"WINNING ON WALL STREET" USING THE MARTIN ZWEIG APPROACH

By Wayne A. Thorp

Zweig's strategy seeks to identify companies with strong growth in earnings and sales, a reasonable price-earnings ratio given the company's growth rate, an absence of heavy insider selling, and relatively strong price action.

In the realm of stock investment strategies, the two main schools are value and growth. Value investment strategies tend to seek out neglected or under-valued firms and growth investing looks for companies exhibiting sustainable or increasing growth in sales or earnings. But it is rare to find a purely growth-oriented or purely value-oriented stock selection strategy anymore; most screens only lean toward one style or the other.

Martin Zweig, who was named stock picker of the year two years running in the 1990s by the Hulbert Financial Digest and is chairman of the Zweig Funds, leans toward the growth methodology. In his book "Martin Zweig's Winning on Wall Street" (Warner Books, 1997), he outlines his strategy for identifying companies with strong growth in earnings and sales, a reasonable price-earnings ratio given the company's growth rate, buying by insiders (or at least an absence of heavy insider selling), and relatively strong price action.

In this article, we'll take a look at Zweig's strategy and show how it can be applied using a stock screening approach. For the screening, we used AAII's *Stock Investor Pro* fundamental screening and database program. *Stock Investor Pro* covers a universe of 9,292 NYSE, Amex, Nasdaq National Market, Nasdaq Small Cap, and over-the-counter stocks. Table 1 is a listing of the 17 companies that passed our Zweig screen.

ARMING YOURSELF

Zweig divides stock-picking into two categories—the shotgun approach and the rifle approach. The shotgun method, which Zweig advocates, entails screening publicly available data on a number of stocks using predetermined criteria. This more mechanical approach allows individuals to follow a large number of stocks at one time, spending a limited amount of time on any one company.

In contrast, the rifle approach involves the in-depth analysis of a select number of companies. The analysis may cover accounting methods used, trends in the company and industry, and a variety of economic variables impacting the company. Zweig points out, however, that this approach is unrealistic for the average individual investor because it requires full-time analysis of the market.

STRONG GROWTH

One of the cornerstones of Zweig's stock-picking strategy revolves around what he terms as "reasonable gains in sales and earnings." To this end, he examines both absolute levels as well as growth from a variety of angles.

Earnings Stability

Zweig begins his search by examining the quarterly earnings and sales. Here he requires positive growth in earnings per share between the most recent fiscal quarter and the same quarter the prior year. Same-quarter growth is a better benchmark than sequential-quarter growth because seasonal patterns are less likely to be an influence. Zweig also examines the same-quarter growth in earnings per share going back several quarters. He warns of stocks

Wayne A. Thorp is associate financial analyst at AAII.

with negative or "skimpy" growth rates on a same-quarter basis.

For our screen, the first filter specifies that the same-quarter growth rate in fully diluted earnings per share from continuing operations for each of the last four fiscal quarters is greater than zero. These screening criteria reduced our initial database of 9,292 companies down to 1,332.

Table 1 shows the same-quarter growth rate in diluted earnings per share from continuing operations for the latest fiscal quarter for the 17 companies that passed the Zweig screen. The last line of the table shows the median values of the various data elements using the entire *Stock Investor* database.

Each of the 17 companies far surpassed the median growth rate of 0% for the quarter. The "weakest" of the 17, Sonic Corporation had a growth rate of "only" 24.2%. The hands-down winner was Westport Resources Corp., which turned in an extraordinary 866.7% performance. However, this is skewed by the fact the earnings grew from $0.09 to $0.87 over the period.

Sales Growth

Since sales drive earnings, Zweig is also interested in companies that maintain their sales as well as those that are experiencing increasing sales growth. To identify such companies, he first requires that a company have positive growth in sales as compared to the same quarter the prior year. This criterion by itself yields 4,904 companies and, when included in our overall screen, it narrowed the list of passing companies to 1,049.

