potential future winners.

These rules are:

- Price-to-book-value ratio less than 1.0;
- Accelerating quarterly earnings;
- Positive five-year growth rate in earnings;
- Positive pretax profit margins;
- Relative price strength of at least 70;
- Relative strength rank in the current quarter that is greater than the rank in the previous quarter;
- O'Neil Datagraph rating of at least 70 (this is a weighted combination of earnings, market capitalization, relative strength and other factors, where 1 is the lowest and 99 is the highest rating);
- Current stock price that is within 15% of its two-year high; and
- Fewer than 20 million shares outstanding.

AAII's Stock Market Winners screen attempts to quantify as many of these rules as possible, given the data available in AAI's fundamental stock screening and research database program *Stock Investor Pro*. This screen is built into the software, and its screening criteria are listed in the "What it Takes" box at the end of this article.

Performance

Figure 1 shows selected performance and risk statistics of the Stock Market Winners screen and several market indexes.

Year-to-date as of August 31, 2011, the screen has bucked the trend of the broader market and generated a price gain of 21.0%. Since the beginning of 1998, the screen has had an average annual gain of 21.4%, significantly outperforming the small-, medium- and large-cap indexes over that period.

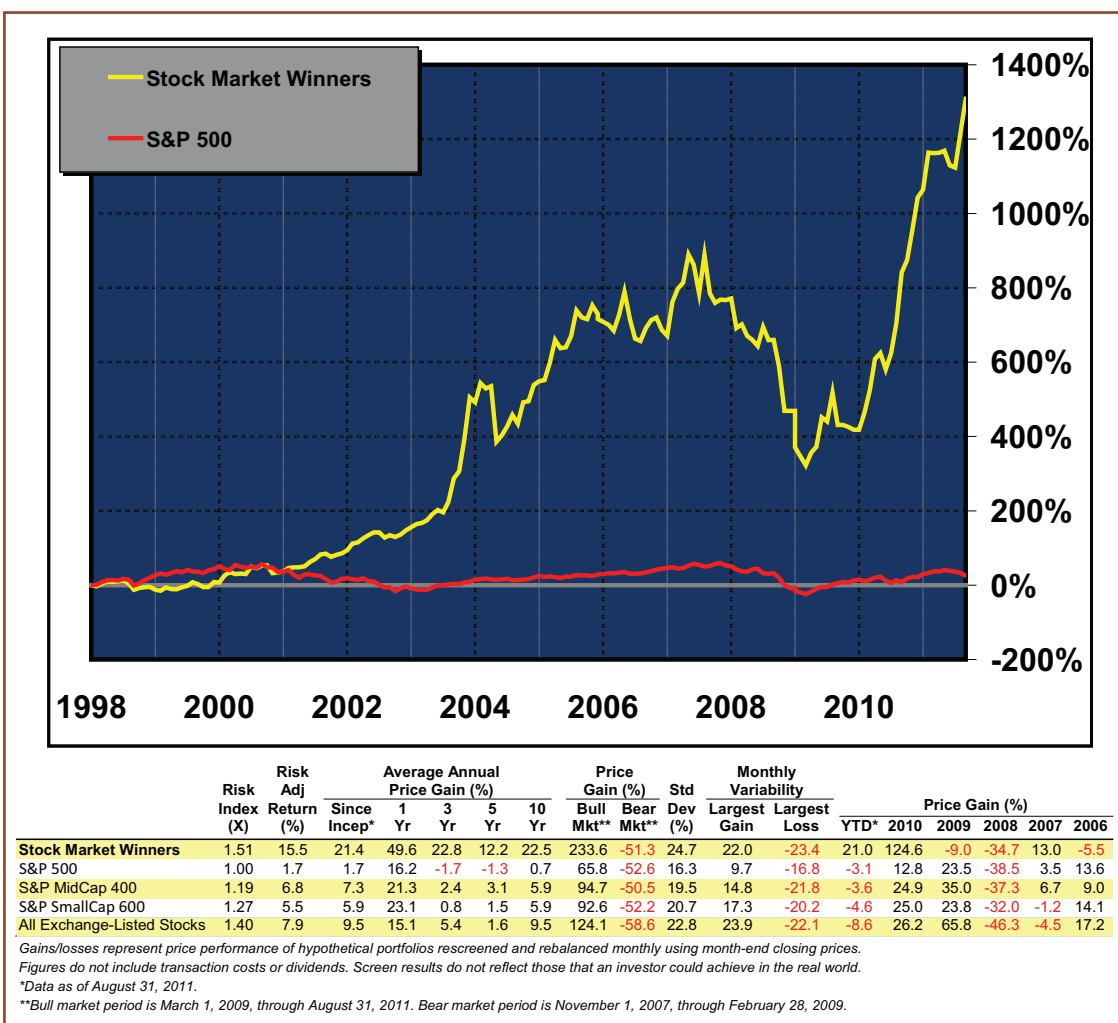
Looking at the overall risk of the screen, we see that its risk index is 1.51, making it 51% riskier than the S&P 500 since the beginning of 1998. This lowers its risk-adjusted return to 15.5% a year, which is still better than the S&P indexes, as well as the typical exchange-listed stock.

