

Chapter Seven

STOCK SELECTION

1. Introduction

The purpose of Part Two is to examine the patterns of each of the main Dow Jones sectors and establish relationships between the relative strength line of the sectors and the most important business and financial cycle indicators.

The main issue is that of predictability. Once investors establish how to predict a sector, then they know when to buy or sell, what to buy or sell, and why to buy or sell.

For instance, if the economic environment is driven by easy monetary policy accompanied by strong monetary growth and low real interest rates, the precious metal sector is likely to outperform the market. Investors can therefore begin an investment program based on buying precious metal stocks. Investors also are aware that when short-term interest rates and real short-term interest rates begin to rise, precious metal stocks will become unattractive. The sector, in other words, is predictable, and should be used as part of the investment program.

Chapter Five and Chapter Six showed you how to identify the investment environment and how to select the sectors likely to perform well under the anticipated economic conditions. This chapter shows you an approach to select timely stocks within the selected sectors.

2. Step 1: Establish an investment theme

This is probably the most important step of the investment process. What kind of economic times are you facing? Investors need to answer this question and relate the answer to the likely direction of the business cycle indicators presented in the previous chapter.

Is the economic and financial environment going to be inflationary? What are the reasons for reaching these conclusions? What are the indicators saying? Is the Fed aggressively easing and pushing real short-term interest rates to low levels? Is the money supply expanding rapidly? Is the dollar declining? Is the economy improving? Are commodities turning up?

These are all questions that, if answered positively, tell investors that the economic and financial environment is characterized by a strong economy followed by rising inflation and commodity prices.

If, on the other hand, the money supply has been slowing down for some time, investors should also expect the economy to slow down. High real interest rates point to a disinflationary environment. Under these conditions, commodities and inflation are likely to decline.

The objective of this analysis is to establish to what extent the economic environment is going to be characterized by rising inflation and higher commodities. The presence of inflation points to the selection of commodity based stocks. The lack of inflation favors assets providing high interest or dividend.

What is found in the press is useless. Investors need to reach their own conclusions based on their own assessment of the trends of the data discussed in previous chapters. At the end of this assessment, using the methodology discussed in Part One, investors will have a forecast of the indicators listed in Chapter Six.

3. Step 2: Identify the strongest sectors

The challenge of this step is to assemble the data needed for the analysis. It takes time, however, to develop and update (at least once a month) the database and the graphs. The graphs need to be analyzed to determine which sectors fit the environment identified in the previous section. The focus is to determine which sectors are likely to have a rising relative strength line and why.

Let's say that an inflationary environment is the most likely outlook. Real interest rates are below 1.4. The analysis of the sectors shows that precious metal or real estate stocks are beginning to display above average strength and are outperforming the market. A rising relative strength line also reflects these conditions. These stocks are excellent investment candidates.

If, on the other hand, a disinflationary environment is anticipated with declining interest rates, investors need to consider the financial sector and bonds. If the bank or the S&L sectors show a rising relative strength line, stocks belonging to these sectors should be included in the portfolio.

Websites such as *BigCharts* rank sectors in terms of their performance. *BigCharts* shows the performance of the Dow Jones sectors over different periods and ranks them relative to all other sectors and sub sectors. This is also an excellent way to spot emerging trends.

4. Step 3: Make a complete list of acceptable stocks

The objective is to find a group of companies that are likely to outperform the market within the chosen sector. Do not necessarily select the well-known companies. Do not approach this step with the assumption you already know which stocks you are going to select. There are a lot of medium size companies that are not well know, yet they are extremely well run enterprises with a superb growth record and a proven business model. Approach this step with the idea you do not know what you are going to find. Be open-minded.

Dow Jones provides the components of the sector or sub sector. *BigCharts* and *Quicken* websites can also be used for this purpose. *BigCharts* lists all the components of the Dow Jones

sectors. It shows also all the stocks listed on the NYSE and Nasdaq belonging to the selected sector and not necessarily belonging to the Dow Jones sectors. *Value Line* or your local library can assist you in finding other available publications that provide the information you need.

You should select stocks with a PE below that of the market. The objective is to find value and to invest in stocks offering a price more attractive than that of the market. It is a way to protect your portfolio from the risk of a broad decline. The assumption is that the most undervalued stocks do not decline as much as overvalued stocks in case of a market correction.

Now that you have a list of stocks to choose from, you have to analyze each stock and find the ones that are promising investments.

