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A Winning System in Good Times or Bad

WILLIAM J. O'NEIL

How to Make Money in Stocks

How to Make Money in Stocks

A Winning System in Good Times or Bad

William J. O'Neil

Second Edition

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You can do it.**

Contents

Preface

From August 1982 to August 1987, the stock market staged a phänomenal 250% increase. Employees' pension funds made a fortune. Then in one day in October 1987, the market dropped a record 24%. Sanity and reality returned. That's the stock market.

During the last 50 years, we have had twelve bull (up) markets and eleveii bear (down) markets. But guess what? The bull markets averaged going up about 100% and the bear markets, on an average, declined 25% to 30%. Not only that, the typical bull market lasted 3 3/4 years and the classic bear market lingered only nine months. Viewed with perspective...that's a terrific deal.

But I will go you one better. Did you know that in the last 100 years we have had more than 25 bear market slumps (natural, normal corrections of the previous bull market advance), and EVERY SINGLE TIME THE MARKET RECOVERED AND ULTIMATELYSOARED INTO NEW HIGH GROUND? That's fantastic.

What causes this continued long-term growth and upward progress? It's one of the greatest success stories in the world—free people, in a free country, with strong desires and the incentives to unceasingly improve their circumstances. America just keeps growing.

The stock market does not go up due to greed. It goes up because of businesses with new products, new Services, and new inventions...and there are hundreds of them every year. The innovative entrepreneurial companies with the best quality new products that serve people's needs are always the top stock market winners.

So, why haven't more people taken advantage of these tremendous investment opportunities? It's that they don't understand the market, and when you don't understand something you are unsure, maybe even afraid.

I am going to solve that problem for you. This book will explain the market to you in simple terms everyone can understand. It will show you how to select which Stocks to buy and exactly when you should buy and when you should seil. There are two entire chapters on when to seil and nail down your profits or cut short potential mistakes. You can learn how to protect yourself against the big risks in good times or bad.

There are three things I feel absolutely certain about concerning the next twenty-five years. Our government will continue to tax you äs much äs it possibly can for äs long äs you live, your cost of living will go up substantially, and the stock market and economy will be much higher. You can't do a lot about the first two, but you can benefit materially from the last one if you learn how to save and invest properly.

Don't be thrown off by the swarm of gloom and doomers. In the long run, they have seldom made anyone any money or provided any real happiness. I have also never met a successful pessimist.

There is one overpowering, overriding reason why there should be other bull markets ahead—the enormous number of baby boomers. Marriages will be up and couples will need housing, furniture, medical care, clothing, and education for all the new children. This giant bulge in future demand will not go away.

Everyone should own common stock! It's a great way to get an extra income, financial independence, and security. It's a way you can "be in business for yourself," and it can be safe and sound over the long term...if you learn to correctly apply all the basic rules for making and protecting your gains and minimizing losses. It could put your kids through school, dramatically increase your Standard of living, and give you freedom and safety in your old age.

I have spent 35 years analyzing how the U.S. economy works. William O'Neil & Co., also built the first daily Computer data base on the stock market in this country and used it to construct models of what the most successful companies looked like just before they became big successes.

In 1970, we moved into the institutional stock research business. We called our first service *Datagraphs.* Today we are regarded by some institutional investors äs the leader in automation in securities analysis and management. A daily chart service was also developed called *Daily Graphs* to which thousands of individual investors subscribe.

In 1983, I designed and created the basic format for *Investor's Daily,* a national business newspaper. It was the first paper to make significant improvements in news available to public investors via daily stock price

tables and to grow and take share of market away from *The Wall Steet Journal. A* completely separate organization was then set up to directly challenge the sacred 100-year-old east coast-based industry giant.

My prime objective in writing this book is to help *everyone* discover how to get ahead by saving and investing.

I'm talking about ordinary people who have never owned Stocks; those deeply concerned about **inflation** and their dwindliiig dollar; everyday individuals investing in a local savings account, a money market fund, or a mortgage; people who may have bought a little art, gold, or silver.

This book will also help renters who dream of one day buying a hörne or income property, and those investors who already enjoy home ownership. It is for amateur investors in the stock market, people considering an IRA (Individual Retirement Account) or a mutual fund, retired persons, teachers of Investment courses, and students attempting to learn about **investments**. It should be used in schools, whether grade school, junior high, high school, or College level. Young people growing up should learn how the American economy and market *really* work and how they can materially benefit from it.

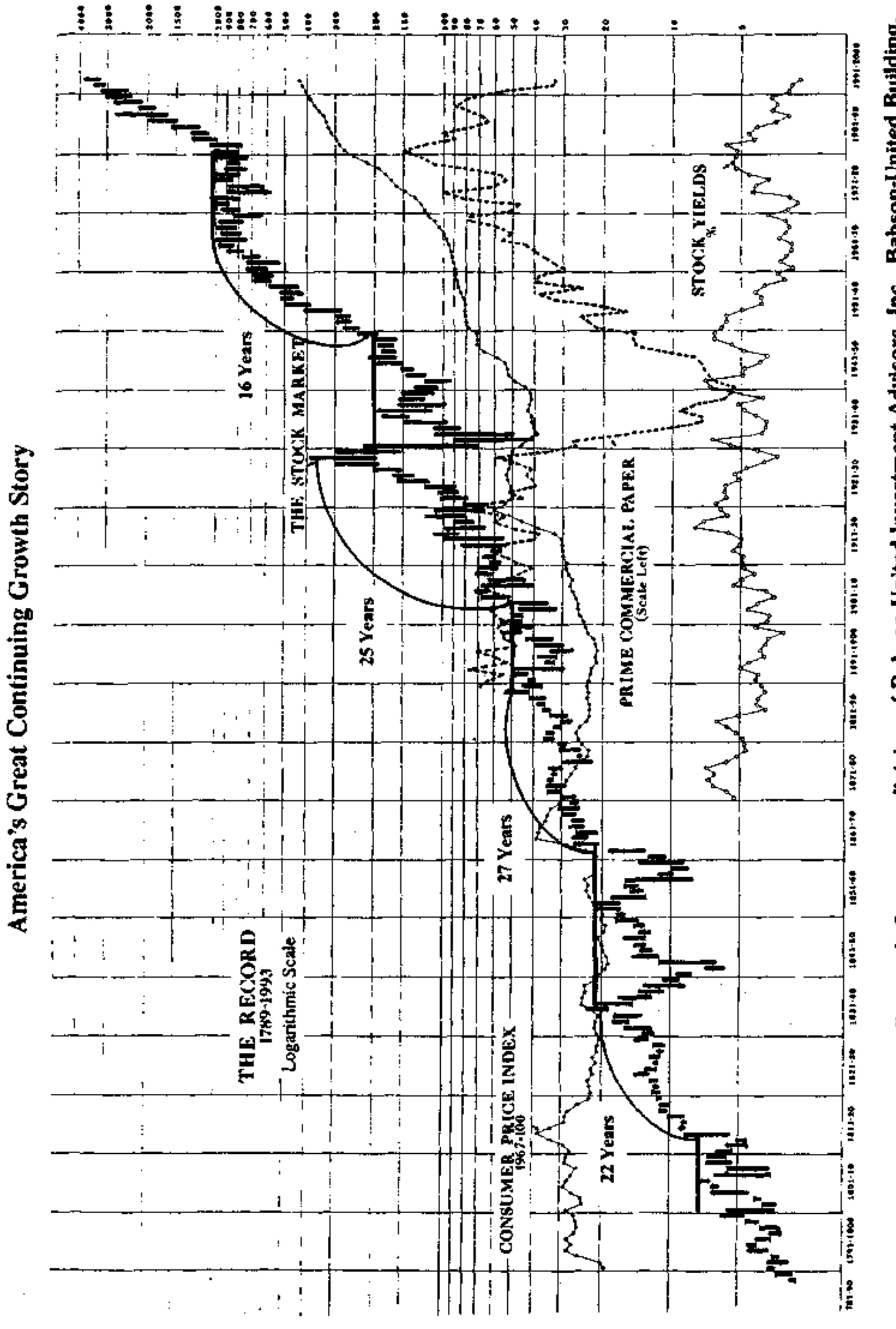
Lastly, this book is for sophisticated professionals managing pension and mutual funds, whose difficult Job it is to produce investment results and stay ahead in a very complex and confusing game.

It is also for those who seek professional advice in the supervision of state and public employee funds and educational and charitable investment portfolios, and for foreign investors who want to invest money in the U.S.A., the land of unmatched personal freedorn and opportunity.

My deep appreciation and heartfelt thanks go out to those loyal hard-working souls who read, edited, worked on the graphics, criticized, typed, and retyped the endless changes made to this work. Some of those dedicated individuals are Anne Gerhard, Carolyn Hoffman, Jeannie Kihm, Jim Lan, Stanley Liu, Diane Marin, Milton Perrin, Kathy Russell, Lindee Shadrake, Kathy Sherman, Frank Spillers, and Susan Warfei. And, of course, a great amount of valuable assistance and numerous suggestions were provided by my wife Fay and Bill Sabin and the excellent McGraw-Hill staff.

William J. O'Neu

How to Make Money in Stocks



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PART 1

A Winning System: C-A-N S-L-I-M

Introduction: Learning from the Greatest Winners

In the following chapters, I will show you exactly how to pick more big winners in the stock market and how to substantially reduce your losses and mistakes. I will examine and discuss other Investments, äs well.

