GROWTH STOCK SELECTION: COVERING ALL THE ANALYSIS BASES

By William J. O'Neil

The key to successful investing is a methodical, comprehensive process that uses both fundamental and technical analysis to their full advantage. The common traits of the biggest stock market winners of the past provide the best starting point for the search process.

There are endless ways to select stocks, but securities research basically falls into two distinct areas: fundamental analysis or technical analysis. You'll find most everyone has an opinion about which works better. My "take" on this debate? Don't limit yourself. Use both analyses to their full advantage. The key to successful investing is really a methodical, step-by-step, comprehensive process.

What should you look for? To answer this question, I first looked for the common traits of the biggest stock market winners dating back to 1953. The study uncovered the key characteristics of winning stocks. There were seven factors that occurred in virtually every major winner, and I gave those recurring elements the acronym CAN SLIM. Each letter in CAN SLIM represents one of the factors that winning stocks showed before their major price moves (see Table 1). The best time to buy stocks is when all seven of the CAN SLIM characteristics are evident.

The following information on fundamental and technical analysis includes the key CAN SLIM elements of successful stock investing.

I've also indicated where you can find this information in Investor's Business Daily. I originally started Investor's Business Daily (IBD) because I felt there was a need for more professional, usable information for investors. The CAN SLIM approach is incorporated into much of the information published by IBD, including IBD's SmartSelect Corporate Ratings, a computer rating system that provides for quick screening and evaluating stock selections. These ratings appear in IBD's NYSE and Nasdaq main tables every day.

FUNDAMENTAL ANALYSIS

The company's profitability is one of the most important factors that affects a stock's price. So buying only those stocks with consistent and improving earnings increases plus strong or accelerating quarterly sales growth along with high profit margins and return on equity makes sense.

Here's what to look for fundamentally:

Strong current and past growth in earnings per share. Increases in earnings per share are the single most important element of stock selection, but that growth needs to be present both currently and in the recent past. In our study of stock market winners, we found that not only were current earnings up 70% or so, but in addition three out of four of the greatest stock market winners were growth stocks that had earnings per share increases of 30% or more in each of the prior three years before the stock had big price gains.

In the case of initial public offerings (IPOs) and companies going public in the last eight years, investors at a minimum should look for each of the last six quarters of earnings to be up 50% to 100% or more. [You can spot IPOs in Investor's Business Daily price tables because they are italicized. Also, we only italicize IPOs showing ratings of at least 80 Earnings Per Share and 80 Relative Price Strength, which will be discussed below.]

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TABLE 1. THE CAN SLIM CRITERIA

C	Current Quarterly Earnings Per Share: Should show an increase of at least 18% to 20% above the same quarter one year prior.
A	Annual Earnings Per Share: Should show meaningful growth over the last five years, and should show consistency, with increases each year over the prior year.
N	New Products, New Management, New Highs: There should be new products or services being sold, or new management offering innovation; stock prices should be reaching new highs.
S	Supply and Demand: There should be a small or reasonable number of shares outstanding to create buying pressure; and there should be volume increases when a stock begins to move up.
L	Leaders: Buy industry and market leaders, avoid laggards.
I	Institutional Sponsorship: Buy stocks with a small number of institutional owners who have good performance records.
M	Market: The general direction of the market should be positive.

If you are screening on your own, you should seek firms showing current earnings percentage increases of at least 18% to 20% over the same quarter's earnings one year prior (comparing same-quarter earnings is important to eliminate seasonal earnings fluctuations). And look for past earnings of between 25% to 50% annually for the last five years.

Investor's Business Daily provides the Earnings Per Share (EPS) Rating, which is the first column in IBD's price tables, and helps spotlight stocks with the best bottom-line earnings performance. Each company's EPS Rating is computed by measuring its earnings per share growth for the last three or five years and combining that figure with the latest two quarters' results (giving more emphasis to the last two quarters). That figure is then compared to the same computation for all other publicly traded companies.

The rating is shown on a relative scale from 1 to 99, with 99 being the best earnings performers. The EPS Rating should normally be 80 or higher, indicating that the company is in the top 20% of all stocks in terms of its earnings growth performance for the last three or five years.

The average EPS Rating of outstanding stocks in recent years before they had their greatest performance was over 80. Stocks rating 90 or higher should be even better, as long as they are not overly extended in price from a sound chart base.

