Screening: The First Step to Finding a Winning Stock

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Discussion Overview

- A computerized screening program can be used to locate/analyze stocks in an organized, systematic, and disciplined fashion

- Discuss screening factors that help to highlight winning stocks
  - Value approach
  - Growth approach
  - AAII Stock Screens
Stock Selection Strategies

- Screening Process
  - Establishing criteria for narrowing a large universe of stocks to a few that might hold promise and warrant further analysis
  - A computerized screening program can be used to locate/analyze stocks in an organized, systematic, and disciplined fashion

- Valuation Process
  - In-depth examination of a company to establish if its stock price reflects a fair value

Benefits of Stock Screening

- Discover potential investment opportunities you might not have otherwise noticed
- Avoid wasting time on companies that don’t meet your basic criteria
- Adds a level of discipline to your investing
  - Forces you to develop and hone investing parameters
  - Helps you to think more clearly about your investing style
  - Helps to keep your emotions in check
Pitfalls of Stock Screening

- Dependent on the accuracy of the underlying data
- Limited mainly to quantitative factors
  - Factors such as management, brand strength, competitive position, etc. must be evaluated separately
- May still be missing good companies that meet most but not all criteria
- Introduces you to companies you are not familiar with and that require further analysis

Screening Process

- Identify stock selection philosophy that fits with time horizon, risk tolerance, analytical skills, and time commitment
- Define clear objectives, and construct and refine primary criteria
- Construct secondary criteria to determine if companies passed the screen for the right reasons
- Even the best screen is only a starting point for further analysis
**Value**

- Buy Cheap, Sell Dear
- Investors do not always act rationally, often assess information emotionally, creating price distortions that can be exploited
- Locate stocks whose market values are low relative to valuation measures such as dividends, earnings, and assets
- Horizon: Typically longer term, less need to monitor stocks tick-by-tick

**Growth**

- Buy High, Sell Higher
- High sales and earnings growth will continue to attract more investors pushing up multiple investors will pay for a stock
- Locate companies and industries in stage of rapid and expanding growth with earnings momentum
- Horizon: Typically shorter term, typically higher turnover, need to monitor stocks closely

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**Growth vs. Value**

![Graph showing the comparison between S&P 500, S&P/Citigroup 500 Growth, and S&P/Citigroup 500 Value from 1998 to 2006. Data as of 4/30/2006.](image)
Popular Approaches

- AAII Journal and Computerized Investing have examined the characteristics of successful investors
- Tracking performance of our interpretation of these approaches in Stock Investor
- Companies passing screens and tables detailing results available on AAII Web site within “AAII Stock Screens” segment in the Portfolios section
Strong Performing Growth & Value Screens

Value Screen: John Neff

- While serving as portfolio manager of the Vanguard Windsor Fund from 1964 until his retirement in 1995, Neff employed a value investing approach using a stringent contrarian's viewpoint.

- Approach presented in book "John Neff on Investing"
Primary Factor: PEG

- The P/E to growth ratio (PEG ratio) is computed by dividing the price-earnings ratio by the earnings growth rate.
  - Rule of thumb: Ratios below one (<1.0) indicate that a stock may be undervalued, while stocks with ratios above one (>1.0) may be overvalued.
  - Purchase stock with earnings growth prospects that are not fully recognized by the market as measured through the price-earnings ratio.
  - Possible variations:
    - Future vs. historical earnings growth
    - Adding dividend yield to growth rate

- For further info see AAll stock screen “A Combination Approach: Value on the Move”
  (www.aaii.com/stockscreens/screendata/overview.cfm?screen=Value)

- P/E Ratio = 10, EPS Growth = 5%
  - PEG = P/E ÷ Growth = 10 ÷ 5 = 2.0

- P/E Ratio = 10, EPS Growth = 10%
  - PEG = P/E ÷ Growth = 10 ÷ 10 = 1.0

- P/E Ratio = 10, EPS Growth = 10, Yield = 5%
  - Div Adj. PEG = P/E ÷ (Growth + Yield)
    = 10 ÷ (10 + 5) = 0.67

  (www.aaii.com/stockscreens/screendata/overview.cfm?screen=Value)
The ratio of the price-earnings ratio to the sum of the estimated growth in earnings and dividend yield (div-adjusted PEG ratio) is less than or equal to half the median value for the entire database.