In the past, most people who bought and sold Stocks either had mediocre results or lost money because of their clear lack of knowledge. But no one has to lose money.

This book will provide you with most of the investment understanding, skills, and methods you need to become a more successful Investor.

I believe that most people in this country and many others throughout the free world, young and old, regardless of profession, education, background, or economic position, can and defmitely should own common stock. This book isn't written for an elite but for the millions of little guys and gals everywhere who want a chance to be better off.

YOU CAN START SMALL

If you are a typical working man or woman or a beginning Investor, it doesn't take a lot of money to Start. You can begin with äs little äs $500 to $1000 and add to it äs you earn and save more money. I began with the purchase of just five shares of Procter & Gamble when I was only 21 and fresh out of school.

You live in a fantastic tinie of unlimited opportunity, an era of outstanding new ideas, emerging industries, and new frontiers. But you have to read to learn how to recognize and take advantage of these extraordinary Situation«.

The opportunities are out there for everyone. You are now witnessing a New America. We lead the world in high technology, medical advancements, Computer Software, military capabilities, and innovative new entrepreneurial companies. The communist socialist System was finally relegated to the ash heap of history under Ronald Reagan and our System of freedom and opportunity serves äs a prime success model for the majority of countries in the world.

It is not enough today to just work and earn a salary. To do the things you want to do, to go the places you want to go, to have the things you want to have in your life, you absolutely must save and invest intelligently. The second income from your Investments and the net profits you can make will help you reach your goals and provide real security.

SECRET TIP #1

The first Step in learning to pick stock market winners is for you to examine leading winners of the past to learn all the characteristics of the most successful Stocks. You will learn from this observation what type of price patterns these Stocks developed just before their spectacular price advances.

Other key factors you will uncover include what kind of Company quarterly-earnings reports were publicly known at the time, what the annual earnings histories of these organizations had been in the prior five years, what amount of stock trading volume was present, what degree of relative price strength occurred in the price of the Stocks before their enormous success, how many shares of common stock were outstanding in the capitalization of each Company, how many of the greatest winners had significant new products or new management, and how many were tied to strong industry group moves caused by important changes occurring in an entire industry.

It is easy to conduct this type of practical, commonsense analysis of past successful leaders. I have already completed such a comprehensive study. In our historical analysis, we selected the greatest winning Stocks in the stock market each year (in terms of percentage increase for the year), spanning more than 40 years.

We call the study *The Record Book of Greatest Stock Market Winners.* It covers the period from 1953 through 1993 and analyzes in detail over 500 of the biggest winning companies in recent stock market history: super Stocks such äs Texas Instruments, whose price soared from $25 to $250 from January 1958 through May 1960; Xerox, which escalated from $160 to the equivalent of $1340 from March 1963 to June 1966;

Syntex, which leaped from $100 to $570 in only six rnonths during the last half of 1963; Dome Petroleum and Prime Computer, which respectively advanced 1000% and 1595% in the 1978-1980 stock market; Limited Stores, which wildly excited lucky shareowners with a 3500% increase between 1982 and 1987; and Cisco Systems, which advanced from a split-adjusted $1.88 to $40.75 between October 1990 and March 1994. Home Depot and Microsoft both increased more than 20 times during the 1980s and early '90s. Home Depot was one of the all-time great performers jumping twentyfold in less than 2 years from its initial public offering in September of 1981 and then again climbing another 10 times from 1988 to 1992. All of these companies offered exciting new products and concepts.

Would you like to know the common characteristics and secret rules of success we discovered from this intensive study of all past glamorous stock market leaders?

It's all in the next few chapters and in a simple easy-to-remember formula we have named *C-A-N S-L-I-M.* Write the formula down, and repeat it several times so you won't forget it.

Each letter in the words *C-A-N S-L-I-M* Stands for one of the seven chief characteristics of these great winning Stocks at their early developing stages, just before they made huge profits for their shareholders.

You can learn how to pick winners in the stock market, and you can become part owner in the best companies in the world. So, let's get started right now. Here's a sneak preview of *C-A-N S-L-I-M.*

C = Current Quarterly Earnings Per Share: How Much Is Enough?
A = Annual Earnings Increases: Look for Meaiiingful Growth.
N = New Products, New Management, New Highs: Buying at the Right Time.
S = Supply and Demand: Small Capitalization Plus Volume Demand.
L = Leader or Laggard: Which Is Your Stock?
I = Institutional Sponsorship: A Little Goes a Long Way.
M = Market Direction: How to Determine It?

Please begin immediately with Chapter 1.

1

C = Current Quarterly Earnings Per Share: How Much Is Enough?

M/A-Com Inc.

Humana Inc.

Kirby Exploration Co.

What did shares of the above-mentioned microwave component manufacturer, hospital operator, and oil Service Company have in common? From 1977 to 1981, they all posted price run-ups surpassing 900%.

In scrutinizing these and other past stock market superstars, I've found a number of other similarities äs well.

For example, tradiiig volume in these sensational winners swelled substantially before their giant price moves began. The winning Stocks also tended to shuffle around in price consolidation periods for a few months before they broke out and soared. But one key variable stood out from all the rest in importance: the profits of nearly every outstanding stock were booming.

The common Stocks you select for purchase should show a major percentage increase in the current quarterly earnings per share (the most recently reported quarter) when compared to the prior year's same quarter.

Earnings per share are calculated by dividing a company's total aftertax profits by the company's number of common shares outstanding. The percentage increase in earnings per share is the single most important element in stock selection today.

The greater the percentage of increase, the better, äs long äs you aren't misled by comparing current earnings to nearly nonexistent earnings for the year earlier quarter, like 1 cent a share.

Ten cents per share versus one cent may be a 900% increase, but it is definitely distorted and not as meaningful as $1 versus $.50. The 100% increase of $1 versus $.50 is not overstated by comparison to an unusually low number in the year ago quarter.

I am continually amazed at how many professional pension fund managers, as well as individual investors, buy common stocks with the current reported quarter's earnings flat (no change), or even worse, down. There is absolutely no reason for a stock to go anywhere if the current earnings are poor.

Even if the present quarter's earnings are up 5% to 10%, that is simply not enough of an improvement to fuel any significant upward price movement in a stock. It is also easier for a corporation currently showing a mere increase of 7% or 8% to suddenly report lower earnings the next quarter.

Seek Stocks Showing Big Current Earnings Incrcascs

In our models of the 500 best performing Stocks in the 40 years from 1953 through 1993, three out of four of these securities showed earnings iricreases averaging rnore than 70% in the latest publicly reported quarter *before* the Stocks began their major price advance. The one out of four that didn't show solid current quarter increases did so in the very next quarter, and those increases averaged 90%!

If the *best* Stocks had profit increases of this magnitude *before* they advanced rapidly in price, why should you settle for mediocre or down earnings?

Our study showed that among all big gainers between 1970 and 1982, 86% reported higher earnings in their most recently published quarter, and 76% were up over 10%. The median earnings increase was 34% and the mean (average) was up 90%.

You may find that only about 2% of all Stocks listed for trading on the New York or American stock exchanges will, at any one time, show increases of this proportion in current quarterly net iiicome.

But, remember you want to find the exceptional Stocks rather than the lackluster ones, so set your sights high and Start looking for the superior Stocks, the small number of real leaders. They are there.

Success is built on dreanis and ideas; however, it helps to know exactly what you're looking for. Before you Start your search for tomorrow's super stock market leader, let nie teil you about a few of the traps and ni t falls.

Watch Out for Misleading Reports of Earnings

Have you ever read a corporation's quarterly earnings report that stated, "We had a terrible first three months. Prospects for our Company are turning down due to inefficiencies in the home office. Our competition just came out with a better product, which will adversely affect our sales. Furthermore, we are losing our shirt on the new midwestern Operation, which was a real blunder on management's part."

No! Here's what you see. "Greatshakes Corporation reports record sales of $7.2 million versus $6 million (+ 20%) for the quarter ended March 31." If you own their stock, this is wonderful news. You certainly are not going to be disappointed. You think this is a fine Company (otherwise you wouldn't own its stock), and the report confirms your thinking.

Is this record-breaking sales armouncement a good report? Let's suppose the Company also had record earnings of $2.10 per share of stock for the quarter. Is it even better now?

What if the $2.10 was versus $2 (+ 5%) per share in the same quarter the previous year? Why were sales up 20% and earnings ahead only 5%? Something might be wrong—rnaybe the company's profit margins are crumbling. At any rate, if you own the stock, you should be concerned and evaluate the Situation closely to see why the earnings increased only 5%.

Most investors are impressed with what they read, and companies love to put their best foot forward. Even though this corporation may have had all-time record sales, up 20%, it didn't mean much. You must be able to see through slanted published presentations if you want the vital facts.

The key factor for the winning investor must always be **how much the current quarter's earnings are up in percentage terms from the same quarter the year before!**

Let's say your Company discloses that sales climbed 10% and net income advanced 12%. This sounds good, but you shouldn't be concerned with the company's total net income. You don't own the whole organization. You own shares of stock in the corporation. Perhaps the Company issued additional shares or there was other dilution of the common stock. Just because sales and total net income for the Company were up, the report still may not be favorable. Maybe earnings per share of common stock inched up only 2% or 3%.

