

The “New” Edge: Characteristics of Winning Stocks

By Christina Wise

Article Highlights

- Strong-performing stocks often have a new product, new management or the lead in a new industry.
- Traits that make an attractive story an attractive investment include strong earnings growth and high return on equity.
- Looking at past market winners can help you learn how to identify potential future market winners.

What characteristic have winning stocks had in common, bull market after bull market, decade after decade?

They brought something new to the table that gave them an edge over the competition.

Followers of the Investor’s Business Daily CAN SLIM Investing System know that a new product, new management, a new industry or other change often gave leading companies the advantage they needed to outpace the competition. This advantage was reflected in the dizzying climbs their stocks made.

Learning to spot innovators like this can help you find—and profit from—stocks that go on to make sizable gains.

A History of Past Winners

Studies show it was true in the 1880s and it’s still true today. Here are a few examples:

New product: General Electric Co. (GE)

- Climbed 124% between June 1898 and April 1900.

In addition to the light bulb, GE had a number of groundbreaking products in a variety of industries in the late 1890s. In 1896, they started making electrical equipment for the production of X-rays. In 1898, they rolled out a new-and-improved electric locomotive. That same year, they began branching out internationally and sending products to France.



New product: General Motors Co. (GM)

- Climbed 1,386% between January 1914 and December 1915.

In 1908, America’s largest car maker, Buick Motor Company, kicked off a series of consolidations that would create General Motors. In 1914, GM’s Cadillac division rolled out the first eight-cylinder engine, and by 1915 the V-8 engines were in all its models. That was a big step in the development of high-speed engines.

New economy: U.S. Smelting, Refining & Mining Co.

- Climbed 526% between March 1933 and February 1934.

Due to deflation, many countries abandoned the gold standard in the early 1930s, including Great Britain and the U.S. This sent prices for precious metals soaring. And companies that mined these metals, like U.S. Smelting, saw big increases in their sales and earnings.

New product: Xerox Corp. (XRX)

- Climbed 1,201% between May 1958 and December 1961.

The introduction of the photocopier in the 1950s saved companies both time and money. As the world’s first fully automated, plain-paper photocopier, Xerox’s model 914 photocopier was superior to its competition. Other photocopiers needed specially treated paper or were very time-consuming and expensive to run.

New markets:**Campbell Soup Co. (CPB)**

- Climbed 90% between October 1960 and December 1961.

Campbell Soup was founded in 1869, and by the time the 20th century rolled around, soup was a regular entree at many American dinner tables. In 1957 Campbell started an international division, and in 1959 they moved into the Mexican marketplace. They also made some strategic acquisitions like TV dinner-maker Swanson & Sons, which put them in the frozen food market. In 1960, they moved into the bakery market with the acquisition of Pepperidge Farm.

New Management:**Apple Inc. (AAPL)**

- Climbed more than 500% between March 2004 and January 2006.

In 1997, Steve Jobs retook the reins at Apple and within a few years had turned the company—which had been on the brink of bankruptcy—around. By 2003, the innovations were rolling out. The company had been opening retail stores around the country to sell its products since 2001, and it branched out overseas with a store in Tokyo in 2003.

