

Finding Growth Stock Winners: Focus on 8 Fundamental Factors

By Louis Navellier



In the classic musical “The Sound of Music,” the character of Sister Maria (played by Julie Andrews) tells us that we should start at the beginning because “that is a very fine place to start.”

In our search for profits investing in growth stocks, however, we do the opposite and start our search at the end. The plain fact is that at the end of the day, what makes for a great growth stock is the fundamentals of the company:

- Can the company continually sell more of its products and services at higher and higher profits?
- Can it continue to innovate and adapt to marketplace changes and maintain a leadership position?

How do you identify these companies?

One definitive factor I have found over the years is that change is a fact of life on Wall Street. All too often I hear a pundit or guru telling us of one magic-bullet variable that is most important in picking winning stocks—such as price-earnings ratio or price-to-cash-flow ratio. Of course, these magic-bullet fundamentals can fall out of favor quickly.

In fact, many fundamental variables have a lifespan, perhaps two to three years at most, before they stop working and the edge is gone.

Variable Variables

Because of this tendency for the game to change, I have found that it is necessary to rank stocks on more than one fundamental variable. I have found that there are eight tried-and-true key fundamental factors that drive stellar stock

price performance and have stood the test of time.

Positive Earnings Revisions

The first fundamental variable is stocks whose earnings estimates are revised upward by the Wall Street analysts who cover and research these companies.

After all the fallout from Tyco, WorldCom, and Enron, along with the crusade by Eliot Spitzer, this factor is becoming more important. Analysts are so cautious that they have to be really impressed to keep raising their estimate of corporate profits. And once an analyst issues an upward earnings projection, it is very likely that more are on the way.

Positive Earnings Surprises

The second fundamental variable is earnings surprises. This measures how far above or below the overall consensus estimate of Wall Street analysts the actual reported earnings are.

Here we are looking for stocks that exceed what Wall Street believes they can achieve. Oil and energy stocks, for example, have continuously earned far more than the analysts thought they could.

Like earnings revisions, earnings surprises tend to persist—that is, once there is a surprise, more tend to follow, as analysts are slow to raise estimates to reflect the new reality.

Sales Growth

All you need to do here is to compare the current quarter’s sales increase against the rate of increase from the

same quarter for the prior year.

Dollars can be maneuvered around the income statement to massage earnings, but it is very difficult to massage top-line revenue. If a company can continually increase sales over long periods of time, then it would seem to indicate that they have a product or service that is very much in demand. Look for companies that show year-over-year sales increases of 20% or more.

Operating Margin Growth

A company's operating margin is simply its operating income (profits left after direct costs such as salary and overhead are subtracted) divided by net sales. We then look at whether this percentage margin is contracting or growing year over year.

A company's operating margin may show a strong but temporary spike for several reasons—if, for instance, it can reduce expenses so each dollar of sales is bringing a bit more to the bottom line. This is nice, but it is not a sustainable source of growth.

The other way margins will increase is when a company's product is in such high demand that it can continue to raise prices for the product or service without an offsetting increase in costs.

Strong Cash Flow

Cash flow is simply the amount of cash actually earned and kept by a company after paying all the costs and expenses of doing business, and it is often the single best measure of corporate financial health. In simple accounting terms, free cash equals operating earnings minus the capital expenditures needed to run the business.

Companies that regularly pay out more than they bring in are likely to experience severe hardship at some point. A company can show earnings, then spend all of it and then some on necessary capital expenditures—which are included in expenses on the in-

come statement—and actually end the year with less money than they started with.

Companies with free cash flow have the ability to grow the business, open new stores, develop new products to increase profits, and reward shareholders with dividends, stock buybacks and higher stock prices.

Earnings Growth

This simple measurement finds those companies that earn more money year after year. It is usually measured in terms of earnings per share, which is just the company's earnings divided by the number of shares they have outstanding.

Stocks are ultimately priced on earnings, and the markets place a huge emphasis on the earnings per share numbers every quarter. Companies that are continually growing earnings per share year over year should get a higher score than those that aren't.

Earnings Momentum

This simply measures the percentage increase of earnings year over year. Companies that are accelerating and growing earnings faster year over year are stronger candidates than those whose earnings are slowing.

There are times when this is easily one of the most important variables. When the market is in a strong bull run, earnings momentum is one of the biggest driving forces behind stock prices.

Return on Equity

Return on equity is a measure of corporate profitability. It is calculated by dividing the earnings per share by the equity (book value) per share. The higher this number, the more profitable a company is and the higher return management is providing to shareholders.

Companies that are dominant in their industry tend to earn very large

returns on the equity invested.

Return on equity can tell you just how effectively the company is using the cash it generates from the business. I like to see return on equity start out high and get higher. A company that has a very high return on the dollars that have been invested is more likely to produce strong free cash flow.

A company's return on equity should be compared across industry groups and not against the entire universe of stocks.

Concentrating on the Numbers

These indicators measure the financial health of a company, how well their products are selling, and whether they are able to maintain and even increase a very high level of profitability. A company that scores very high across all eight of these mental model variables is highly likely to have all the characteristics of a potential 10-bagger growth stock.

I cannot emphasize enough that you need to use all of these variables when seeking market-beating growth stocks to add to your portfolio. Why not just focus on one or two variables that have performed the best over time?

There will be periods of time when the market favors stocks with earnings momentum, and periods where operating cash flow or earnings before interest, taxes, depreciation and amortization (EBITDA) are the darlings of the day. As soon as the dance cards are full and everyone can be found chasing after the same thing, the band will stop and the party will be over.

Instead you should focus on all eight variables. The amount each variable counts may be changed or tweaked over time, but all eight variables need to be considered.

By concentrating on the numbers, and just the numbers, you can take the guesswork out of picking winning stocks. ▲

Louis Navellier is chairman and founder of Navellier & Associates in Reno, Nevada, an advisory firm that manages over \$5 billion in mutual funds and institutional accounts. He is also editor of four investment newsletters/trading services. This article is adapted from Chapter 1 of Louis Navellier's new book. Reprinted with permission of the publisher, John Wiley & Sons, Inc., from "The Little Book That Makes You Rich: A Proven Market-Beating Formula for Growth Investing," by Louis Navellier. Copyright 2007 by Phillips Investment Resources, LLC. All rights reserved.