Break Down Six or Nine Month Earnings into Quarterly Percentage Changes

Suppose your Company announces that earnings for the six months that earlier (+ 25%). Your "pet" stock inust be in great shape. You couldn't ask for better results—or could you?

Beware. The Company reported earnings for six months. What did the stock earn in the last quarter, the three months ended in June?

Maybe in the first quarter ended in March the stock earned $1.60 per share versus $1 (+ 60%). What does this leave for the last quarter ended June 30? Ninety cents versus one dollar. This is a terrible report, even though the way it was presented to you sounded terrific.

If you own common stock in a Company whose earnings had been up 60% and they came out with a Statement of $.90 versus $1 (down 10%), you had better wake up. The outfit might be deteriorating.

You can't always assume that because an earnings report appears to be rosy, everything is fine. You have to look deeper and not accept the reassuring manner of corporate news releases reported in your favorite newspaper.

Many times, earnings declarations are published for the most recent nine months. This teils you nothing, and all too ofteii it masks serious weakness in the numbers that really count. The first quarter may have been up 30%, the second quarter up 10%, and the last quarter off 10%. By always breaking down the figures to show the quarter-by-quarter earnings, you will be able to see a completely different picture and trend.

Omit a Company's One-Time Extraordinary Gains

The last important trap the winning investor should sidestep is being influenced by nonrecurring profits.

If an organization that manufactures Computers reports earnings for the last quarter that include profits from the sale of real estate or a plant, for example, that pari of the earnings should be subtracted from the report. Those are one-time, nonrecurring earnings and are not representative of the true, ongoing profitability of corporate operations. Ignore them.

Set a Minimum Level for Current Earnings Increases

As a general guide for new or experienced investors, I would suggest you *not* buy any stock that doesn't show earnings per share up *at hast 18% or 20%* in the most recent quarter versus the same quarter the

year before. Many successful money-makers use 25% or 30% äs their minimum earnings parameter. And make sure you calculate the percentage change; don't guess or assume. You will be even safer if you insist the last two quarters each show a significant percentage increase in earnings from year-ago quarters.

During bull markets, I prefer to concentrate in equities (comrnon Stocks) that show powerful current earnings leaping 40% or 50% up to 500%. Why not buy the very best merchandise available?

If you want to further sharpen your stock selection process, before you buy, look ahead to the next quarter or two and check the earnings that were reported for those same quarters the previous year. See if the Company will be coming up against unusually large or small earnings achieved a year ago.

In some instances, where the unusual year-earlier earnings are not due to seasonal factors (the December quarter is always big for retailers, for example), this procedure may help you anticipate a strong or poor earnings report due ahead in the coming months.

Many individuals and institutions alike buy Stocks with earnings down in the most recently reported quarter just because they like a Company and think the stock's price is cheap. Usually they accept a story that earnings will rebound strongly in the near future.

While this may be true in some cases (it frequently isn't), the main point is that at any time in the market, you have the choice of investing in at least 5000 or more Stocks. You don't have to accept promises of something that may never occur when alternative investments are actually showing current earnings advancing strongly.

The Debate on Overemphasis of Current Earnings

Recently it has been noted that Japanese firms concentrate more on longer-term profits rather than on trying to maximize current earnings per share.

This is a sound concept and one the better-managed organizations in the United States (a minority of companies) also follow. That is how well-managed entities create colossal quarterly earnings increases, by spending several years on research, developing superior new products, and cutting costs.

But don't be confused. You äs an individual Investor can afford to wait until the point in time when a Company positively proves to you its efforts have been successful and are starting to actually show real earnings increases.

Requiring that current quarterly earnings be up a hefty amount is just another smart way the intelligent investor can reduce the risk of excessive mistakes in stock selection.

Many corporations have mediocre management that continually produces second-rate earnings results. I call them the "entrenched maintainers." These are the companies you want to avoid until someone has the courage to change top management. Ironically, these are generally the companies that strain to pump up their current earnings a dull 8% or 10%. True growth companies with outstanding new products do not have to maximize current results.

Look for Accelerating Quarterly Earnings Growth

My studies of thousands of the most successful concerns in America proved that virtually every corporate stock with an outstanding upward price move showed accelerated quarterly earnings increases some time in the previous ten quarters before the towering price advance began.

Therefore, what is crucial is not just that earnings are up or that a certain price-to-earnings ratio (a stock's price divided by its last twelve months' earnings per share) exists; it is the change and improvement from the stock's prior percentage rate of earning increases that causes a supreme price surge. Wall Street now calls these earnings surprises.

I once mentioned this concept of earnings acceleration to Peter Vermilye, the former head of Citicorp's Trust Investment Division in New York City. He liked the term and feit it was much more accurate and relevant than the phrase "earnings momentum" sometimes used by Investment professionals.

If a Company's earnings are up 15% a year and suddenly begin spurting 40% to 50% a year, it usually creates the basic conditions for important stock price improvement.

Two Quarters of Major Earnings Deceleration May Mean Trouble

Likewise, when the rate of earnings growth Starts to slow and begins meaningful deceleration (for instance, a 50% rate of increase suddenly decreases to only 15% for a couple quarters), the security probably has either topped out permanently, regardless of what analysts and Wall Street [illegible] say, or the rate of nr)warc[orogress will dwindle into a

lengthy and unrewarding price consolidation period characterized by prolonged sideways movement.

I prefer to see two quarters of *material* slowdown before turning negative on a company's earnings since the best of organizations can periodically have one slow quarter.

Consult Log Scale Weekly Graphs

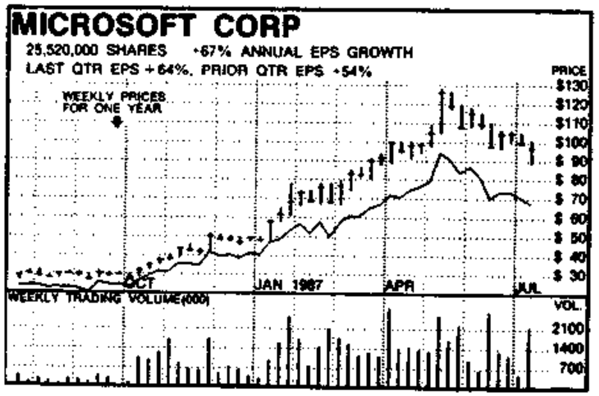
One reason that logarithmic scale graphs are of such great value in security analysis is that acceleration or deceleration in the percentage rate of quarterly earnings increases can be seen very clearly on a log graph.

Log graphs show percentage changes accurately, since one inch anywhere on the price or earnings scale represents the same percentage change. This is not true of arithmetically scaled charts.

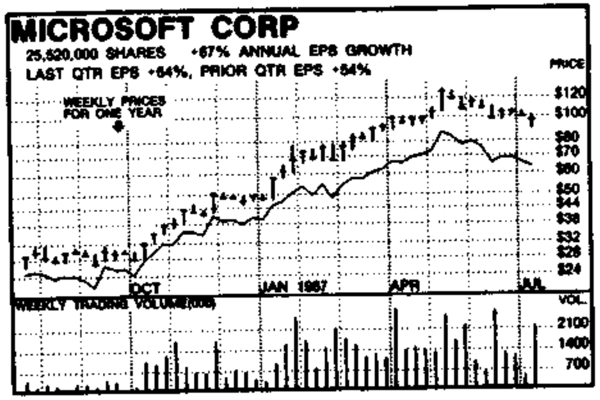
For example, a 100% stock price increase from $10 to $20 a share would show the same space change äs a 50% increase from $20 to $30 a share on an arithmetically scaled chart. A log graph, however, would show the 100% increase äs twice äs large äs the 50% increase.

The principle of earnings acceleration or deceleration is essential to understand.

Fundamental security analysts who recommend Stocks because of an absolute level of earnings expected for the following year could be looking at the wrong set of facts. A stock that earned $5 per share and expects to report $6 the next year can mislead you unless you know the previous trend in the percentage rate of earnings change.



Arithmetic price scale



Log price scale

To say the security is undervalued just because it is selling at a certain price-earnings ratio or because it is in the low range of its historical P/E ratio is also usually nonsense unless primary consideration has first been given to whether the momentum and rate of change in earnings is substantially increasing or decreasing.

Perhaps this partially explains who so few public or institutional investors, such as banks and insurance companies, make worthwhile money following the buy-and-sell recommendations of most securities analysts.

You, as a do-it-yourself investor, can take the latest quarterly earnings per share, add them to the prior three quarters' earnings of a company, and plot the amounts on a logarithmic scale graph. The plotting of the most recent twelve-month earnings each quarter should, in the best companies, put the earnings per share close to or already at new highs.

Check Other Key Stocks in the Group

For added safety, it is wise to check the industry group of your stock. You should be able to find at least one other noteworthy stock in the industry also showing good current earnings. This acts as a confirming factor. If you cannot find any other impressive stock in the group displaying strong earnings, the chances are greater that you have selected the wrong investment.

Note the date when a company expects to report its next quarterly earnings. One to four weeks prior to the report's release, a stock frequently displays unusual price strength or weakness, or simply "hesitates" while the market and other equities in the same group advance. This could give you an early clue of an approaching good or bad report. You may also want to be aware and suspicious of stocks that have gone several weeks beyond estimated reporting time without the release of an earnings announcement.