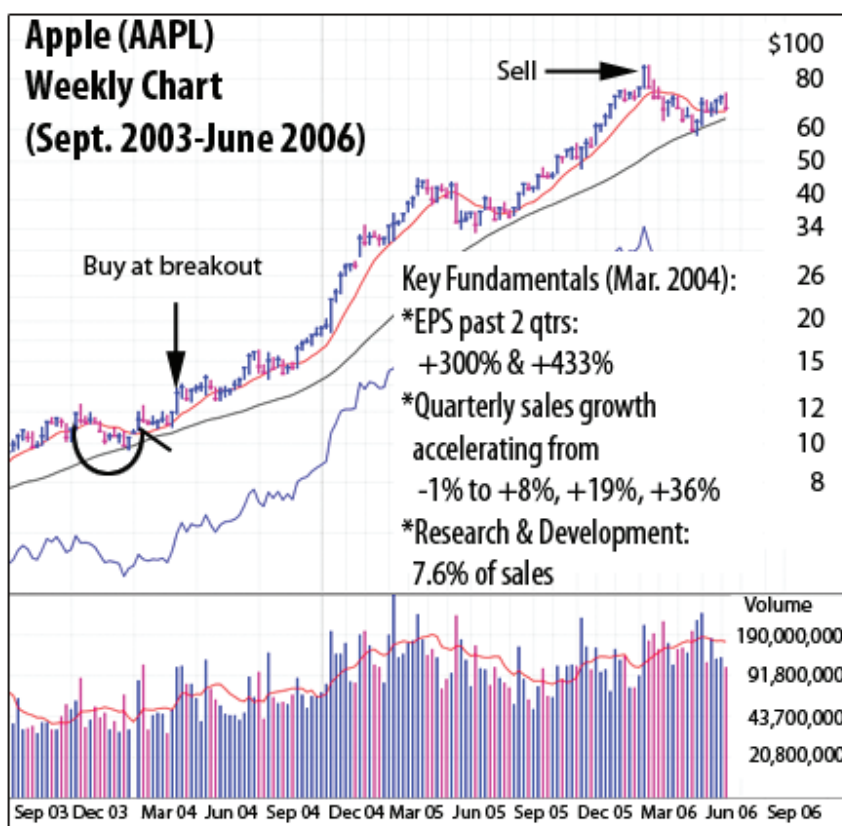
Apple also launched iTunes music store, where people could purchase and download music online for just 99 cents a song. Among other things, they also continued to improve the iPod music player, releasing a series of new versions that were lighter, thinner and more user-friendly. The iPod also introduced millions of people who had never tried Apple's products to the firm's technology, which helped further grow its customer base.

Figure 1 shows how these developments translated into strong sales and profit growth for Apple and a big rise in its stock price.

Studying Home Depot's Rise

One way you learn how to spot and invest in stocks like this is by studying past market winners, which IBD's founder William O'Neil features in his weekly columns.

Recently, O'Neil wrote about The

Figure 1. Key Drivers to Apple's Stock Price Rise

Apple's innovations resulted in strong fundamentals, which helped drive its stock northward.

Source: *Investor's Business Daily*.

Home Depot Inc. (HD). The stock made its market debut in the middle of a bear market in 1981 and then went on to soar 1,600% in less than two years. Like many other big market winners, Home Depot had great fundamentals. Its earnings were up 500% in the quarter before it made its move, and profits were expected to rise more than 100% the coming year. Also, sales growth had averaged 180% for the past five years. Its return on equity was also a hefty 28%.