Beyond positive growth in same-quarter sales, Zweig also likes companies that are able to increase this same-quarter growth rate. To capture this element, our screen compares the same-quarter growth rate in sales for the last fiscal quarter to the same-quarter growth rate in sales for the previous quarter. Those companies that have been able to increase this growth rate pass this criterion. In *Stock Investor*, 2,811 companies meet this requirement, and when added to our prior screens, it left us with 360 companies.

Earnings Persistence

Zweig also looks for companies with persistent, rising earnings on an annual basis. Here, our screen requires that a company's earnings per share for the last four quarters (trailing 12 months) be greater than or equal to the earnings per share for the last fiscal year as well as requiring year-to-year increases in earnings per share for each of the last two fiscal years. As a group, these three screening elements resulted in 1,525 passing companies, and when combined with the previous screens narrowed the list down to 206 passing companies.

Zweig is also impressed with stocks that exhibit "strong" longer-term growth rates. To isolate companies that meet this requirement, our screen specifies a three-year annualized growth rate in diluted earnings per share from continuing operations of at least 15%. From the entire database, 3,213 companies passed this requirement, and when added to our previous screens it shortened the list to 151 companies.

Sales Growth vs. Earnings Growth

Zweig makes a point of discussing the relationship between sales growth and earnings growth. He points out that one cannot draw any negative conclusions when earnings do not grow as fast as sales without further study. He points to competition and price cutting as potential culprits, but the expenses required to introduce a new product may also serve as an explanation.

On the other hand, he is leery of situations where earnings growth far outstrips that of sales. While it may be possible in the short term for a company to improve earnings through cost cutting, ultimately increases in sales are what drive long-term earnings growth. If you see a company with a long-term growth rate in earnings that is substantially greater than the growth rate in sales, this is a red flag warning to study the sustainable nature of the growth. In the interim, however, it is possible for a company to increase its earnings at a rate higher than that of sales due to operating efficiencies, financial leverage, etc. For this reason, a screen that would require sales growth to outpace earnings growth could punish good companies. Therefore, the screen instead implements the same sales growth requirement as for earnings—the compounded growth rate in sales for the last three-year period must be at least 15%. This way, the screen seeks out companies that are growing at a healthy clip for both earnings and sales. It is then up to you to perform further analysis to decide whether the favorable growth conditions will persist in the future. This eliminated all but 3,641 companies, leaving 100 passing companies to this point.

Table 1 presents the three-year growth rates in earnings and sales for the companies that passed the complete screen. From an earnings standpoint, Mitchell Energy & Development led the way with a three-year annualized growth rate of 90.7%. On the sales side, United States Exploration came in at 62.2%.

Eleven of the 17 passing companies have earnings growth rates that are higher than that of sales. Some, such as Mitchell Energy and Development, show rather large disparities, with earnings growing at 90.7% over the last three years while sales grew at 28.4%. These situations warrant further investigation to see how realistic it is for growth such as this to continue into the future.

Earnings Momentum

The next element Zweig looks for is increasing momentum in earnings growth, both over the short term and longer term.

Zweig compares the growth rate in earnings between the last fiscal quarter and the same quarter one year prior, to the growth in earnings between the sum total of the prior three fiscal quarters and the same three quarters one year ago. This requirement on its own yielded 3,619 companies, while it narrowed our list down to 40 passing companies.

Zweig did make an exception here, not wanting to exclude companies that had experienced strong growth in earnings per share for the last quarter, especially if they might be able to continue that growth going forward. For that reason, he also accepts companies whose same quarter growth rate for the most recent quarter is at least 30%. This relaxed standard isolated 2,734 companies on its own, and increased our total list of passing companies to 70.

Zweig also compares the growth in same-quarter earnings for the last fiscal quarter to the longer-term growth, hoping to find companies where the quarterly growth rate was higher. For this element, our screen required that the same quarter growth rate in earnings per share be greater than the three-year earnings per share growth rate. As an individual criterion, 3,582 companies passed and when added to the prior screens brought the list down to 52 companies.

The criteria that make up the Zweig screen will return companies that are benefiting from the current business cycle and market environment. Seven of the 17 companies that pass the screen are in the oil and gas operations industry, which has been one of the strongest performing industries over the last year. As economic and market conditions change over time, the industries that make up the bulk of the passing companies will probably change as well.