Where to Find Current Corporate Earnings Reports

New quarterly corporate earnings statements are published every day in the financial section of your local paper, in *Investor's Business Daily*, and in *The Wall Street Journal*. *Investor's Business Daily* separates all new earnings reports into companies with "up" earnings and those disclosing "down" results so you can easily see who produced excellent gains.

AMERICAN TRAVELLERS CORP		ATVC 27¾
Insurance-Acc & Health		Eps 99 Rel 99
Quar Mar 31:	1990	1989
Sales	$18,619,000	$10,010,000
Net Income	2,555,000	1,199,000
Avg shares	3,784,470	3,526,960
Share earns:		(OTC)
Net Income	0.68	0.34
% Change	+100% ★	

WAL-MART STORES		WMT 52
Retail-Discount&Variety		Eps 98 Rel 98
Quar Apr 30:	1990	1989
Sales	$6,819,227,000	$5,403,117,000
Net Income	253,443,000	198,289,000
Avg shares	567,743,000	567,356,000
Share earns:		(NYSE)
Net Income	0.45	0.35
% Change	+29% ★	

NORDSTROM INC		NOBE 27¾
Retail-Apparel/Shoe		Eps 67 Rel 23
Quar Apr 30:	1990	1989
Sales	$565,038,000	$512,210,000
Net Income	13,169,000	22,973,000
Avg shares	81,617,436	81,504,205
Share earns:		(OTC)
Net Income	0.16	0.28
% Change	-43%	

Which earnings report do you think is best?

Chart services published weekly also show earnings reported during the prior week as well as the most recent earnings figures for every stock they chart.

One last point to clarify: **You should always compare a stock's percentage increase in earnings for the quarter ended December, to the December quarter a year earlier.** Never compare the December quarter to the immediately prior September quarter.

You now have the first critical rule for improving your stock selection: **Current quarterly earnings per share should be up a major percentage (at least 20% to 50% or more) over the same quarter last year.** The best ones might show earnings up 100% to 500%! A mediocre 8% or 10% isn't enough! In picking winning stocks, it's the bottom line that counts.

2

A = Annual Earnings Increases: Look for Meaningful Growth

If you want to own part of a business in your home town, do you choose a steadily growing, successful concern or one that is unsuccessful, not growing and highly cyclical?

Most of you would prefer a business that is showing profitable growth. That's exactly what you should look for in common stocks. **Each year's annual earnings per share for the last five years should show an increase over the prior year's earnings.** You might accept one year being down in the last five as long as the following year's earnings quickly recover and move back to new high ground.

It is possible that a stock could earn $4 a share one year, $5 the next year, $6 the next, and the following year—$2. If the next annual earnings statement were $2.50 versus the prior year's $2 (+ 25%), that would not be a good report. The only reason it may seem attractive is that the previous year ($2) was so depressed any improvement would look good. In any case, the profit recovery is slow and is still substantially below the company's peak earnings of $6:

Select Stocks with 25% to 50% Annual Growth Rates

Owning common stock is just the same as being a part owner in a business. And who wants to own part of an establishment showing no growth? **The annual compounded growth rate of earnings in the superior firms you hand pick for purchasing stock in should be from 25% to 50%, or even 100% or more, per year over the last 4 or 5 years.**

Between 1970 and 1982, the average annual compounded earnings

growth rate of all outstanding performing stocks at their early emerging stage was 24%. The median, or most common, growth rate was 21% per year, and three out of four of the prominent winners revealed at least some positive annual growth rate over the five years preceding the giant increase in the value of the stock. One out of four were turnarounds.

A typical successful yearly earnings per share growth progression for a company's latest five-year period might look something like $.70, $1.15, $1.85, $2.80, $4.

The earnings estimate for the next year should also be up a healthy percentage; the greater the percentage, the better. However, remember **estimates are opinions.** Opinions may be wrong whereas actual reported earnings are facts that are ordinarily more dependable.

What Is a Normal Stock Market Cycle?

Most bull (up) market cycles last two to four years and are followed by a recession or bear (down) market and eventually another bull market in common stocks.

In the beginning phase of a new bull market, growth stocks are usually the first sector to lead the market and make new price highs. Heavy basic industry groups such as steel, chemical, paper, rubber, and machinery are commonly more laggard followers.

Young growth stocks will usually dominate for at least two bull market cycles. Then the emphasis may change for the next cycle, or a short period, to turnaround or cyclical stocks or newly improved sectors of the market, such as consumer growth stocks, over-the-counter growth issues, or defense stocks that sat on the sidelines in the previous cycle.

Last year's bloody bums become next year's heroes. Chrysler and Ford were two such spirited turnaround plays in 1982. Cyclical and turnaround opportunities led in the market waves of 1953—1955, 1963-1965, arid 1974-1975. Papers, aluminums, autos, chemicals, and plastics returned to the fore in 1987. Yet, even in these periods, there were some pretty dramatic young growth stocks available. Basic industry stocks in the United States frequently represent older, more inefficient industries, some of which are no longer internationally competitive and growing. This is perhaps not the area of America's future excellence.

Cyclical stocks' price moves tend to be more short-lived when they do occur, and these stocks are much more apt to suddenly falter and encounter disappointing quarterly earnings reports. Even in the stretch where you decide to buy strong turnaround situations, the annual compounded growth rate could, in many cases, be 5% to 10%.

Requiring a company to show two consecutive quarters of sharp earnings recovery should put the earnings for the latest twelve months into, or very near, new high ground. If the 12 months earnings line is shown on a chart, the sharper the upswing the better. This will make it possible in many cases for even the "old dog" about-face stock to show some annual growth rate for the prior five-year time period. Sometimes one quarter of earnings turnaround will suffice if the earnings upswing is so dramatic that it puts the 12 months ended earnings line into new highs.

Check the Stability of a Company's Five-Year Earnings Record

While the percentage rate of increase in earnings is most important, an additional factor of value, which we helped pioneer in the measurement and use of, is the stability and consistency of the past five years' earnings. We display the number differently than most statisticians do.

Our stability measurements are expressed on a scale from 1 to 99. The lower the figure, the more stable the past earnings record. The figures are calculated by plotting quarterly earnings for the last five years and fitting a trend line around the plot points to determine the degree of deviation from the basic earnings trend.

Growth stocks with good stability of earnings tend to show a stability figure below 20 or 25. Equities with a stability rating over 30 are more cyclical and a little less dependable in their growth. All other things being equal, you may want to choose the security showing a greater degree of consistency and stability in past earnings growth.

Earnings stability numbers are usually shown immediately after a company's five-year growth rate, although most analysts and investment services do not bother to make the calculation.

EARNINGS GROWTH RATE (STABILITY) RANK		
1983-87	+31%	(6)
1981-85	+19%	(8)
1979-83	+19%	[illegible]

Earning* stability rank

If you primarily restrict your selections to ventures with proven growth records, you avoid the hundreds of investments having erratic earnings histories or a cyclical recovery in profits that may top out as they approach earnings peaks of the prior cycle.

How to Weed Out the **Losers** in a Group

When you investigate a specific industry group, **using the five-year growth criteria** will also **help you weed out** 80% **of the stocks in an industry.** This is because the majority of companies in an industry have lackluster growth rates or no growth.

When Xerox was having its super performance of 700% growth from March 1963 to June 1966, its earnings growth rate averaged 32% per year. Wal-Mart Stores, a discount retailer, sported an annual growth rate from 1977 to 1990 of 43% and boomed in price an incredible 11,200%. Cisco Systems growth rate in October 1990 was an enormous 257% per year and Microsoft's was 99% in October 1986, both before their long advances.

The fact that an investment possesses a good five-year growth record doesn't necessarily cause it to be labeled a growth stock. Ironically, in fact, some companies called growth stocks are producing a substantially slower rate of growth than they did in several earlier market eras. These should usually be. avoided. Their record is more like a fully matured or nearly senile growth stock. Older and larger organizations frequently show slow growth.

New Cycles Create New Leaders

Each soaring new cycle in the stock market will catapult fresh leadership stocks to the attention of the market, some of which will begin to be called growth stocks. The growth record in itself, however, is only a starting point for would-be victorious investors, and it should be the first of many earnings measurements you should check.

For example, companies with outstanding five-year growth records of 30% per year but whose current earnings in the last two quarters have slowed significantly to + 15% and + 10% should be avoided in most instances.

Insist on Both Annual and Current Quarterly Earnings Being Excellent

We prefer to see current quarterly earnings accelerating or at least maintaining the trend of several past quarters. **A standout stock needs a**

sound growth record during recent years but also needs a strong current earnings record in the last few quarters. It is the unique combination of these two critical factors, rather than one or the other being outstanding, that creates a superb stock, or at least one that has a higher chance of true success.

Investor's Business Daily provides a relative earnings ranking (based on the latest five-year annual earnings record and recent quarterly earnings reports) for all common stocks shown in the daily NYSE, AMEX, and OTC stock price quotation tables.

More than 6000 stocks are compared against each other and ranked on a scale from 1 to 99. An 80 earnings per share rank means a company's current and five-year historical earnings record outclassed 80% of all other companies.

The earnings record of a corporation is the most critical, fundamental factor available for selecting potential winning stocks.

