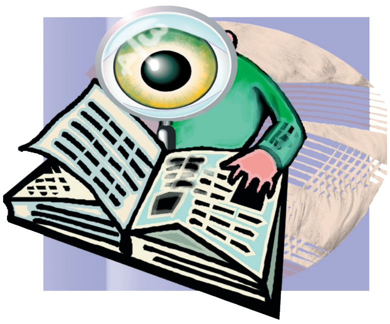
Revising the MAGNET Screens

By Jordan Kimmel

Article Highlights

- The MAGNET Simple and Complex Screens are being modified to allow a greater number of companies to pass, while keeping the strategies highly selective.
- The most important factor is still revenue growth, and like the original AAII screens, the revised strategies continue to look for a high level of sales growth.
- Operating and net income are added to the criteria to identify companies whose revenue flows down to the bottom line and to exclude those "engineering" their earnings.



The ability to screen for stocks might be taken for granted by some individual investors.

I think back to when I first created The MAGNET Stock Selection Process, and it is no wonder that more investors are now developing their own screens. When I first built the MAGNET screens, my intention was to blend the best aspects of value, growth and momentum investing. At the time, it was considered somewhat foolish to use a collection of factors that evaluated so many things.

I was honored when Wayne Thorp interviewed me and AAII began tracking two models, MAGNET Simple and MAGNET Complex, as part of the AAII stock screens. The experience over the last 15 years in the business has been quite fascinating and has offered so many lessons! The original MAGNET backtests suggested we would see outstanding returns, but that we would achieve our outsized returns with more volatility than the passive indexes.

At times over the last several years, AAII's MAGNET screens were at the very top of the rankings on the AAII website. During one of the months that showed MAGNET Simple with only one passing the stock, the stock turned out to be one of several Chinese stocks that had been charged with financial fraud. This particular stock declined by over 50% in one day. Although I personally did not own shares in the company, I have lost money on others in the same way. And because my models rely more on a company's financials than the chart pattern of its stock, I unfortunately now eliminate all Chinese stocks from consideration.

In my professional career as a portfolio and fund manager (as well as with the screens AAII has been running), the strong returns showed up and so did the volatility. Over the last several years my focus has been on learning to mute the volatility while still creating significant alpha [excess return over that of the market]. I thought this would be a great time to give an update to the AAII screens and share my thought processes in doing so.

Better Returns Through Stock Selection

The MAGNET Stock Selection Process is a unique and proprietary process to achieve superior long-term risk-adjusted returns. When I first introduced The MAGNET Stock Selection Process several years ago, I suggested that the approach of screening for stocks would rise in popularity. Now most stock market software packages include a screening feature. By utilizing a screening process, the universe of companies can be quickly brought down to a manageable list to further investigate. This list is then taken through a deeper dive before companies are brought into my portfolios. I believe that excess market returns can be achieved through the construction and management of a fundamentally sound portfolio of companies whose revenue growth and profit margins are accelerating above market expectations. I construct some proprietary measures for company fundamentals, some of which are proxies for what would be earnings performance from corporate financial data. As a result, the MAGNET analysis is not misled by reported earnings and responds much more

Table 1. Comparing the AAII Magnet Simple Screen to the Revised Magnet Simple Screen

Category	AAII Magnet Simple Screen	Revised Magnet Simple Screen
Valuation	Forward PEG Ratio is no more than 0.5x forecast long-term earnings growth	Price-to-sales is no higher than the industry median
Growth	Sales have increased by at least 15% over the past 12 months	Sales have increased by at least 15% over the past 12 months; net income and cash flow have increased by at least 10% over the past 12 months
Price Momentum	13- and 52-week relative strength rank of at least 90%	13-week relative strength rank above 60% and 26-week relative strength rank above 80%
Volume	NA	At least 50,000 shares per day
Institutional Ownership	NA	At least 3%
Profitability	NA	12-month operating margin 10% or higher
Earnings Surprise	NA	Beat the consensus estimate for the most recently reported quarter by at least 5%
Share Price	NA	At least $8
Market Capitalization	NA	At least $75 million
Exchange Listing	NA	Over-the-counter (OTC) stocks excluded
Country	NA	China-based companies excluded

NA = not applicable

directly to strong sales, low price-to-sales ratios, and other value measures taken from corporate balance sheets.