PRICE-EARNINGS RATIO

The other key element of Zweig's stock selection is the price-earnings ratio. Zweig avoids living on the edge—he believes that a price-earnings ratio can be too high or too low.

On the low end, he feels that there are two types of companies—those that are experiencing financial difficulties and those companies in neglected industries. The risks of investing in financially troubled firms, in Zweig's opinion, are too great to justify the investment in them, since the risk of these firms going under overshadows any potential "value" in these stocks.

Neglected stocks, on the other hand, are ignored by the market because of bad news surrounding the company itself or the industry in which it operates. In some cases, this overly negative view subsides and the stock goes on to enjoy above-average price appreciation. Studies have shown that these stocks tend to outperform higher price-earnings ratio stocks in the long run.

However, due to the nature of the Zweig screen, it is doubtful that we will run across any neglected companies in our list of passing companies.

TABLE 1. STOCKS PASSING THE ZWEIG SCREEN

Company Name (Exchange: Ticker)	EPS Dil Cont Growth From Q5 to Q1 (%)	EPS Dil Cont Growth 3 Yr. (%)	Sales Growth 3 Yr. (%)	P/E (X)	LT Debt/ Equity Q1 (%)	Ind. LT Debt/ Equity Q1 (%)	Relative Strength 26 Wk. (S&P=0) (%)	Net Insider Trans-actions*	Description
Anderson Exploration (N: AXN)	340.9	42.7	23.2	7.0	87.5	39.6	104	0	Oil & gas
CACI Int'l (M: CACI)	26.3	18.2	21.6	23.0	34.0	0.2	80	–5	Info sys & hi tech servs
United States Exploration (A: UXP)	566.7	27.6	62.2	10.0	10.4	39.6	74	0	Oil & natural gas
Mechanical Dynamics (M: MDII)	100.0	39.1	15.6	23.8	1.8	0.0	56	–2	Virtual prototyping sols
A.C.L.N. Limited (N: ASW)	50.0	44.7	47.0	11.2	0.0	36.1	55	0	Marine logistics co
Insight Health Services (M: IHSC)	85.7	47.5	26.9	13.1	829.0	31.4	52	0	Diagnostic imaging
Sonic Corp. (M: SONC)	24.2	22.9	15.0	22.6	65.0	38.5	45	–2	Drive-in restaurants
W Holding Co. (M: WBPR)	36.4	19.9	36.8	13.7	15.9	0.0	38	+1	Bank holding co
Chieftain Int'l (A: CID)	360.9	56.3	18.5	10.6	4.0	39.6	36	0	Natural gas & oil
Daktronics (M: DAKT)	50.0	32.0	29.6	19.7	22.5	2.3	36	–1	Large video displays
General Dynamics (N: GD)	30.8	18.0	20.2	17.0	5.6	41.9	31	–3	Defense sys
CREDO Petroleum (M: CRED)	142.9	44.2	15.9	13.7	0.0	39.6	27	0	Oil
D.R. Horton (N: DHI)	40.6	38.4	32.3	8.3	0.0	46.9	25	–4	Home building & sales
Westport Resources (N: WRC)	866.7	51.9	51.6	9.6	0.0	39.6	23	0	Oil & natural gas
Nara Bancorp (M: NARA)	63.0	37.2	46.0	9.1	0.0	0.0	13	+1	Bank holding co
Vintage Petroleum (N: VPI)	77.4	42.9	24.6	5.2	57.4	39.6	6	0	Oil & gas properties
Mitchell Energy & Develp. (N: MND)	173.9	90.7	28.4	6.4	29.6	39.6	1	0	Natural gas & crude oil
Median—All Companies	**0.0**	**4.1**	**12.9**	**15.9**	**7.6**	**—**	**3**	**0**	

**Minus sign designates net sell transactions; plus sign indicates net buy transactions.*
Source: AAII's Stock Investor Pro*/Market Guide Inc. Statistics are based on data as of 8/3/2001. Insider transaction data from MSN Money Web site.*

Exchange Key: N = New York
A = American
M = Nasdaq

Zweig notes that if you do run across a company with a very low price-earnings ratio, given the growth requirements of the screen you should immediately examine the balance sheet for any potential problems.