Over the last bear market, which ran from the end of October 2007 through the end of February 2009, the Stock Market Winners screen lost 51.3%, which was on par with the broader market indexes. However, over the ensuing bull market, which was still in effect as of the end of August 2011, the screen gained an impressive 233.6%, almost doubling the return of the typical exchange-listed stock over the same period.

Profile of Passing Companies

The characteristics of the six stocks passing the AAI Stock Market Winners screen as of September 9, 2011, are presented in Table 1. Historically, 12 companies, on average, have passed the screen each month since the start

Figure 1. Performance of the Stock Market Winners Screen



of 1998. Furthermore, the Stock Market Winners screen has one of the highest monthly turnover rates of any screen AAI tracks—on average, 61.9% of the portfolio is replaced each month.

The passing companies are listed in Table 2, in ascending order by price-to-book-value ratio.

All but one of the passing companies are in the financial sector, the sole exception being Taylor Devices, Inc. (TAYD), which designs and manufactures shock absorption, rate control, and energy storage devices for use in various types of machinery, equipment and structures.

Unlike O'Neil's CAN SLIM approach, which focuses on earnings and price momentum, with no value elements, the cornerstone of the Stock

Market Winners approach is a price-to-book-value ratio of no more than 1.5. This is slightly higher than the maximum value used in Reinganum's original study in order to allow for a larger pool of potential candidates. Financial holding company First BancTrust Corp. (FIRT) has the lowest price-to-book-value ratio among these passing companies at 0.63.

Because of the screen's strict value-oriented rule, it is not surprising that the current group of passing companies has a lower price-earnings multiple (11.6) than the typical exchange-listed stock (14.4), as well as a lower median price-to-book-value ratio (1.0 versus 1.4).

Low price-to-book-value screens typically identify neglected stocks, but many of these stocks deserve to be neglected. Therefore, secondary or

Table 1. Stock Market Winners Portfolio Characteristics

Portfolio Characteristics (Median)	Stock Market Winners	All Exchange-Listed Stocks
Price-earnings ratio (X)	11.6	14.4
Price-to-book-value ratio (X)	1.0	1.4
Price-to-sales ratio (X)	1.3	1.4
EPS 5-yr. historical growth rate (%)	12.6	1.1
EPS 3-5 yr. estimated growth rate (%)	na	12.7
Market cap. (\$ million)	56.2	401.8
Relative strength vs. S&P 500 (%)	22	(5)
Monthly Observations		
Average no. of passing stocks	12	
Highest no. of passing stocks	60	
Lowest no. of passing stocks	0	
Monthly turnover (%)	61.9	

Source: AII's Stock Investor Pro/Thomson Reuters. Data as of September 9, 2011.

conditioning screens are needed to help separate those stocks that deserve to be ignored from those that may be poised for a turnaround.

Some of these conditioning filters in the Stock Market Winners screen focus on quarterly earnings momentum. The first require that earnings from continuing operations for the two most recent fiscal quarters be above earnings for the respective quarters a year ago. Comparing one quarter to the same quarter a year prior eliminates the seasonality in earnings that many companies experience.

First Investors Financial (FIFS), a consumer finance company specializing in lending to consumers with impaired credit, saw its earnings jump 866.7% for the quarter ending April 30, 2011. (Results for the quarter ended July 31, 2011, were released after the screen was run.) When you see such a large percentage increase, it is a good idea to examine the scale of earnings. Upon further investigation, we found that earnings grew from \$0.03 per share for the quarter ending April 30, 2010, to \$0.29 per share for the quarter ending April 30, 2011. The company has benefited

from the lagging U.S. economy and high unemployment that has damaged the credit of many consumers.

Furthermore, the Stock Market Winners screen requires that the growth in earnings between the most recent fiscal quarter and the same quarter a year ago be greater than the growth between the previous quarter and its counterpart a year ago.

This short-term growth seems to have carried over to the longer term, as the current passing companies have a median five-year average growth rate of 12.6%, compared to 1.1% for the typical exchange-listed stock. Taylor Devices has the highest average annual growth in earnings over the last five years at 22.4%, while on the other end of the spectrum First Investors Financial, despite its stellar quarterly growth, has seen earnings grow at an average rate of 5.5% over the last five years.