Arc Price-Earnings Ratios Important?

Now that we've discussed the indispensable importance of a stock's current quarterly earnings record and annual earnings increases in the last five years, you may be wondering about a stock's price-to-earnings (P/E) ratio. How important is it in selecting stocks? Prepare yourself for a bubble-bursting surprise.

P/E ratios have been used for years by analysts as their basic measurement tool in deciding if a stock is undervalued (has a low P/E) and should be bought or is overvalued (has a high P/E) and should be sold.

Factual analysis of each cycle's winning stocks shows that P/E **ratios have very little to do with whether a stock should be bought or not.** A stock's P/E ratio is not normally an important cause of the most successful stock moves.

Our model book studies proved the percentage increase in earnings per share was substantially more crucial than the P/E ratio as a cause of impressive stock performance.

During the 33 years from 1953 through 1985 the average P/E for the best performing stocks at their early emerging stage was 20 (the Dow

IFRANKLIN RES INC
3.494.000 SHARES -97% ANNUAL EPS GROWTH
LAST QTR **EPS** -115%, PRIOR QTR EPS -150%

Profile of a standout stock

Jones Industrial's P/E at the same time averaged 15). While advancing, these stocks expanded their P/Es to approximately 45 (125% expansion of P/E ratio).

Why You Missed Some Fabulous Stocks!

While these figures are merely averages, they do strongly imply that **if you were not willing to pay an average of 20 to 30 times earnings for growth stocks in the 40 years through 1993, you automatically eliminated most of the best investments available!**

P/Es were higher on average from 1953 to 1970 and lower between 1970 and 1982. From 1974 through 1982, the average beginning P/E was 15 and expanded to 31 at the stock's top. P/Es of winning stocks during this period tended to be only slightly higher than the general market's P/E at the beginning of a stock's price advance.

High P/Es were found to occur because of bull markets. With the exception of cyclical stocks, low P/Es generally occurred because of bear markets. Some OTC growth stocks may also display lower P/Es if the stocks are not yet widely owned by institutional investors.

Don't buy a stock solely because the P/E **ratio looks cheap.** There usually are good reasons why it is cheap, and there is no golden rule in the marketplace that a stock which sells at eight or ten times earnings cannot eventually sell at four or five times earnings. Many years ago, when I was first beginning to study the market, I bought Northrop at four times earnings and in disbelief watched the outfit decline to two times earnings.

How Price-Earnings Ratios Are Misused

Many Wall Street analysts inspect the historical high and low price-earnings ratios of a stock and feel intoxicating magic in the air when a security sells in the low end of its historical P/E range. Stocks are frequently recommended by researchers when this occurs, or when the price starts to drop, because then the P/E declines and the stock appears to be a bargain.

Much of this kind of analysis is based on questionable personal opinions or theories handed down through the years by academicians and some analysts. Many "green" newcomers to the stock market use the faulty *method of* selecting stock investments based chiefly 011 low P/E ratios and go wrong more often than not.

This system of analysis often ignores far more basic trends. For example, the general market may have topped out, in which case all stocks are headed lower and it is ridiculous to say "Electronic Gizmo" is undervalued because it was 22 times earnings and can now be bought for 15 times earnings. The market break of 1987 hurt many value buyers.

The Wrong Way to Analyze Companies in an Industry

Another common, poor use of price-earnings ratios by both amateurs and professionals alike is to evaluate the stocks in an industry and conclude that the one selling at the cheapest P/E is always undervalued and is therefore, the most attractive purchase. This is usually the company with the most ghastly earnings record, and that's precisely why it sells at the lowest P/E.

The simple truth is that stocks at any one time usually sell near their current value. So the stock which sells at 20 times earnings is there for one set of reasons, and the stock that trades for 15 times earnings is there for other reasons the market already has analyzed. The one selling for seven times is at seven times because its overall record is more deficient. **Everything sells for about what it is worth** at the time.

If a company's price level and price-earnings ratio changes in the near future, it is because conditions, events, psychology, and earnings continue to improve or suddenly start to deteriorate as the weeks and months pass.

Eventually a stock's P/E will reach its ultimate high point, but this normally is because the general market averages are peaking and starting an important decline, or the stock definitely is beginning to lose its earnings growth.

High P/E stocks can be more volatile, particularly if they are in the high-tech area. The price of a high P/E stock can also get temporarily ahead of itself, but so can the price of low P/E stocks.

Some High P/Es That Were Cheap

It should be remembered that in a few captivating smaller-company growth situations that have revolutionary new product breakthroughs, high P/E ratios can actually be low. Xerox sold for 100 times earnings

in 1960—before it advanced 3300% in price (from a split-adjusted price of $5 to $170). Syntex sold for 45 times earnings in July 1963, before it advanced 400%. Genentech was priced at 200 times earnings in the over-the-counter market in early November 1985, and it bolted 300% in the next five months. All had fantastic new products.

Don't Sell High P/E Stocks Short

When the stock market was at rock bottom in June 1962, a big, heavyset Beverly Hills investor barged into the office of a broker friend of mine and in a loud voice shouted Xerox was drastically overpriced because it was selling for 50 times earnings. He sold 2000 shares short at $88.

After he sold short this "obviously overpriced stock," it immediately started advancing and ultimately reached a price equal to $1300 before adjusting for stock splits. So much for amateur opinions about P/E ratios being too high. **Investors' personal opinions are generally wrong; markets seldom are.**

Some institutional research firms in recent years published services and analyses based on the principle of relative P/E ratios for companies, compared to individual company earnings growth rates. Our detailed research over many cycles has shown these types of studies to be misleading and of little practical value.

The conclusion we have reached from years of in-depth research into winning corporations is that the percentage increase and acceleration in earnings per share is more important than the level of the stock's P/E ratio. At any rate, it may be easier to spot emerging new trends than to accurately assess correct valuation levels.

In summary: **Concentrate on stocks with a proven record of significant annual earnings growth in the last five years.** Don't accept excuses; insist the annual earnings increases plus strong recent quarterly earnings improvements be there.

3

N = New Products, New Management, New Highs: Buying at the Right Time

It takes something new to produce a startling advance in the price of a stock.

This something new can be an important new product or service, selling rapidly and causing earnings to accelerate above previous rates of increase. It could also be new top management in a company during the last couple of years. A new broom sweeps clean, or at least may bring inspiring ideas and vigor to the ball game.

Or the new event could be substantial changes within the company's industry. Industrywide shortages, price increases, or new technology could affect almost all members of the industry group in a positive way.

New Products That Created Super Successes

1. Rexall's new Tupperware division, in 1958, helped push the company's stock to $50 a share, from $16.
2. Thiokol in 1957-1959 came out with new rocket fuels for missiles, propelling its stock from $48 to the equivalent of $355.
3. Syntex, in 1963, marketed the oral contraceptive pill. In six months the stock soared from $100 to $550.
4. McDonald's, in 1967-1971, with low-priced fast food franchising, snowballed into an 1100% profit for stockholders.
5. Levitz Furniture stock increased 660% in 1970-1971, with the popularity of their giant warehouse discount furniture centers.

6. Houston Oil & Gas, in 1972-1973, with a major new oil field ran up 968% in 61 weeks and later in 1976 picked up another 367%.
7. Computervision stock advanced 1235% in 1978-1980, with the introduction of new Cad-Cam factory automation equipment.
8. Wang Labs Class B stock grew 1350% in 1978-1980, due to the creation of their new word-processing office machines.
9. Price Company stock shot up more than 15 times in 1982-1986 with the opening of a southern California chain of innovative wholesale warehouse membership stores.
10. Amgen developed two successful new biotech drugs, Epogen and Neupogen, and the stock raced ahead from 60% in 1990 to the equivalent of 460% in January 1992.
11. Cisco Systems, another California company, created routers and networking equipment that allowed company links with geographically dispersed local area computer networks. The stock advanced over 2000% in 3½ years.
12. International Game Technology rose an astounding 1600% in 1991-1993 with new microprocessor-based gaming products.

In our study of greatest stock market winners from 1953 through 1993, we discovered more than 95% of these stunning successes in American industry either had a major new product or service, new management, or an important change for the better in the conditions of their particular industry.

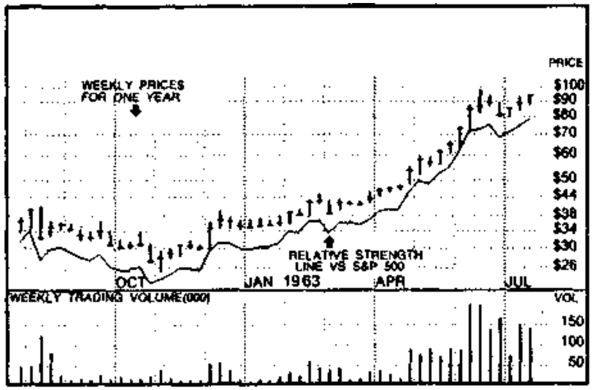
The Stock Market's Great Paradox

There is another fascinating phenomenon we found in the early stage of all winning stocks. We call it "the great paradox." Before I tell you what this last new observation is, I want you to look at three typical stocks shown on the next page. Which one looks like the best buy to you? Which stock would you probably avoid?

