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Stock Picking: The Formula For Success

by: Kate Stalter

There are two essential truths to investing in any market. The first is that the market never changes. Whether it's up, down or sideways, human psychology—fear, greed, excitement, hope, ego—always drives the action. And just as human psychology is about consistent patterns of behavior, so too is the stock market.

The second truth is this: The traits that define market-leading stocks never change. All stock winners have the same performance traits in common: consistent leadership in earnings and sales growth; strong interest from institutional investors like mutual funds, pension funds and banks; industry group and sector leadership; and a new product or service. New products and services are the backbone of many companies' growth. After all, innovation is a significant part of driving sales and earnings.

It's Not a New Story

These winning criteria have defined emerging leaders for decades. Stocks leave a trail of clues to follow even before they soar in price. That's the foundation of CAN SLIM investing, the seven traits great stocks exhibit before their major price moves. In studies of CAN SLIM stocks from the 1880s to the present, the basic traits of leading stocks just do not change. There has been an increase in trading volume, but that has absolutely no effect on this methodology. Great earnings, sales and institutional buying continue to drive companies. One other element to be aware of: The market has been especially news-sensitive in recent years. This attention to daily news cycles can cause index volatility day-to-day, but again, does not change our concept of watching the market's overall direction.

For individual investors, the most prudent approach remains: Invest in leading stocks in leading industries during a market rally, and protect money by going to cash when the market is in a correction. [For more information on these traits, see SFO's July 2004 article "How to Spot Winning Stocks Before They Make Big Moves" by William J. O'Neil.]

In this article, we will go over a checklist to help you find leading stocks. But first, let's review a strategy for identifying the trend of the general market to help you determine whether it's the right time to get in, stay in or stick to the sidelines.

How to Spot a Bull Market

All bull markets begin with a “follow-through day.” Here’s how it works: Following a downtrend, start watching for a day in which one of the major indexes rises in price. The size of the price gain and the volume that day don’t matter. That up day counts as day one of an attempted rally. The next two sessions—days two and three of the rally attempt—aren’t that important. As long as the market indexes don’t undercut the day one session low, the rally attempt remains intact.

But starting on day four, look for at least one of the major indexes—the Nasdaq, the S&P 500, the Dow or the NYSE Composite—to log a significant price gain in higher volume than the previous session. Every bull market has begun with a follow-through day. But not every follow-through yields an uptrend. After a follow-through session, keep watching the performance of the major indexes and leading stocks. This action will show you whether the follow-through has legs. Why is the follow-through day important? It confirms that big institutional investors—the banks, mutual funds and pension funds that make up 75 percent of all trading in the market—are putting their money back in. Their buying power is what drives the market into bullish or bearish territory.

Let’s look at an example. Recall the bull market that began on Aug. 15? See Figure 1. After a downturn that began in April, the market began to rally in mid-July. On Aug. 15, it followed through, rising 2 percent on heavier volume than the previous session. This preceded a 26 percent rise in the Nasdaq.



[click image for larger view](#)

How to Spot a Correction

No market goes up or down forever. How can a trader or investor determine that a bull move may be nearing an end? The way to spot trouble in a bull market is by tracking price and volume changes on the major indexes. Look for a day when an index sells off in heavier volume than in the previous session. That’s known as a distribution day. It can be a sign of trouble, but by itself is not normally enough to reverse a rallying market. It’s also not necessarily a bad thing, as profit-taking here and there is healthy.

Investor's Business Daily's (IBD) research into past corrections and downtrends shows that five or six distribution days over a period of about four weeks can be a signal that the market's uptrend is weakening. Using charts, follow the price and volume every day on the Nasdaq, the Dow, the S&P 500 and the NYSE Composite.

Let's take another look at the Nasdaq in 2006. Between March 21 and April 21 five distribution days appeared. This was a clear sign that the rally, which began in July, was on the ropes. And sure enough, those distribution days preceded a 15 percent decline in the Nasdaq over the next three months.

When a market goes into a downturn, that's the time to take some profits before gains turn into losses. Three out of four stocks follow the market's direction. That means even the biggest winners are likely to start falling in a downturn. In rare instances, a market can have a dramatic drop without being preceded by five or six distribution days. For example, the S&P 500 had two distribution days in 1989 before breaking hard on Oct. 13 that year. See Figure 2.