Strong profitability. There are three key measures to look for in evaluating the strength and profitability of a company:

- Strong sales growth, indicating there is a strong and growing market for the firm's products or services. You should look for strong increases in quarterly sales compared to the same quarter the year before, and you also want an acceleration in the rate of increase in the latest quarter over the previous quarter.
- High profit margins. Profit margin is net income divided by revenue, and it measures the ability of a firm to generate earnings from revenues. Comparing profit margins over time for a firm provides an indication of the strength of management and its abilities over time. You should be looking for companies whose current quarter's aftertax profit margin is at or close to its peak and whose profit margins are improving and are among the best in its industry. And in general, the annual pretax profit margin should be 18% or more, although retailers will tend to have lower margins.
- High return on equity (ROE). Return on equity is net income after all expenses and taxes divided by stockholder's equity (book value), and it provides an indication of how well the firm used reinvested earnings to generate additional earnings. My rule of thumb is to look for ROEs of 17% or higher.

Investor's Business Daily combines these profitability indicators into a single measure called the SMR Rating (Sales + Profit Margins + ROE). It takes into consideration a company's sales growth rate over the last three quarters, quarterly increases in aftertax profit margins, annual increases in pretax profit margins, and return on equity. An 'A' to 'E' rating scale is used, with an 'A' indicating the top 20% most profitable companies.

TECHNICAL ANALYSIS

There are important elements outside the fundamental picture of a company that will alert you to potential problems or opportunities earlier than those changes occurring in fundamental numbers alone.

Here are the key technical factors you should look for:

High relative price strength. The majority of the biggest stock market winners in our study consistently showed very strong relative strength—that is, their prices were moving up faster than most other stocks. It's a key indicator that shows you what value the market itself is placing upon a stock. In fact, the combination of both strong earnings per share growth and strong relative strength proved to be one of the most significant factors in our study.

In general, you should seek stocks

that are market leaders—the relative strength should indicate the stock is outperforming roughly 80% or more of other stocks, and the relative strength should not be in a downtrend.

It also pays to buy in a leading or a strong industry group. As with people, you can tell a lot about a stock by the company it keeps, so there should be at least one other stock in the same industry group that is showing strong price action as well. If you can't find any other strong stocks in the group or, as a group, an industry is underperforming, perhaps you may want to rethink your selection.

Investor's Business Daily provides two relative strength ratings. The Relative Price Strength (RS) rating is computed by taking a stock's price one year ago and its price today, calculating the percent change and then comparing it to all other stocks. It is shown on a scale of 1 to 99, and measures precisely how the price of a company's stock has performed relative to the rest of the stock market during the latest 12 months. Generally, stocks with RS Ratings lower than 70 should be avoided.

IBD also provides a measure of the relative strength of a stock's industry group. The Industry Group Relative Price Strength rates a stock's industry group price action over the past six months on a scale of 'A' to 'E.'

Accumulation and distribution. Supply and demand considerations for the outstanding shares of a stock are important considerations, since these factors directly impact the price of a stock. Institutional owners, because of their size, play a large role in supply and demand.

Investor's Business Daily provides an Accumulation/Distribution Rating to help identify whether a stock is under buying demand or selling pressure by institutional investors. It is based on an evaluation of the stock's daily price and volume action over the past 13 weeks of trading, and uses an 'A' to 'E' scale, with 'A' indicating heavy buying, or accumulation, 'C' representing a neutral amount of buying and selling, and 'E' showing heavy selling or distribution.

Investors should look for 'A' and 'B' Accumulation/Distribution Rating, to identify stocks experiencing moderate to heavy accumulation. A 'C' may be acceptable if all other factors are strong. However, you may want to temporarily avoid stocks showing a 'D' or 'E' rating.

CHARTING ANALYSIS

Along with these fundamental and technical characteristics, it pays to study carefully the stock's one year or longer price and volume chart. "A picture is worth a thousand words" aptly applies to charts since they can help you determine the historical behavior and overall health of a stock.

Many chart price patterns repeat themselves throughout stock market history, so studying historical chart models of the most successful ones can be used as precedents for new investments.

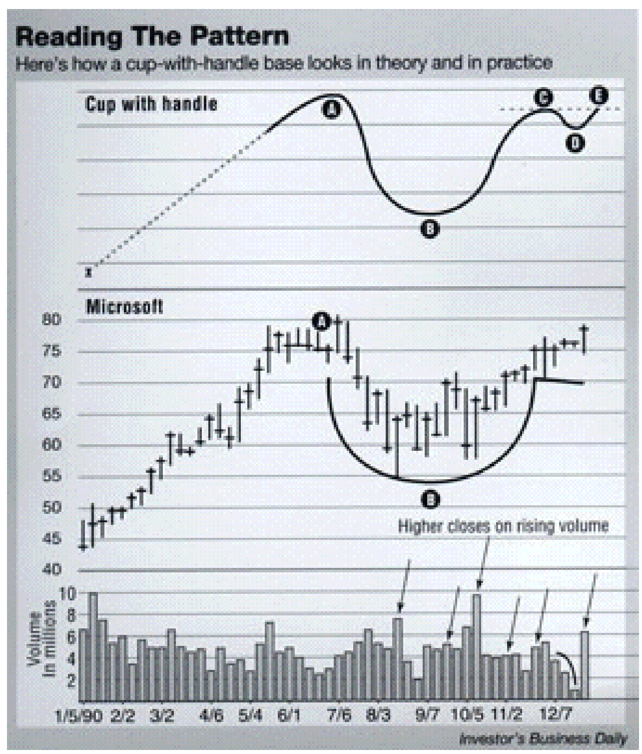
The key is to learn to identify sound, healthy price patterns, or "bases," that indicate important institutional accumulation taking place. Chartists aim to pinpoint the best time to buy or sell, forecasting as well as the precise area to take trading action.