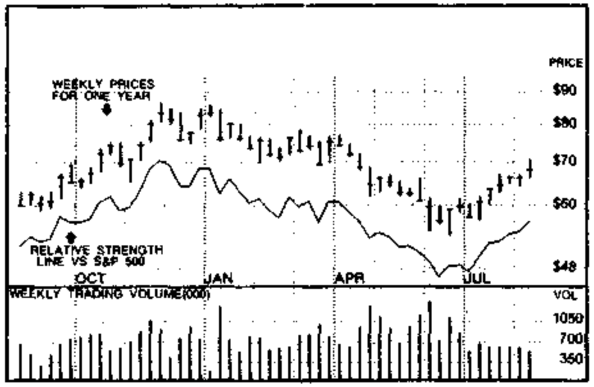
Among the thousands of individual investors attending my investment lectures in the 1970s, 1980s, and 1990s, 98% said they do not buy stocks that are making new highs in price.

The staggering majority of individual investors, whether new or experienced, feel delightful comfort in buying stocks that are down substantially from their peaks.

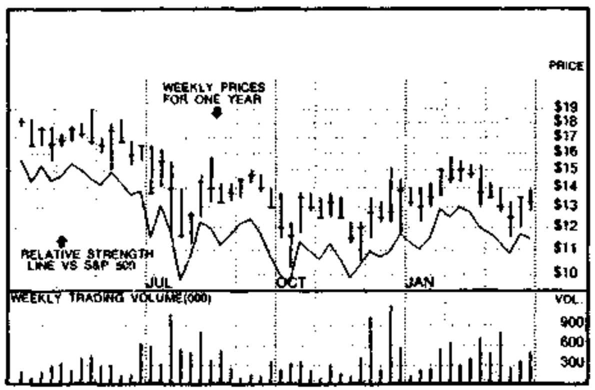
Stock A



Stock B



Stock C



Which stock looks like the best buy?

I have provided extensive research for over 600 institutional investors in the United States. It is my experience that most institutional money managers are also bottom buyers—they, too, feel safer buying stocks that look cheap because they're either down a lot in price or selling near their lows.

The hard-to-accept great paradox in the stock market is that **what seems too high and risky to the majority usually goes higher and what seems low and cheap usually goes lower.** Haven't you seen this happen before?

In case you find this supposed "high-altitude" method a little difficult to boldly act upon, let me cite another study we conducted. An analysis was made of the daily newspapers' new-high and new-low stock lists during several good, as well as poor, market periods.

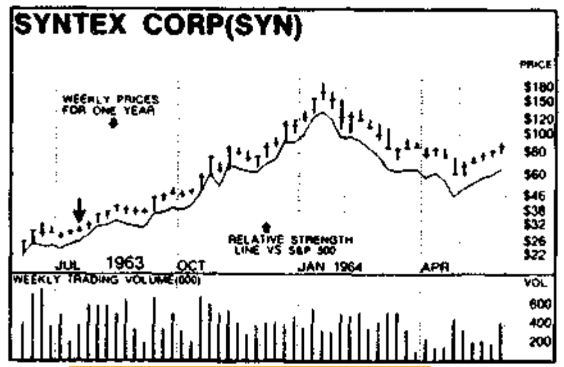
Our findings were simple. Stocks on the new-high list tended to go higher, and those on the new-low list tended to go lower.

Put another way, a stock listed in the financial section's new-low list of common stocks is usually a pretty poor prospect, whereas **a stock making the new-high list the first time during a bull market and accompanied by a big increase in trading volume might be a red-hot prospect worth checking into. Decisive investors should be out of a stock long before it appears on the new-low list.**

You may have guessed by now what the last intriguing new realization is that I promised to disclose to you earlier. So here are the three stocks you had to choose among on the previous page, Stock A, Stock B, and Stock C. Which one did you pick? Stock A (Syntex Corp, see below) was the right one to buy. The small arrow pointing down above the weekly prices in July 1963 shows the same buy point at the end of Stock A in July on the previous page. Stock B and Stock C both declined.

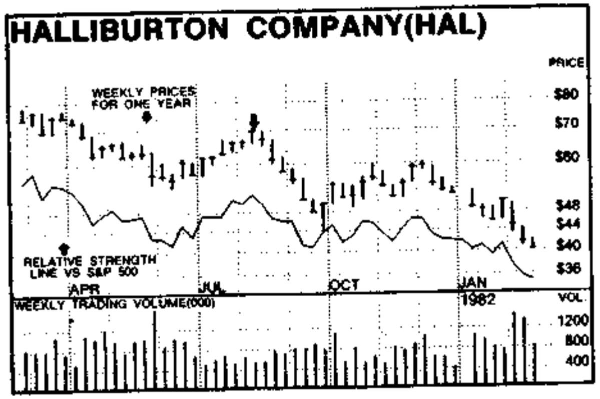
Stock A

ADJUSTED FOR A 3:1 SPLIT



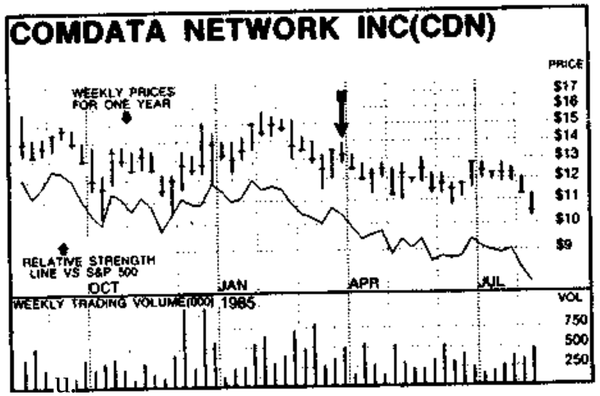
+ 400% in six month* from July 1963

Stock B



- 42% in six months from August

Stock C



- 21% in five months from March

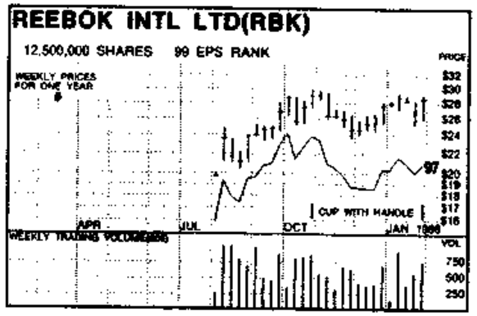
When to Correctly Begin Buying a Stock

A stock should be close to or actually making a new high in price after undergoing a price correction and consolidation. The consolidation (base-building period) in price could normally last anywhere from seven or eight weeks up to fifteen months.

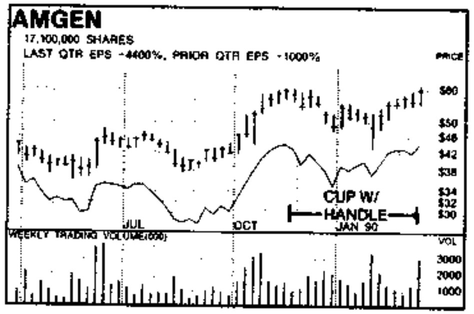
As the stock emerges from its price adjustment phase, slowly resumes an uptrend, and is approaching new high ground, this is, believe it or not, the correct time to consider buying. The stock should be bought just as it's starting to break out of its price base.

You must avoid buying once the stock is extended more than 5% or

10% from the exact buy point off the base. Here is an example of the proper time to have bought Reebok, at $29, in February 1986 before it zoomed 260%. The second graph shows the correct time to have bought Amgen at $60—in March 1990—before itjumped more than sixfold.



392% increase in 13 months



681% increase in 22 months

How Does a Stock Go from $50 to $100?

As a final appeal to your trusty common sense and judgment, it should be stated that if a security has traded between $40 and $50 a share over many months and is now selling at $50 and is going to double in price, it positively must first go through $51, $52, $53, $54, $55, and the like, before it can reach $100.

Therefore, **your job is to buy when a stock looks high to the majority of conventional investors and to sell after it moves substantially higher and finally begins to look attractive to some of those same investors.**

In conclusion: **Search for corporations that have a key new product or service, new management, or changes in conditions in their industry. And most importantly, companies whose stocks are emerging from price consolidation patterns and are close to, or actually touching, new highs in price are usually your best buy candidates.** There will always be something new occurring in America every year. In 1993 alone, there were nearly 1,000 initial public offerings. Dynamic, innovative new companies—a bundle of future, potential big winners.

4

S = Supply and Demand: Small Capitalization Plus Big Volume Demand

The law of supply and demand determines the price of almost everything in your daily life. When you go to the grocery store and buy fresh lettuce, tomatoes, eggs, or beef, supply and demand affects the price.

The law of supply and demand even impacted the price of food and consumer goods in former Communist, dictator-controlled countries where these state-owned items were always in short supply and frequently available only to the privileged class of higher officials in the bureaucracy or in the black market to comrades who could pay exorbitant prices.

The stock market does not escape this basic price principle. **The law of supply and demand is more important than all the analyst opinions on Wall Street.**

Big Is Not Always Better

The price of a common stock with 300 million shares outstanding is hard to budge up because of the large supply of stock available. A tremendous volume of buying (demand) is needed to create a rousing price increase.

On the other hand, if a company has only 2 or 3 million shares of common stock outstanding, a reasonable amount of buying can push the stock up rapidly because of the small available supply.