[click image for larger view](#)

How to Screen for Leaders in a New Bull Market

Investing in stocks during a bear market or in a correction is not typically a good idea. As noted above, three-fourths of stocks follow the market's direction. The odds are against investors in a downward trending market. It's not to say that money can't be made, but the odds are against it. Does that mean investors should completely ignore the market and do nothing? No! In fact, every downturn is a great opportunity to seek out new leadership that is showing strength. Then, investors are ready before the next bull phase.

That leadership probably won't come from the old winners. That's important, because only one out of eight leaders from the previous bull market goes on to lead in the next. So the idea is not to be focusing on the old leaders, per se. Instead, look at stocks showing traits of emerging

growth—whether or not they led in an earlier bull rally. It's a mistake, in other words, to continue focusing on previous leaders. By doing that, investors will miss out on the new crop of potential winners.

Blend Fundamentals and Technicals

In a correction, look for stocks outperforming in key fundamental and technical areas. Many investors make the mistake of looking only at fundamentals, but that only tells them half the story. Consider some key fundamental factors to monitor. This list serves as a guide to find stocks showing the right level of earnings and sales growth. The technical checklist helps determine stronger buy decisions. The fundamental checklist:

- **Quarterly and Annual Earnings:** Look for stocks that show quarterly and annual earnings up at least 25 percent. The greatest stock winners consistently show this level of growth—and the stronger the increases, the better.
- **Sales:** Look for accelerating sales over the past three quarters, and the previous quarter's sales up at least 25 percent. The greatest stock market winners have shown strong sales growth driven by new products or services.
- **Return on Equity (ROE):** Look for return on equity of at least 17 percent. IBD's research has shown that the biggest winners tend to have this type of ROE or more.
- **Profit Margins:** Look for quarterly after-tax profit margins to be improving. Watch for this to occur while earnings and sales are growing. It's best to have at least two quarters of growth.

For those traders familiar with technical analysis, these suggested items will not come as a surprise. Investors who blend technical and fundamental screens into their investing and trading decisions can find benefits. Here's a technical checklist to monitor:

- **Relative Price Strength:** Look for stocks with a relative price strength that have outperformed in the past 12 months, and have at least a 30 percent prior uptrend before they set up for a new rally. IBD's research has shown that stocks are more likely to stage successful breakouts from a holding pattern or small correction after they have had a prior run-up of 30 percent.
- **Industry Group Price Strength:** Look for stocks trading an industry group whose relative price strength is also leading the market.
- **Institutional Sponsorship:** Look for at least 10 big institutional investors to own the stock. Institutional buying is what pushes stock prices higher. A stock needs enough institutional support if it is to make a big price move.

Analysis in Action

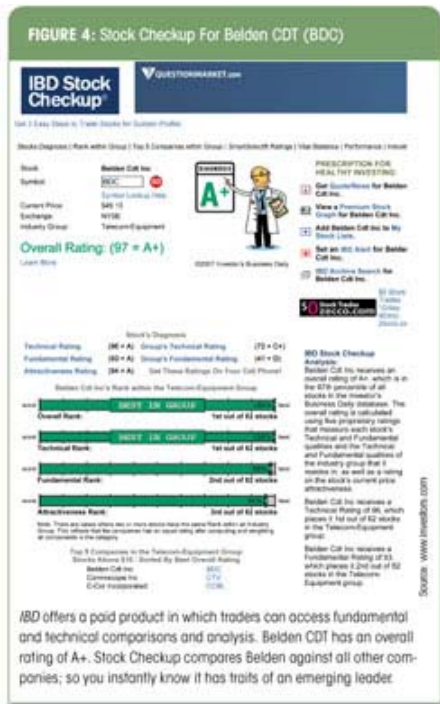
Let's look at an example. In September 2006, IntercontinentalExchange

(ICE) was part of the IBD 100 list of top-performing stocks. This was a company that boasted strong fundamentals. In fact, its earnings had grown at a triple-digit rate in recent quarters. A few weeks after the general market followed through on its rally attempt, IntercontinentalExchange cleared what's called a "cup-with-handle" pattern. See Figure 3. For those new to technical analysis, the cup with handle is the most common pattern that winning stocks form before making their big moves. It's so named because it resembles a coffee cup with a handle, viewed from the side. When the handle forms, that's a sign that the last investors who are doubters are being shaken out and selling. This often sets the stage for a big run-up. Charts are not hocus-pocus. These successful patterns have repeated themselves over and over again for decades. After showing strength along with the rest of the market, IntercontinentalExchange went on to rally 156 percent, reaching a high of \$167 on Feb. 21.