Figure 1 is an example of a price/volume pattern that illustrates one of the better examples of market timing. The figure shows a 'cup with handle,' which is one of the more important patterns, named because it resembles the outline of a cup with a handle on the upper half of the cup. Shown at the top is the general shape of the chart pattern. A to B is the left-hand declining part of the cup, B is the bottom rounding out process of the cup with the price going back and forth for a few weeks, and from B to C, the stock rallies back up in price to a point usually just below its old high. Then C to D to E forms the handle. The entire area from Point A to Point E is called the 'cup with handle.'

The optimal buy point for a stock is usually at the end of a sound basing area when the stock price "breaks out" into new high ground; this is the point of least resistance, when the stock has its greatest chance of moving even higher based on its current and historical price and volume activity.

In the 'cup with handle' pattern shown, the correct time to buy the stock would be as soon as it trades one-eighth of a point above the peak

FIGURE 1. CUP-WITH-HANDLE CHART



Source: Investor's Business Daily

price in the handle (CDE). While we call this a new high, it is actually a new high breaking out of the handle trading range, which is usually a little below the actual old high price at Point A. This gives you a slight jump or edge on the stock.

A proper 'cup with handle' must take at least seven or eight weeks to form (from Point A to Point E). Otherwise, it may be unsound and fail after its breakout.

INTERPRETING THE MARKET

The most widely used measurements of the overall health of the general market are the Dow Jones industrial average, the S&P 500 index, and the Nasdaq composite index. You should be looking at all of these indexes rather than just a single index, examining their action over the last seven to nine months to see if you can spot divergences, where one index moves higher or lower than the others. This can be a significant early warning signal of a change in market trends.

A divergence in the broad Nasdaq or S&P 500 upward, while the Dow falters or remains unchanged, may indicate that the broader markets are gaining strength. If you had only been following the Dow, you may have missed this important indication of a market turn. Many investors miss these distinct opportunities because they are simply used to viewing the Dow for market interpretations.

Investor's Business Daily overlays those indexes on a single page, along with our Growth Mutual Fund Index, which allows for easier comparisons of the indexes.

FINE-TUNING

There are several other factors you should examine that will help you fine-tune your investments.

The most dynamic corporations in our research study often had something "new" occur. Usually, it was a new product or service, or a unique concept of doing business that accelerated the company's sales and earnings. Sometimes new management signifies a positive change.

Another positive factor is when companies are buying back their own stock in the open market. Not only does this reduce the number of shares outstanding (a plus, since it increases demand and reduces supply), but more importantly it implies that management most likely expects improved sales and earnings.

Lastly, it is useful to see at least some institutional ownership to create demand, liquidity and marketability in a stock—three to 10 institutional owners is a reasonable number—and as a confirmation of a good purchase. Knowing how many of the better-performing mutual funds, banks and other institutional investors have bought the stock can serve as your back-up fundamental research department. The top institutions do thorough fundamental analysis before they buy. However, if you use institutional ownership to be a sign of a good purchase, make sure the institution has good performance; ownership by one or two top-performing mutual funds is a positive sign.

In Investor's Business Daily's price tables, we denote a new CEO within the last two years with a (c). Also shown are those companies that are in the S&P 500 (shown as [5] in the tables), particularly important with the growth of index funds and indexing today. Companies that in the last year were buying back their own stock have an (r) after the company name. And every Thursday, the IBD price tables indicate the Institutional Sponsorship Rank, which averages the three-year performance rank of all mutual funds owning the stock.

SUMMARY

The pure fundamentalist or technician can get hurt by not paying attention to both aspects of analysis. The fundamentalist may find all variables seem to be strong in a stock, but if the timing is off on buying or selling the stock, big losses could occur. The technician, on the other hand, can incur significant losses if he or she doesn't pay close attention to key fundamental data.

The biggest opportunities in investing come from covering all the bases in your stock selection.✦