If you are choosing between two stocks to buy, one with 10 million shares outstanding and the other with 60 million, the smaller one will usually be the rip-roaring performer if other factors are equal.

The total number of shares of common stock outstanding in a company's capital structure represents the potential amount of stock available for purchase.

The stock's "floating supply" is also frequently considered by market professionals. It measures the number of common shares left for possible purchase after subtracting the quantity of stock that is closely held by company management. **Stocks that have a large percentage of ownership by top management are generally your best prospects.**

There is another fundamental reason, besides supply and demand, that companies with large capitalizations (number of shares outstanding) as a rule produce dreadful price appreciation results in the stock market. The companies themselves are simply too big and sluggish.

Pick Entrepreneurial Managements Rather Than Caretakers

Giant size may create seeming power and influence, but size in corporations can also produce lack of imagination from older, more conservative "caretaker managements" less willing to innovate, take risks, and keep up with the times.

In most cases, top management of large companies does not own a meaningful portion of the company's common stock. This is a serious defect large companies should attempt to correct.

Also, too many layers of management separate the senior executive from what's really going on out in the field at the customer level. And in the real world, the ultimate boss in a company is the customer.

Times are changing at a quickening pace. A corporation with a fast-selling, hot new product today will find sales slipping within three years if it doesn't continue to have important new products coming to market.

Most of today's inventions and exciting new products and services are created by hungry, innovative, small- and medium-sized young companies with entrepreneurial-type management. As a result, these organizations grow much faster and create most of the new jobs for all Americans. This is where the great future growth of America lies. Many of these companies will be in the services or technology industries.

If a mammoth-sized company occasionally creates an important new product, it still may not materially help the company's stock because the new product will probably only account for a small percentage of the gigantic company's sales and earnings. The product is simply a little drop in a bucket that's just too big.

Institutional Investors Have a Big Cap Handicap

Many large institutional investors create a serious disadvantage for themselves because they incorrectly believe that due to their size they can *only* buy large capitalization companies. This automatically eliminates from consideration most of the true growth companies. It also practically guarantees inadequate performance because these investors may restrict their selections mainly to slowly decaying, inefficient, fully matured companies. As an individual investor, you don't have this limitation.

If I were a large institutional investor, I would rather own 200 of the most outstanding, small- to medium-sized growth companies than 50 to 100 old, overgrown, large-capitalization stocks that appear on everyone's "favorite fifty" list.

If you desire clear-cut factual evidence, the 40 year study of the greatest stock market winners indicated **more than 95% of the companies had fewer than 25 million shares in their capitalization when they had their greatest period of earnings improvement and stock market performance. The average capitalization of top-performing listed stocks from 1970 through** 1982 **was** 11.8 **million shares. The median stock exhibited 4.6 million shares outstanding before advancing rapidly in price.**

Foolish Stock Splits Can Hurt

Corporate management at times makes the mistake of excessively splitting its company's stock. This is sometimes done based upon questionable advice from the company's Wall Street investment bankers.

In rny opinion, it is usually better for a company to split its shares 2-'for-1 or 3-for-2, rather than 3-for-l or 5-for-l. (When a stock splits 2-for-1, you get two shares for each one previously held, but the new shares sell for half the price.)

Overabundant stock splits create a substantially larger supply and may put a company in the more lethargic performance, or "big cap," status sooner.

It is particularly foolish for a company whose stock has gone up in price for a year or two to have an extravagant stock split near the end of a bull market or in the early stage of a bear market. Yet this is exactly what most corporations do.

They think the stock will attract more buyers if it sells for a cheaper price per share. This may occur, but may have the opposite result the company wants, particularly if it's the second split in the last couple of years. Knowledgeable professionals and a few shrewd traders will probably use the oversized split as an opportunity to sell into the obvious "good news" and excitement, and take their profits.

Many times a stock's price will top around the second or third time it splits. However, in the year preceding great price advances of the leading stocks, in performance, only 18% had splits.

Large holders who are thinking of selling might feel it easier to sell some of their 100,000 shares before the split takes effect than to have to sell 300,000 shares after a 3-for-l split. And smart short sellers (a rather infinitesimal group) pick on stocks that are beginning to falter after enormous price runups—three-, five-, and ten-fold increases—and which are heavily owned by funds. The funds could, after an unreasonable stock split, find the number of their shares tripled, thereby dramatically increasing the potential number of shares for sale.

Look for Companies Buying Their Own Stock in the Open Market

One fairly positive sign, particularly in small- to medium-sized companies, is for the concern to be acquiring its own stock in the open marketplace over a consistent period of time. This reduces the number of shares of common stock in the capital structure and implies the corporation expects improved sales and earnings in the future.

Total company earnings will, as a result, usually be divided among a smaller number of shares, which will automatically increase the earnings per share. And as we've discussed, **the percentage increase in earnings per share is one of the principal driving forces behind outstanding stocks.**

Tandy Corp., Teledyne, and Metromedia are three organizations that successfully repurchased their own stock during the era from the mid-1970s to the early 1980s. All three companies produced notable results in their earnings-per-share growth and in the price advance of their stock.

Tandy (split-adjusted) stock increased from $2¾ to $60 between 1973 and 1983. Teledyne stock zoomed from $8 to $190 in the thirteen years prior to June 1984, and Metromedia's stock price soared to $560 from $30 in the six years beginning in 1977. Teledyne shrunk its capitalization from 88 million shares in 1971 to 15 million shares and increased its earnings from $0.61 a share to nearly $20 per share with eight different huvbacks.

Low Corporate Debt to Equity Is Usually Better

Alter you have picked a stock with a small or reasonable number of shares in its capitalization, it pays to **check the percentage of the firm's total capitalization represented by long-term debt or bonds. Usually the lower the debt ratio, the safer and better the company.**

Earnings per share of companies with high debt-to-equity ratios can be clobbered in difficult periods of high interest rates. These highly leveraged companies generally are deemed to be of poorer quality and higher risk.

A corporation that has been reducing its debt as a percent of equity over the last two or three years is well worth considering. If nothing else, the company's interest expense will be materially reduced and should result in increased earnings per share.

The presence of convertible bonds in a concern's capital structure could dilute corporate earnings if and when the bonds are converted into shares of common stock.

It should be understood that smaller capitalization stocks are less liquid, are substantially more volatile, and will tend to go up and down faster; therefore, they involve additional risk as well as greater opportunity. There are, however, definite ways of minimizing your risks, which will be discussed in Chapter 9.

Lower-priced stocks with thin (small) capitalization and no institutional sponsorship or ownership should be avoided, since they have poor liquidity and a lower-grade following.

A stock's daily trading volume is our best measure of its supply and demand. Trading volume should dry up on corrections and increase significantly on rallies. As a stock's price breaks out of a sound and proper base structure, its volume should increase at least 50% above normal. In many cases, it can increase 100% or more.

In summary, remember: **stocks with a small or reasonable number of shares outstanding will, other things being equal, usually outperform older, large capitalization companies.**

5

L = Leader or Laggard: Which Is Your Stock?

Most of the time, people buy stocks they like, stocks they feel good about, or stocks they feel comfortable with, like an old friend, old shoes, or an old dog. These securities are frequently sentimental, draggy slowpokes rather than leaping leaders in the overall exciting stock market.

Let's suppose you want to buy a stock in the computer industry. If you buy the *leading* security in the group and your timing is sound, you have a crack at real price appreciation.

If, on the other hand, you buy equities that haven't yet moved or are down the most in price, because you feel safer with them and think you're getting a real bargain, you're probably buying the sleepy losers of the group. Don't dabble in stocks. Dig in and do some detective work.

Buy among the Best Two or Three Stocks in a Group

The top two or three stocks actionwise in a strong industry group can have unbelievable growth, while others in the pack may hardly stir a point or two. Has this ever happened to you?

In 1979 and 1980, Wang Labs, Prime Computer, Datapoint, Rolm Corp., Tandem Computer, and other small computer companies had five-, six-, and seven-fold advances before topping and retreating, while grand old IBM just sat there and giants Burroughs, NCR, and Sperry Rand turned in lifeless price performances. In the next bull market cycle, IBM finally sprang to life and produced excellent results. Home

Depot advanced 10 times from 1988 to 1992, **while Waban** and Hechinger, the laggards, clearly underperformed.

Avoid Sympathy Stock Moves

There is very little that's really new in the stock market. History just keeps repeating itself. In the summer of 1963, I bought Syntex, which afterwards advanced 400%. Yet most people would not buy it then because it had just made a new high in price at $100 and its P/E ratio, at 45, seemed too high.

Several investment firms recommended G. D. Searle, a sympathy play, which at the same time looked much cheaper in price and had a similar product to Syntex's. But Searle failed to produce stock market results. Syntex was the leader, Searle the laggard.

Sympathy plays are stocks in the same group as a leading stock, but ones showing a more mediocre record and weaker price performance. They eventually attempt to move up and follow "in sympathy" the powerful price movement of the real group leader.

In 1970, Levitz Furniture became an electrifying stock market winner. Wickes Corp. copied Levitz and plunged into the warehouse furniture business.

Many people bought Wickes instead of Levitz because it was cheaper in price. Wickes never performed. It ultimately got into financial trouble, whereas Levitz increased 900% before it finally topped. As Andrew Carnegie, the steel industry pioneer, said in his autobiography, "The first man gets the oyster; the second, the shell."