On the other end of the spectrum, Zweig gets nervous about stocks with very high price-earnings ratios. These stocks run the risk of facing the wrath of the market should they fail to meet expectations. The higher the price-earnings ratio, the higher the expectation for that company, and the more painful the fall should it fail to meet them. Ideally, he selects stocks whose price-earnings ratios are near or slightly above the "market" average. He avoids stating an absolute ceiling, citing the fact that they rise and fall over time.

The price-earnings ratios constraints for our screen consist of a minimum level of 5.0 (to avoid potentially troubled firms) and a maximum level of one and a half times the *median* price-earnings ratios for the entire *Stock Investor* database. As of August 3, the median price-earnings ratio was 15.94. This put our maximum price-earnings ratio for our screen at 23.91 (1.5 times 15.94). In all, 2,988 companies fell between these two limits—4,259 companies with a price-earnings ratio above 5.0 and 3,266 with a price-earnings ratio that was less than 1½ times the database median. Adding these screens to the prior screens reduced the list to 27 companies.

The price-earnings ratios for the 17 companies that passed all of the screens ranged from a low of 5.2 for Vintage Petroleum to a high of 23.8 for Mechanical Dynamics. While it does have the highest ratio of the passing companies, its price-earnings ratio is actually below the median of 39.5 for its industry (software and programming).

RELATIVE PRICE STRENGTH

In his book, Zweig spends a good amount of time discussing price action and relative price strength of individual companies.

As a minimum, Zweig compares the movement of the market and that of the individual stock. He is in search of companies that have outperformed the overall market. A stock may be rising in price, but if it fails to gain at the same rate as the overall market you are still losing out. For that reason, Zweig eliminates those companies that are underperforming the market as a whole, especially when the market is performing well. He theorizes that if a company is as good as it appears, it should perform *at least* as well as the overall market.

Our screen eliminates those companies whose price strength relative to the S&P 500 over the last 26 weeks has been *below* zero. Of the entire database, 4,730 companies match this requirement. When this screen was added to the previous screens, the list of passing companies was reduced to 22. For those companies that ultimately passed the Zweig screen, the relative strength values range from a high of 104 for Anderson Exploration to a "low" of one for Mitchell Energy & Development.

REMAINING CRITERIA

To round out the Zweig screen, supplemental criteria were applied to the database to further ensure the integrity of the companies we ultimately want to examine. The first of these eliminates those companies traded as American depositary receipts, or ADRs—foreign listed companies that are traded on U.S. exchanges. After applying this criterion, we were still left with 22 passing companies.

We then excluded companies categorized as part of the miscellaneous financial services and real estate operations industries, which usually consist of closed-end mutual funds and real-estate investment trusts. Here three companies were dropped to put the list of passing companies at 19.

Lastly, the screen addresses the difficulty that can arise when attempting to invest in stocks that are lacking liquidity—they have relatively low daily trading volume. While Zweig believes that the

Definitions of Screens and Terms

EPS Dil Cont Growth From Q5 to Q1: The growth rate in fully diluted earnings per share from continuing operations between the latest fiscal quarter and the same quarter one year prior. (Diluted earnings measures the impact on earnings per share created by the conversion and exercising of any convertible bonds or stocks, stock options or warrants into common stock.)

EPS Dil Cont Growth (3 Yr.): The compounded annual growth rate in fully diluted earnings per share from continuing operations over the last three-year period.

Sales Growth (3 Yr.): The compounded annual growth rate in sales (revenue) over the last three-year period.

Price-Earnings Ratio (P/E): Market price per share divided by the firm's earnings per share over the last four quarters (trailing 12 months).

LT Debt-to-Equity (Q1): Long-term debt as a percentage of total common equity for the latest fiscal quarter.

Ind. LT Debt-to-Equity (Q1): The industry median value of long-term debt as a percentage of total common equity for the latest fiscal quarter.