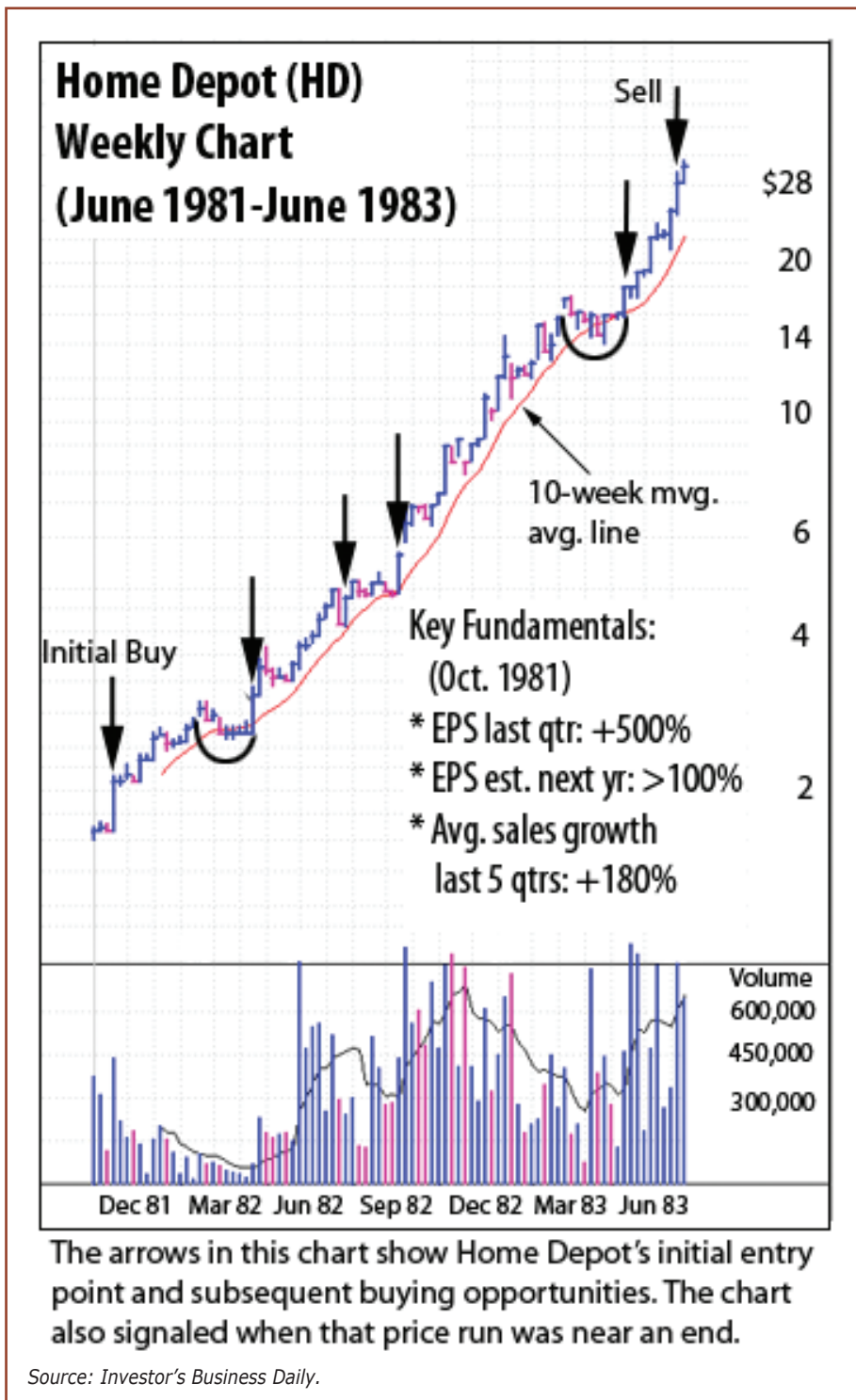
The company got its start when Bernie Marcus and Arthur Blank—who'd been unexpectedly fired from a hardware chain—decided to start a new type of hardware store. Their idea was to open a huge hardware store with a wide array of products at low prices. It would be a one-stop shop, so that people making

home improvements would no longer have to run from the hardware store to the lumberyard to the plumbing supply house when they took on a project. They also hired people to work at their stores who had real-life experience in carpentry, plumbing and other fields and who could give customers valuable advice on their projects.

Home Depot was a great entrepreneurial story and is the kind of profile you look for when searching for investment candidates. These companies are out there in front of us.

If you go into a restaurant and see it packed at all times of the day, it could be worth checking to see if its stock is publicly traded. Then take a look at its earnings and sales track record and learn to read its stock chart.

Figure 2. Home Depot Chart Signals the Best Time to Buy & Sell



Look at the products you are buying or the ones your kids and friends are snatching up. Are they flying off the shelves or back-ordered? If you see in-demand products or services, you might want to dig a little deeper into the

company to find out its story.

Traits of "New America" Companies

Stocks like Home Depot with an

edge are what we call New America companies. These companies are screened for good fundamentals and are profiled to show what sets them apart from their peers.