5. Step 4: Technical analysis of your stock candidates

The behavior of the price line of a stock over 5 to 10 years contains considerable information about a company. An enterprise with a successful financial record, an above average management team, and a winning business model has a steady loyal following of investors. They are most likely to invest for the long-term because they trust the people and culture behind the success of the company. The price chart of these stocks is likely to present little volatility with a steady up trend through many years.

Companies that have a complex business model, a constantly changing product mix, a volatile financial record due to an ever-changing management team, or a confused vision about the company's future, have volatile stock prices. Investors are not sure on the outlook. Sometimes government pronouncements or legal suits determine the fate of the company and appreciation of the stock. Drug stocks, for instance, fit this model. Other times tobacco stocks. Investors want to avoid these companies. These uncertainties are reflected in a volatile stock price. Companies with proven success, even if not widely known, represent above average value. This is reflected in low volatility and steady appreciation in the price of their stock.

As the companies on the list are analyzed, investors learn to recognize which stocks are the most attractive. As you go through the list, ask yourself: Which company would I like to own? One with a lot of volatility like the one in front of me? Or one with a steadily rising trend over several years?

Another aspect of the analysis is to establish when the major turning points in the price of these stocks take place. Are all stocks turning up or down at the same time? Why? What was happening to the business and financial indicators listed in the previous chapter during such times? Do they all follow the pattern typical of the sector you have chosen?

For instance, most of the S&L stocks show a pronounced decline in 1998-2000. What happened then? Going through the list of indicators helps to confirm that short-term rates were rising during those years. These stocks act like the sector. Select those S&L stocks that seem to behave in the same way. The selection process is not over yet; so, do not try to reach any conclusions. You want to make sure, however, that you have a reliable buy and sell rule like: "I

will start selling S&L stocks when short-term interest rates are going to rise.” Or, “I am going to buy S&L stocks when short-term interest rates are going to fall.”

Select those stocks that have the same turning points and that can be related to the scenario you are expecting. If you find that some stocks in your list do not follow the pattern of the majority of the other stocks, they should be ignored. The business model of these companies is different from the majority and is not as predictable as the majority of the stocks in your list.

At the end of this step, you will probably have eliminated more than a half of the companies you initially selected. It is useful to rank them on the basis of their volatility and appreciation through many years. Many financial websites such as *Yahoo!* or *BigCharts* allow you to compare the performance of each stock relative to the others. Make the comparisons over 5, 2, and one year. The outcome of this ranking, based on appreciation and volatility, gives an excellent idea about which companies passed the test of time.

6. Step 5: Financial analysis

You have now a much shorter list of candidates than when you started – possibly five to ten names. The objective of this step is to find which one of the stocks in your list represents value and is a financially successful company. The important word is *value*. In order to represent value they have to have an established financial history that you can analyze.

The following parameters are useful to evaluate your list. You want to go back at least three to five years in the financial scrutiny of your stocks. The performance of these companies has to be compared to the performance of the industry and to that of the overall market. The “*Stock Evaluator*” option on the website *Quicken.com* is highly recommended for this analysis.

1. **Growth rates.** You need to examine the growth in revenues (sales), net income (earnings), and cash flow to see how well a company is translating revenues into earnings, which are necessary for growth. Look for companies whose revenues, net income, and cash flow are rising steadily -- or at faster rates than their competitors.
2. **Total revenue.** The dollar amount of annual sales, net of allowances (discounts, returned merchandise), is the "top line" figure from which costs are subtracted to determine net income. In evaluating stocks, revenue growth is often an indication of a healthy company. However, acquisitions and divestitures will skew revenue growth figures. For all but the most successful companies, the growth rates change quarterly, so these values should be checked often.
3. **Net income.** Net income is the amount of a company's total sales (revenue) remaining after subtracting all of its costs, in a given period of time (also referred to as "net earnings"). This very important figure (literally the source of the term "the bottom line" from where you find it on an income statement) is the best measure of the current operating state of a company.

Earnings per share (or "EPS") are found by dividing this figure by the number of shares of common stock outstanding.