Another component of the Stock Market Winners screen is price momentum. To this end, the screen makes use of a weighted relative strength measure that emphasizes more recent price performance. This measure gives the most recent quarterly price change relative to the S&P 500 a weight of 40% and that of each of the previous three quarters a 20% weighting. In order to pass this Stock Market Winners screen, a stock must have a weighted relative strength value that is higher than 70% of all stocks.

Table 2. Companies Passing the Stock Market Winners Screen

Company (Ticker)	Price (\$/Sh)	P/B Ratio (%)	EPS Growth			Pretax Marg 12-Mo (%)	Avg Shs Out (Mil)	Rel Strgth Idx (%)	Price as % 52-Wk Hi (%)	Description
			Q5 to Q1 (%)	Q6 to Q2 (%)	5 Yr (%)					
First BancTrust Corp. (FIRT)	8.30	0.63	37.0	30.8	15.3	24.1	2.07	82	91.7	financial holding co.
Beacon Federal Bancorp (BFED)	13.50	0.72	20.8	19.0	16.2	17.7	6.08	72	90.1	bank holding co.
First Investors Financial (FIFS)	7.90	0.88	866.7	33.3	5.5	9.3	4.69	78	98.8	consumer finance
CCFNB Bancorp Inc. (CCFN)	34.50	1.09	12.2	4.3	9.9	34.6	2.23	75	91.4	bank holding co.
Hills Bancorporation (HBIA)	61.00	1.34	19.7	14.8	9.6	37.8	4.38	72	93.9	bank holding co.
Taylor Devices, Inc. (TAYD)	6.97	1.37	57.1	20.0	22.4	8.1	3.23	78	96.9	energy storage

Source: AII's Stock Investor Pro/Thomson Reuters. Data as of September 9, 2011.

What It Takes: Stock Market Winners Screen Criteria

- The price-to-book-value ratio is less than or equal to 1.5
- Earnings per share from continuing operations for each of the last two fiscal quarters (Q1 and Q2) are greater than the earnings per share from continuing operations for the same quarters one year ago (Q5 and Q6)
- Same-quarter growth in earnings per share from continuing operations from Q5 to Q1 is greater than the same-quarter growth in earnings per share from continuing operations from Q6 to Q2
- The five-year growth rate in earnings per share from continuing operations is positive (greater than zero)
- The weighted relative price strength for the last four quarters is higher than 70% of the entire stock universe
- The pretax profit margin for the last 12 months is positive
- The current stock price is within 15% of the highest price at which it has traded over the last two years
- The average number of shares outstanding for the last fiscal quarter (Q1) is less than or equal to 20 million

The companies that passed the Stock Market Winners screen as of September 9, 2011, had outperformed the S&P 500 by 22% over the last 52 weeks, while the typical exchange-listed stock underperformed the S&P 500 by 5% over the last period. First BancTrust Corp. has had the strongest relative price performance over the last 52 weeks, ranking in the 82nd percentile among all companies in the *Stock Investor Pro* database. Beacon Federal Bancorp (BFED) and Hills Bancorporation (HBIA) are just above the cutoff, ranking in the 72nd percentile over the last 52 weeks.

The Stock Market Winners screen also requires that the current stock price be within 15% of its two-year high. All of the current passing companies are trading within 10% of their two-year highs. First Investors Financial is at the top, with a current stock price that is

almost 99% of its two-year high.

Lastly, Reinganum's research revealed that 90% of the firms in his study had fewer than 20 million shares outstanding before their price increase. Therefore, this is the limit we institute in our Stock Market Winners screen. All of the passing companies had less than seven million shares outstanding for their latest fiscal quarters; First BancTrust Corp. had the lowest number of shares outstanding at just over two million shares.

Limiting the number of shares outstanding (and not excluding stocks trading over the counter, or OTC) leads this screen to isolate very small firms in terms of market capitalization (shares outstanding multiplied by price per share). The stocks currently passing the screen have a median market capitalization of only \$56.2 million, whereas

the typical exchange-listed stock has a market cap of over \$400 million.

Conclusion

By creating a stock screen based on characteristics that have worked well in the past, we are assuming that the factors will remain relevant going forward, which is by no means guaranteed.

No matter how well a stock screen has performed historically, it is important to remember that stock screening is only the first step in the analysis process. Once you have winnowed the stock universe down to a more manageable set of companies, it is important to perform additional due diligence on the remaining companies to verify their financial strength as well as to determine how well they match your risk tolerances and investment time horizon. ▲

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