[click image for larger view](#)

As seasoned technical traders are well aware, charts are a terrific way to identify stocks showing technical strength. However, it's important to understand both a stock's fundamental and technical characteristics. Trying to invest by using just one of those perspectives, but not the other, is like trying to drive a stick-shift car with one hand tied behind your back. The bottom line is that trading and investing is hard work and requires homework. Take, for example, the stock in Figure 4, which as of March 2007 had both strong fundamentals and technicals: Belden CDT (BDC).



click image for larger view

Stick to the Facts

By focusing on the facts, rather than emotions or someone else's hot tip, investors can verify for themselves whether a stock shows the proven traits of an emerging leader. Watch the general market indexes, first and foremost. That's the gauge that will determine your course of action. And by screening for emerging leaders with the right selection criteria, informed investors will be many steps ahead of the average investor.

SIDEBAR

Scanning Tools Spot Stocks About to Take Off

Sifting through thousands of stocks to pick the right ones, and likewise good entry points, is a formidable task for even the most experienced of traders. Coupled with a market that is, as Kate Stalter points out, exceptionally news-sensitive, the job becomes downright Herculean. How is a trader supposed to know when an under-the-radar stock is about to make an extraordinary move? Thankfully, there are a variety of software scanning tools available to help traders discern the tortoise from the hare. In addition to Investor's Business Daily's Stock Checkup mentioned in Stalter's article, Townsend Analytics has developed Hottrend, www.hottrend.com, a scanner/filter included in RealTick Pro Plus and RealTick Order Entry.

Hottrend monitors three markets—Nasdaq, the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex)—on three separate versions of the program. This program constantly monitors stocks, evaluating and tracking price velocity, volume, rate of price change,

bid-ask spread, bid-ask update and the average trade size. For every stock on the exchange, for every minute of the day, Hottrend has an "expectation of where that individual stock should be in terms of those variables," says Michael J. Felix, co-founder of Hottrend. This expectation is determined based on a database that constantly adjusts itself, collecting ticks and weighing exponentially towards the day's point in time.

Felix explains that "[Hottrend] compares what's occurring in real time with every stock to its expectation, then [Hottrend] computes the standard deviation to all those variables." Variables are weighed and aggregated, based on back testing conducted by Hottrend, to create an abnormal value. So if Hottrend is evaluating Nasdaq, it will measure the abnormal value of one stock against the abnormal values of the other 3,999 stocks on the exchange. Hottrend will then publish a list of the top 30 stocks for that minute.

Felix says, "A lot of traders are looking for the crystal ball, and we don't believe in the crystal ball." Hottrend does not foretell the future, but it does help traders navigate the haze of information (close to 10,000 news stories in one day alone) and alert traders to the news important to their trading. He notes that the average trader looks at 20-30 stocks at most, "[with] 3,980 or 3,970 stocks with potential to come into play."

Liquidity events, such as insider activity, court decisions, mergers or just the standard leak, can jumpstart a sleepy tortoise. Hottrend often reveals events before they happen. "We see this all of the time on Hottrend. The stock runs up and you see tremendous abnormal activity and then at the end of the day there is an announcement of a merger or that a patent has been approved," Felix says.

Essentially, Hottrend puts those otherwise sleepy stocks on a trader's radar. " Felix offers this caveat, however: "Hottrend can tell you when a good potential time to enter a trade is. It's up to the user to put a stop on it and to manage [his or her] risk on the trade, because the volatility of that stock is going up."

Traders should contact their brokers for more information about which stock scanning tools are available on their platforms.

By Megan Milliken

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