4. **Cash flow.** Cash flow is a measure of the cash receipts and cash payments a company makes over a given time period. If a company has negative cash flow, the company must borrow money to operate its business. If a company has positive cash flow, the company has money available to spend on research and development, to expand operations, and to pay dividends to investors.
5. **Debt.** Long-term and total debt/equity compare the company's debt to its assets minus its liabilities to reveal how much debt is cutting into the bottom line. The higher the debt, the more important it is to have positive earnings and steady cash flow -- at some point, the company must pay off the debt, or interest payments will sap its finances. Some industries have more debt, so compare the company's debt to the industry average and competitors' debt.
6. **Long-term debt.** This is corporate debt coming due in more than a year. Long-term debt includes mortgages, bank loans, and bonds. Investors can find it listed on the balance sheet in a company's annual report. Long-term debt is an important component in the long-term debt-equity ratio, an indicator of a company's debt level. Debt can be a good tool for a corporation. It can help the company invest in new plants and equipment that will increase profitability. Too much debt, however, is risky. It locks the company into regular interest payments whether earnings are up or down. If a company stumbles, it may have trouble recovering under a heavy debt load.
7. **Debt to equity ratio.** The debt to equity ratio is the ratio of a company's liabilities to its equity (total value of stock). Long-term debt-equity is the ratio of a company's long-term liabilities (debt that won't be paid off in one year) to its equity. Total debt-equity is the ratio of a company's long-term and current liabilities (debt that will be paid off within one year) to its equity. The higher the level of debt, the more important it is for a company to have positive earnings and steady cash flow. Debt in and of itself is not "bad," but since it requires the timely payout of interest to debt holders, it is important to analyze a company within the context of the likeliness that it will have adequate resources to meet its payments in the coming business and economic environment. By the nature of certain industries, you will find that some contain only companies with a high ratio (or vice versa). So, for comparative purposes, debt-equity ratio is most useful for companies within the same industry. See also debt-assets ratio.
8. **Management performance.** Return on Equity, Return on Assets, and Return on Invested Capital are used to measure a company's profitability. Are managers successfully converting shareholders' equity, assets, and invested capital into net earnings? Compare to the industry average and competitors to gauge the company's success.
9. **Return on equity (ROE).** This is a percentage indicating how well common stockholders' invested money is being used. The percentage is the result of dividing net earnings by common stockholders' equity. The ROE is used for measuring growth and

profitability. You can compare a company's ROE to the ROE of its industry to determine how a company is doing compared to its competition.

10. **Return on assets (ROA).** ROA is the amount of profits earned (before interest and taxes), expressed as a percentage of total assets. This is a widely followed measure of profitability, thus the higher the number the better. As long as a company's ROA exceeds its interest rate on borrowing, it's said to have positive financial leverage.
11. **Return on investment (ROI).** This measure is also known as return on invested capital (ROIC), a measure of how well a company's management is performing. ROI is calculated by dividing earnings by total assets. It is a broader measure than return on equity (ROE) because assets include debt as well as equity. Companies sometimes define terms differently, but in general, they use earnings before taxes and the book value of assets at the end of the year. Some investors think that ROI is the most important financial indicator because it shows how well management has used the company's resources. Companies with the same sales and earnings may look as if they performed the same. However, a company that needed less investment capital to achieve the same result would actually be the better-run company. It is useful to compare a company's ROI with others in the same industry.
12. **Valuation.** The right company for your portfolio is one with a realistic PE below that of the market. This is an important element in the overall selection process. Another item is the dividend yield, which should also be above the market average. Companies that pay dividends over long time (at least five to ten years) should have a preference. Dividend growth rate is also part of the overall valuation. Dividends play a crucial role in the overall return of the stocks you choose. Investors have been spoiled in the late 1990s because they learned to believe that return from a portfolio was mostly coming from price appreciation. The poor performance of the market after 2000 has shown that relying on dividends should be the norm in assessing the total return from a stock. The long-term return from the stock is close to 9%. Close to 40% of the return comes from dividends and dividend growth according to some studies. For this reason investors should choose stocks with an above average yield and a company with a proven record of dividend growth.

7. Selecting the best stocks

You are almost at the end of the selection process. You need now to prepare a table showing in each column, for each stock, the financial performance and growth rates discussed in the previous section. The stocks you want to select have the highest performance and consistency through at least three years. When in doubt, make the most conservative choice. You are looking for above average growth rates, above average management performance measures, low levels of debt, and solid valuation (PE below that of the S&P 500) with a proven history of dividend growth.

Do not be overwhelmed by the stringent requirements. There are many companies meeting these criteria. You will probably be surprised when you find that these companies are

not well known and are seldom mentioned in the financial press or TV. They are likely to be medium size companies that have developed a niche for their products and service and are doing very well because the big companies do not find that particular market attractive.