Individual investors now have a significant advantage over the big institutions. Individuals can identify companies with strong fundamentals that are still too small to be picked up by the bigger institutional funds. Once the institutions find them and drive them higher, the real profits materialize. By just placing a few of these companies in a portfolio and then being patient, individual investors can achieve outstanding results. Individuals willing to continue to do their homework to find these companies will be rewarded.

The MAGNET System

The MAGNET system targets the fastest-growing companies that are still trading at a discount to their intrinsic value. Companies in this category are likely to enjoy dynamic earnings growth. We call these companies "MAGNETs." They tend to stimulate investor response and create powerful returns. The approach is designed to isolate the strongly performing stocks through a screening and ranking process that evaluates each company, industry and market sector based on numerous fundamental criteria.

Companies that rank highly on my process tend to have some common characteristics:

- High top-line revenue growth,
- Leader within a market niche,
- Internally financed by their growth, and
- Conservative accounting.

I believe that the best opportunities come from smaller companies that have great products and execution, grow into midsize companies, and then mature into slowing-growing powerhouses. I just do not want to be too early. Therefore the new screens require some institutional investors to be already invested in the passing companies, as well as a share price above $8, a market capitalization of least $75 million and daily volume of at least 50,000 shares. Ideally, the companies still have significant insider ownership by their senior management team—you want them to care about the company more than their salaries—but this is not a strict requirement. (The original AAII screens, which can be seen at www.aaii.com/stock-screens, do not have a market capitalization requirement. Only the AAII Complex screen requires institutional ownership of at least 5% and minimum share price of $8.)

Most investors look at earnings when evaluating a company's growth. You hear about cost cutting and marginal initiatives that are boosting earnings, but for me the most important factor is still revenue growth. There is no substitution for increasing revenue, so both the revised MAGNET Simple and Complex companies have to have at least 15% year-over-year sales growth. (The AAII MAGNET Simple screen requires at least 15% growth, while the AAII MAGNET Complex screen requires at least 25% growth.)

There are many ways for companies to "engineer" their earnings. I use factors to track the revenue from the top line all the way to the bottom line by screening for operating margins and net income. Both revised screens now require an operating margin of at least 10%. The revised Simple screen requires net income to have grown by at least 10% over the past 12 months, while the revised Complex screen also requires three-year net income growth of at least 5%. (The AAII MAGNET Simple screen does not have any minimum operating margin or net income growth requirements; the AAII MAGNET Complex screen requires 12-month earnings per share growth of at least 25%.)

When it comes evaluating the "value" aspect of a company, the focus of many on Wall Street remains on the price-earnings (P/E) ratio. There are too many shortcomings of just using the price-earnings ratio to fully discuss them in this article. I instead use the price-to-sales (P/S) ratio, because revenues are far less subject to manipulation than earnings per share are. In using the price-to-sales ratio to screen, remember to be industry- or sector-specific, meaning compare companies to their peers—otherwise you will have a portfolio of supermarkets and wholesalers. (The AAII Simple screen requires a price-earnings ratio based on forecasted earnings for the next fiscal year to be no more than one-half the projected long-term growth rate in earnings per share. The AAII MAGNET Complex screen requires a price-to-sales ratio below median for a company's industry group.)

Table 2. Comparing the AAII Magnet Complex Screen to the Revised Magnet Complex Screen

Category	AAII Magnet Complex Screen	Revised Magnet Complex Screen
Valuation	Price-to-sales ratio below the industry median	Price-to-sales ratio no higher than the industry median
Growth	Sales and earnings per share have increased by at least 25% over the past 12 months	Sales have increased by at least 15% over the past 12 months; net income and cash flow have increased by at least 10% over the past 12 months and by at least 5% over the past three years
Price Momentum	13- and 52-week relative strength rank of at least 75%	13-week relative strength rank above 60%; 26-week and 52-week relative strength rank above 80%
Volume	NA	At least 50,000 shares per day
Institutional Ownership	At least 5%	At least 3%
Profitability	NA	12-month operating margin 10% or higher
Earnings Surprise	NA	Positive surprise of at least 5% for the most recently reported quarter
Earnings Estimate Revisions	NA	Consensus estimate must not have declined over the past month
Share Price	At least $8	At least $8
Market Capitalization	NA	At least $75 million
Exchange Listing	NA	Over-the-counter (OTC) stocks excluded
Balance Sheet Strength	Current ratio is at least 1.5; long-term debt to equity is no higher than 40%	NA
Country	NA	Chinese-based companies excluded