Relative Strength (26 Wk.): Price performance of a stock over the last 26 weeks as compared to the price performance of the S&P 500 index over the same time period. A value of zero indicates price performance equal to that of the S&P 500 index.

Net Insider Transactions: The net number of stock buy (+) and sell (–) transactions made by company officers and directors of their company's securities in the last three months.

average investor will not run into liquidity problems, it is a good idea to establish a minimum level of daily trading volume.

Our screen uses the percent rank function in *Stock Investor*, which breaks down the entire database into percentiles for a given data field. We required companies to have an average monthly trading volume (based on the last three months) that falls in the top 75% of the database. When this final piece of criterion was added, we arrived at the list of 17 passing companies shown in Table 1. Companies are ranked by relative strength.

QUALIFYING FACTORS

The list of passing companies shown in Table 1 embodies the "mechanical" elements of the Martin Zweig approach. As always, the results of any stock screen are more of a starting point than a finish line. With the database winnowed down, it is time to examine each of these stocks using some other factors that Zweig feels are relevant.

DEBT LEVELS

Zweig makes a point of mentioning that you should not pay too much for a company that has a high level of debt. Companies that carry higher levels of debt also carry with them higher risk levels, mainly due to the higher fixed costs associated with interest expense.

Since the level of debt a company can safely carry tends to depend heavily on the industry in which it operates, it is best to compare an individual company's level of debt to that of its industry. Table 1 lists both the long-term debt-to-equity ratios for the last fiscal quarter for each of the 17 passing companies as well as the median debt-to-equity level for the company's respective industry.

Insight Health Services immediately stands out with a 829.0% debt-to-equity ratio compared to its industry's median level of 31.4%. While it has lowered this ratio by almost 96% since fiscal year 1998, it deserves close attention going forward to see if its debt level becomes a burden.

PRICE ACTION

You won't find Zweig buying companies that are making new lows. He states very plainly that he is on the lookout for companies whose stock prices are on the rise, especially when those increases are spurred by an unexpected earnings announcement.

The 17 companies that appear in Table 1 would represent a "watch list" of companies. Zweig watches for these companies to announce their quarterly results and then follows a two-step process. First, he confirms, based on the new quarterly or annual data, that the company would still be included on the watch list. If that is the case, the second step would be to check the price performance on the announcement day.

The price behavior following an earnings release can serve as a barometer that measures the market's reaction to the news. If prices fall following an earnings announcement, chances are the market's expectations were not met. Studies have shown that, in cases such as these, the negative impact on the stock's price could last for up to a year. It is for this reason that Zweig chooses not to "fight the tape." He overlooks those companies whose prices fall "significantly" on the day the latest quarterly results are announced.

Likewise, an announcement that is better than what the market was expecting could have a positive impact on the stock price for a long time.

INSIDER ACTIVITY

In general, Zweig is more concerned with heavy insider selling than a lack of insider buying.

Zweig uses insider buying and selling activity over the last three months as potential buy and sell signals—three insider buys indicates a potential buy signal and three insider sells, a potential sell signal. He also prefers his signals to be unanimous, meaning at least three insider buys and no sells for a buy signal and at least three insider sells with no buys for a sell signal. While *Stock Investor* does track insider buy and sell activity, this data covers the last six months. Therefore, we went to the MSN MoneyCentral Web site to track insider activity over the last three months
moneycentral.msn.com).

Looking at our list of passing companies in Table 1, six of the 17 companies had more net insider sell (–) transactions than buy (+) transactions over the last three months. CACI International had the highest number of net insider sell transactions with five. While there was one insider buy transaction over the period, the net dollar value of shares sold—$14.76 million—was significant. It is highly unlikely that Zweig would commit to the stock at this time. On the buy side, both W Holding Company and Nara Bancorp led the way with a net of one insider buy transaction over the last three months.

CONCLUSION

When following any stock screening strategy, it is important to remember that the process is only a first step.

Martin Zweig's principles help to reveal a collection of companies exhibiting strong earnings and sales growth, reasonable price-earnings ratios relative to the overall stock universe, and strong relative price strength that can prove to be an interesting starting point. ❖