Choose the best 5-10 companies – depending on the sector you are analyzing -- from the list you have prepared. And now, the final test. Compare the price history of the chosen stocks over one, two, five, and 10 years. Rank them again by market performance and price volatility. Check again when the major turning points took place. What happened when they declined? Were interest rates rising? Were there other relationships you might have ignored? How predictable is the price action of the stock based on the indicators discussed in the previous chapter? Did the stocks outperform the S&P 500 in the past few years?

Low price volatility and steady price appreciation are a sign the market agrees with your selection. Investors feel comfortable with the business model of the enterprise and with the management team. Avoid stocks that show too much price volatility. It means that investors are not unanimous in how the company is managed and/or its business model. Highly volatile stocks are used as trading vehicles rather than an investment. Avoid them!

At this point, a question might arise. How do I know which stocks to select on the basis of volatility and financial performance? The answer is simple. You do not know. You do not know because you are operating in an uncertain world. Nothing in life is one hundred percent sure. For this reason, you do not invest in the best stock of your list. You want to choose the top 2-3 stocks. Invest a minimal amount in each of them, possibly not at the same time, and let their price performance be the final judge. You should not be surprised if some of the stocks fail your expectation. This is the main reason you did not invest much capital in any of them. Give your stocks the chance to prove themselves.

After a few weeks, you will see that some will perform much better than others. Gradually increase your investment in the best performing stocks. Eventually you should sell the worst performing ones. You are now left with the best of the best, until the time comes when you should sell them. The reason is that the indicators, which told you to buy, are now telling you to start reducing your exposure in these stocks and shift your capital to another sector.

8. Portfolio management

Diversification across too many sectors is fruitless. Your portfolio is bound to perform like the market because, through excessive diversification, your portfolio is the market. If you want to outperform the market, your portfolio needs to be focused and be invested in a few sectors. These sectors are selected because they have proven to have superior performance during times similar to the current one (see the summary table at the end of Chapter Six).

Your portfolio is likely to contain as many as 30 stocks depending on the size of the portfolio. You will need to monitor the performance of the portfolio and of each stock once a week. The appreciation of your capital tells you if you have been correct in your selection as far as stocks and timing. Emotions have to be set aside. Adjustments of about 1% of your capital have to be made to gradually reduce the losers and gradually increase the exposure to the

winning positions. The author's experience is that investors should not increase their capital to more than 6% in each stock.

9. Conclusions

The main objective of this book has been to propose an investment process to help you decide when to buy/sell, what to buy/sell, why to buy/sell, how much to buy/sell. This chapter provides the final item of the process – selecting the attractive stocks in the strongest sectors.

Understanding the economic times and the current position of the business cycle is the keystone step for investing and selecting sectors. The stocks included in your portfolio depend on the trends of the business cycle indicators discussed in Chapter Five and how they relate to sectors, as shown in Chapter Six.

The second most important requirement is discipline. This chapter provides guidelines on how to select stocks and manage your portfolio. You have to be disciplined in investigating which sectors may become attractive and which stocks you should choose. You want to maintain a list of alternative stocks, based on alternative strategies, to use in case your portfolio begins to under perform due to changes in economic times.

Measuring the performance of your portfolio relative to the market is the final test of your success. Whatever the reason for under performing, follow these very simple rules:

1. Be patient. Do not panic. Do not sit on your hands. Make decisions. Be alert. Do not fall in love with your stocks. Investors who fell in love with Cisco or Enron on their way up, lost huge sums of money when these stocks collapsed in 2000-2002.
2. Be focused on the performance of your portfolio. Be responsive to which stocks are out performing and which ones are under performing.
3. Follow closely the stocks that are under performing. They are penalizing the performance of your portfolio. If a stock declines 10%, it is probably a good "sell" candidate.
4. Act slowly. Gradually, repeat – gradually, reduce your investment in the weakest stocks, and increase your investment in the strongest stocks.
5. Be aware of changes in the business and financial cycle. These changes establish which sectors will become more (or less) attractive.
6. Always be prepared with alternative investment strategies, corresponding stocks, and stock sectors to be used.

Stock selection and portfolio management

- ✓ Establish an investment theme
- ✓ Identify the strongest sector(s)
- ✓ List the stocks in these sector(s)
- ✓ Screen the list from a technical viewpoint
- ✓ Use financial analysis to identify the best stocks
 1. Company performance
 2. Level of debt
 3. Management performance
 4. Valuation measures
- ✓ Prune the list using market performance and volatility measures
- ✓ Invest in the strongest stocks
- ✓ Focus on performance evaluation and portfolio management to minimize losses and maximize gains