NA = not applicable

Earlier in my career, I was mistakenly reluctant to follow momentum in the market. I thought it was too risky, and I never wanted to feel like I was chasing stocks. But I personally learned that I did not possess the patience to hold stocks for years waiting for them to move. I have also learned that the market leaders of one bull market cycle are often not the leaders in the next cycle. Both of my models need the selected companies to be "going up now." I require a 26-week relative strength rank of more than 80%, meaning that the stock has outperformed 80% of all other companies. To ensure the positive momentum is current, I also require the shorter 13-week relative strength rank to be above 60%. The revised Complex screen also requires a 52-week relative price strength rank of more than 80%. (The AAII Simple screen requires a 13-week and a 52-week relative price strength rank of at least 90%. The AAII MAGNET Complex screen requires a 13-week and a 52-week relative price strength rank of at least 75%.)

While some people are afraid of "using momentum," I liken it to sports. You should expect the current top 50 golfers to be on top of next week's leader board as well. If I was selecting a golf team, I'd like to leave the players with current swing problems off of my roster, the same way I'd leave companies with "earnings issues" out of my portfolio. To only find the good players, I require companies to have topped earnings expectations for the most recently reported quarter by at least 5%. The revised Complex screen also avoids companies with recent downward revisions to their earnings estimates. (The AAII MAGNET Simple and Complex screens do not consider earnings surprises or changes to earnings estimates.)

Diversify, but Don't Over-Diversify

I have always maintained that

over-diversification simply removes your opportunity to outperform the market. In my long career of professionally managing accounts and funds, my outperformance always resulted from investing in a concentrated portfolio of superior MAGNET stocks. My biggest losses, however, came from being too concentrated. Always trying to improve as an investor, and willing to share with the AAII community, is what prompted me the write this article and update my MAGNET models on the AAII website.

The screens built by AAII to establish the portfolios for MAGNET Simple and MAGNET Complex were so selective that often only one company was picked each month. Often no stocks were selected, sometimes two or three. Obviously that would lead to highly erratic returns, wild turnover, and excessive volatility. These are not traits you like to see in your portfolio. This is why I have decided to update the screens I use and share the changes with you. In modifying the screens, I continue to use a very highly selective screening process, but with a goal of selecting at least five to eight companies per month.

The adjustments to both models are a result of another 25 years of experience through some amazing times, good and bad. I am happy to share these with you. It will be interesting to see how the new models will compare to the originals over the next 10 years.

[Editor's Note: The original MAGNET screens continue to be tracked on AAII.com. Instructions on how to create the revised screens in Stock Investor Pro *can be downloaded from the online version of this article.]*

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to-book ratio as a criterion reflect its appeal to value-oriented investors. The low limits also reflect the historical success of buying stocks trading near or below their net asset value and the underperformance of highly valued stocks. As Fama and French showed, low book value has historically beaten high book value over the long term.

Most value investors look beyond merely cheap stocks. They pair a low price-to-book ratio with other indicators to better ensure the stock is a bargain, as opposed to merely cheap. Cloonan requires profitability and a low price-to-sales ratio. Piotroski seeks out companies with improving financial strength. Reinganum requires earnings growth and price momentum.

O'Shaughnessy recommends paring the price-to-book ratio with other criteria to reduce the risk of the valuation indicator underperforming over a specific period of time. Among the best performers of the strategies he tested were several combining price-to-book with above median price momentum (defined as relative price strength, or how a stock has performed versus an index over a given period of time—such as three or six months—relative to all other stocks). The combination worked particularly well with small- and micro-cap companies, though O'Shaughnessy also found the strategies have performed well with his "all stock" universe.

The use of qualifying criteria in addition to a low price-to-book ratio shows the importance of not solely relying on a single indicator. While many value investors refuse to pay above a certain price-to-book ratio, they also take steps to separate stocks that are cheap for a reason from those that are bargains. Even Benjamin Graham—whose strategy Warren Buffet has described as looking for cigar butts with one puff left—advised readers of "The Intelligent Investor" to seek out companies with a history of profitability and dividend payments.

It's also important to pair the price-to-book ratio with other measures because the balance sheet is not an accurate measure of current values, but rather an estimation using historical accounting decisions and a company's assets and liabilities on a specified day, such as at the end of a calendar quarter. The actual value of assets and liabilities changes every business day, making a precise assessment of current value difficult. What the price-to-book ratio does do, however, is provide a good estimation of whether a stock is attractively or expensively priced, and that is why this indicator has worked very well over the long term.

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