If you're inclined to do your own screening, once you spot a stock you're interested in, the next step is to check out its fundamentals. Does it have a recent history of strong sales and earnings growth? If so, it may be worth exploring further.

So what traits make an attractive story stock an attractive investment? Some key fundamentals to look for include:

- Annual earnings up 25% or more in each of the last three years,
- Recent quarterly earnings and sales growth of at least 25% and preferably accelerating,
- Return on equity of at least 17% and
- Quarterly aftertax profit margins that are improving and among the best in its industry.

Take Mellanox Technologies Ltd. (MLNX), which has shown up a number of times in recent years in IBD's New America section, including in late May 2012. The company's high-speed interconnect products for servers and data storage systems have been popular among firms beefing up their infrastructures for cloud computing, data centers and so-called big data analytics systems.

Running Mellanox through our IBD Stock Checkup tool on Investors.com showed (at the time of this writing) the stock passed in a number of key categories, including for its 267% earnings increase last quarter and the fact that that growth has been accelerating. The 264% forecast for earnings growth in the current quarter and the 111% sales gain achieved last quarter also score green lights. But the company's 12.6% return on equity is below the 17% minimum typically seen in winning stocks. So that gets a non-passing mark.

Use the Chart to Your Advantage

Charts are the best way to gain cru-

cial insight into demand for a stock and the stock's potential. A chart enables you to see at a glance if professional buyers are creating bigger volume, while the price begins to move up—a key sign for you to join that potential move. So, don't let charts intimidate you.

Plus, studies have shown that stocks form the same trading patterns over and over again, year after year. For instance, in 2004 after its initial public offering (IPO), Google Inc. (GOOG) repeated a pattern similar to what Home Depot had carved out more than two decades earlier.

Some people buy on fundamentals alone, but the most accurate timing comes from viewing a chart as well. Stock charts show the best time to buy a stock with the least amount of risk and the most upside potential. And when it comes to selling, some of the most successful investors use only charts to spot the right time to exit, since that shows the most recent action.

Home Depot gave investors a first chance to get on board in October 1981 when, after going public and trading in a tight price range for three weeks, it burst

past resistance on huge volume. That was a sign big investors were buying. That is important because institutional investors have the buying power to make or break a stock.

During the course of its run, Home Depot gave investors other opportunities to buy in and ride the buying power of those big investors, as they pushed the stock upward. Those buying areas (indicated with arrows in Figure 2) included breakouts from base patterns—also known as consolidations—and bounces up from key moving averages like the 10-week line.

The key was to watch the chart for big price gains on heavy volume. That's a sign institutional investors are buying shares. As Home Depot shares neared the end of their run in 1983, the chart also signaled when it was time to exit. The stock formed what we call a climax top. This occurred after the stock experienced a long, upward price run, when it began charting price gains that were much bigger and faster than others it had previously logged. Plus, those gains came on very heavy volume. When such action occurs at the beginning of a price

run, it is a sign of strength. However, when this action occurs well into an upward run, the chart is showing you it is time to sell and lock in your gains.

Furthermore, those big gains occurred as Home Depot underwent its second stock split in six months—an excessive number of stock splits can also be a sell signal.

Similarly, Apple's chart also alerted investors when it was time to take money off the table. In January 2006, after its long string of price gains, the stock formed a consolidation that was too short to qualify as a proper, classic base pattern. When it tried to break out and climb up from that formation, the stock stumbled and fell into a retreat that lasted for months. Investors who spotted that improper base knew the chart action was getting sloppy and it was time to sell.

Conclusion

Now that you have the basic tools, keep your eyes peeled for the “new” in companies with the best potential—and the extra edge you've been looking for. ▲

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September First Cut column: John Bajkowski uses the fundamental traits listed in Wise's article to identify potential “new edge” companies with attractive fundamentals. See which ones made his First Cut at www.aaii.com/new-edge-stocks.