Is the Stock's Relative Price Strength Below 70?

Here is a simple, easy-to-remember measure that will help tell you if a security is a leader or a laggard. If the stock's relative price strength, on a scale from 1 to 99, is below 70, it's lagging the better-performing stocks in the overall market. That doesn't mean it can't go up in price, it just means *if it* goes up, it will probably rise a more inconsequential amount.

Relative price strength normally compares a stock's price performance to the price action of a general market average like the Standard & Poor's (S&P) Index, or in some cases, all other stocks. A relative strength of 70, for example, means a stock outperformed 70% of the stocks in the comparison group during a given period, say, the last six or twelve months.

The 500 best-performing listed equities for each year from 1953 through 1993 averaged a relative price strength rating of 87 just before their major increase in price actually began. So the determined winner's rule is: Avoid laggard stocks and avoid sympathy movements. Look for the genuine leaders!

Most of the better investment services show both a relative strength line and a relative strength number and update these every week for a list of thousands of stocks.

Relative strength numbers are shown each day for all stocks listed in the *Investor's Business Daily* NYSE, AMEX, and NASDAQ price tables. Updated relative strength numbers are also shown in Daily Graphs charting service each week.

Pick 80s and 90s That Arc in a Chart Base Pattern

If you want to upgrade your stock selection and concentrate on the best leaders, you could consider restricting your buys to companies showing a relative strength rank of 80 or higher. Establish some definite discipline and rules for yourself.

If you do this, make sure the stock is in a sound base-building zone (proper sideways price consolidation pattern) and that the stock is not extended (up) more than 5% or 10% above this base pattern. This will prevent you from chasing stocks that have raced up in price too rapidly above their chart base patterns. For example, in the Reebok chart shown at the end of Chapter 3, if the exact buy point was $29, the stock should not be purchased more than 5% or 10% above $29.

If a relative price strength line has been sinking for seven months or more, or if the line has an abnormally sharp decline for four months or more, the stock's behavior is questionable.

Why buy an equity whose relative performance is inferior and straggling drearily behind a laige number of other, better-acting securities in the market? Yet most investors do, and many do it without ever looking at a relative strength line or number.

Some large institutional portfolios are riddled with stocks showing prolonged downtrends in relative strength. I do not like to buy stocks with a relative strength rating below 80, or with a relative strength line in an overall downtrend.

In fact, the really big money-making selections generally have a relative strength reading of 90 or higher just before breaking out of their first or second base structure. A potential winning stock's relative strength should be the same as a major league pitcher's fast ball. The average big league fast ball is clocked about 86 miles per hour and the outstanding pitchers throw "heat" in the 90s.

The complete lack of investor awareness, or at least unwillingness, in establishing and following minimum realistic standards for good stock selection reminds me that doctors many years ago were ignorant of the need to sterilize their instruments before each operation. So they kept killing off excessive numbers of their patients until surgeons finally and begrudgingly accepted studies by a young French chemist named Louis Pasteur on the need for sterilization.

It isn't very rewarding to make questionable decisions in any arena. And in evaluating the American economy, investors should zero in on sound new market leaders and avoid anemic-performance investments.

Always Sell Your Worst Stock First

If you own a portfolio of equities, you must learn to **sell your worst-performing stocks first and keep your best-acting investments a little longer.** In other words, sell your cats and dogs, your losers and mistakes, and try to turn your better selections into your big winners.

General market corrections, or price declines, can help you recognize new leaders if you know what to look for. The more desirable growth stocks normally correct 1½ to 2/2 times the general market averages. However as a rule, growth stocks declining the least (percentagewise) in a bull market correction are your strongest and best investments, and stocks that plummet the most are your weakest choices.

For example, if the overall market suffers a 10% intermediate term falloff, three successful growth securities could drop 15%, 20%, and 30%. The ones down only 15% or 20% are likely to be your best investments after they recover. Of course, a stock sliding 35% to 40% in a general market decline of 10% could be flashing you a warning signal, and you should, in many cases, steer clear of such an uncertain actor.

Pros Make Mistakes Too

Many professional investment managers make the serious mistake of buying stocks that have just suffered unusually large price drops. In

June 1972, a normally capable, leading institutional investor in Maryland bought Levitz Furniture after its first abnormal price break in one week from $60 to around $40. The stock rallied for a few weeks, rolled over, and broke to $18.

Several institutional investors bought Memorex in October 1978, when it had its first unusual price break. It later plunged.

Certain money managers in New York bought Dome Petroleum in September 1981 after its sharp drop from $16 to $12, because it seemed cheap arid there was a favorable story going around Wall Street on the stock. Months later Dome sold for $1, and the street talk was that the company might be in financial difficulties.

None of these professionals had recognized the difference between the normal price declines and the highly abnormal corrections that were a sign of potential disaster in this stock.

Of course, the real problem was that these expert investors all relied solely on fundamental analysis (and stories) and their personal opinion of value (lower P/E ratios), with a complete disregard for what market action could have told them was really going on. **Those who ignore what the marketplace is saying usually suffer some heavy losses.**

Once a general market decline is definitely over, the first stocks that bounce back to new price highs are almost always your authentic leaders.

This process continues to occur week by week for about three months or so, with many stocks recovering and making new highs. To be a truly astute professional or individual investor you must learn to recognize the difference between normal price action and abnormal activity. When you understand how to do this well, people will say you have "a good feel for the market."

Control Data—Abnormal Strength in a Weak Market

During a trip to New York in April 1967, I remember walking through a broker's office on one day when the Dow Jones Industrial Average was down over twelve points. When I looked up at the electronic ticker tape showing prices moving across the wall, Control Data was trading in heavy volume at $62, up $3\frac{1}{2}$ points for the day. I immediately bought the stock at the market, because I knew Control Data well, and this was abnormal strength in the face of a weak overall market. The stock subsequently reached $150.

In April 1981, just as the 1981 bear market was commencing, MCI Communications, a Washington, D.C.-based telecommunications stock trading in *the* over-the-counter market, broke out of a price base at $15. It advanced to the equivalent of $90 in the following 21 months.

MCI tripled in a declining market. This was a great example of abnormal strength during a weak market. Lorillard did the same thing in the 1957 bear market. Software Toolworks soared in January 1990.

So don't forget: **It seldom pays to invest in laggard performing stocks even if they look tantalizingly cheap. Look for the market leader.**

6

I = Institutional Sponsorship: A Little Goes A Long Way

It takes big demand to move supply up, and the largest source of demand for stocks is by far the institutional buyer. A **stock certainly does not need a large number of institutional owners, but it should have at least a few such sponsors. Three to ten might be a minimum or reasonable number of mutual fund sponsors, although some stocks might have a good deal more.**

The would-be **winning investor should learn to sort through and recognize that certain institutional sponsors are more savvy, have a stronger performance record, and are better at choosing stocks than others are. I call it analyzing the quality of sponsorship.**

What Is Institutional Sponsorship?

Sponsorship may take the form of mutual funds; corporate pension funds; insurance companies; large investment counselors; hedge funds; bank trust departments; or state, charitable, and educational institutions.

For measurement purposes, I do not consider brokerage firm research department reports as institutional sponsorship, although a few exert influence on certain securities. Investment advisory services and market letter writers are also not considered to be institutional or professional sponsorship in this definition.

Financial services such as Vickers and Arthur Weisenberger & Co. publish fund holdings and investment performance records of various institutions. In the past, mutual funds have tended to be slightly more aggressive in the market, but banks have managed larger amounts of

money. More recently, numerous new "entrepreneurial type" investment counseling firms have been organized to manage institutional monies.

Performance figures for the latest 12 months plus the last three- to five-year period are usually the most relevant. However, results may change significantly as key portfolio managers leave one money management organization and go to another. The institutional leaders continually rotate and change.

For example, Security Pacific Bank (now merged into Bank America) had somewhat modest performance in its trust investment division up to 1981. But with the addition of new management and more realistic concepts in the investment area, it polished up its act to the point that it ranked at the very top in performance in 1982. In 1984, the top manager of Security Pacific left and formed his own company, Nicolas Applegate of San Diego.

If a stock has no professional sponsorship, chances are that its performance will be more run-of-the-mill. The odds are that at least several of the more than 1000 institutional investors have looked at the stock and passed it over. Even if they are wrong, it still takes large buying to stimulate an important price increase in a security.

Also, sponsorship provides buying support when you want to get out of your investment. If there is no sponsorship and you try to sell your stock in a poor market, you may have problems finding someone to buy it.

Daily marketability is one of the great advantages of owning stock. (Real estate is far less liquid and commissions and fees are much higher.) Institutional sponsorship helps provide continuous marketability and liquidity.

Is It "Overowncd" by Institutions?

A stock can also have too much sponsorship and become "overowned." **Overowned** is a term we coined and began using in 1969 to describe a stock whose institutional ownership had become excessive. In any case, excessive sponsorship can be adverse since it merely represents large potential selling if anything goes wrong in the company or the general market. On the other hand, Snapple, in April 1993, was underowned.

The "favorite 50" and other lists of the most widely owned institutional stocks can be rather poor, and potentially risky, prospect lists. By the time performance is so obvious that almost all institutions own a stock, it is probably too late. The heart is already out of the watermelon.