- Look for "cheapo" stocks with a dividend-adjusted PEG that is noticeably out of line with market or industry benchmarks.

Current Market PEG
Avg: 2.28
Median: 1.50
Stocks: 2,499
194 firms passing from a total of 8,706 companies
(data as of 5/5/2006)
The estimated growth rate in earnings per share is greater than or equal to 7% and less than or equal to 20%

- Neff wants companies with strong projected earnings growth, but not too high to avoid high risk stocks

2,176 firms passing independently, 104 cumulatively

The five-year growth rate in sales is greater than or equal to 7% and less than or equal to 20%

- Growing sales leads to growing earnings
- Strong, but reasonable growth

1,870 firms passing independently, 33 cumulatively
Free cash flow per share over the last 12 months and the last fiscal year (Y1) is positive

- Free cash flow is cash from operations left over after satisfying capital expenditures and dividend payments
- Excess cash generation will hopefully be used to benefit investors: stock repurchase, increase dividends, strategic acquisitions, expansion, etc.

The operating margin over the last 12 months and last fiscal year is greater than or equal to the industry's median operating margin

- Robust margins point to competitive advantage
- Comparison should be made against industry norm because margins are very industry specific
**Value Summary**

- Produces consistent, long-term success, but can fall behind other approaches on occasion, particularly in the strongest portion of a bull market
- Well suited to larger-cap companies with resources to bounce back
  - Better access to capital when needed
  - Deeper management
  - More visibility with rebound
Growth Screen: CAN SLIM

- William O’Neil developed his growth stock approach through study of company characteristics prior to their big stock increase
- Approach presented in “How to Make Money in Stocks: A Winning System in Good Times or Bad”

C=Current Quarterly Earnings

- Strong and improving quarterly EPS performance—at least 18% to 20%
- Important to compare a quarter to the same quarter from the previous year
- O’Neil looks at earnings from continuing operations

1,232 firms passing from a total of 8,706 companies

(data as of 5/5/2006)
A = Annual Earnings Increases

- Significant and steady increase in annual earnings
  - Increase in EPS for each of the last five years
  - Strong annual growth rate of 25% or greater over the last five years

325 firms passing independently, 83 cumulatively

N = New Products, Management, Highs

- Catalyst to start a strong price advance
  - New product or service, management team, technology
  - Stocks reaching new high after consolidation period

Screen for stocks within 10% of their 52-week high
3,538 firms passing independently, 51 cumulatively
**S=Supply and Demand**

- Firms with a smaller number of shares outstanding should increase more quickly
- O’Neil recommends looking at “float”
  - Shares outstanding less shares held by insiders

Screen for float of less than 20 million shares outstanding

4,501 firms passing independently, 18 cumulatively

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**L=Leader or Laggard**

- Look for market leaders in rapidly expanding industries
  - Buy among the best two or three stocks in a group
- Use relative strength to identify market leaders

Screen for 52-week relative strength rank above 70%

2,546 firms passing independently, 10 cumulatively
I = Institutional Sponsorship

- A few institutional sponsors are needed for above-market performance, but not too many
- Look at record of institutions

Screen for at least 5 institutional shareholders, consider cap

5,916 firms passing independently, 10 cumulatively

M = Market Direction

- The trend of the overall market will have a tremendous impact on the performance of your portfolio
- O’Neil tends to focus on technical measures when determining the market’s overall direction
- O’Neil suggests that any good technical analysis program or study of Investor’s Business Daily should be sufficient
Growth Summary

- Requires close monitoring; beyond the ability of many individuals
- Look beyond high expected or historical growth and consider stability of earnings and ability to achieve expectations
- Relative strength works reasonably well independently or when combined with value factors
Popular Approaches

- AAll Journal/Computerized Investing has examined the characteristics of successful investors.
- Tracking performance of our interpretation of these approaches in Stock Investor.
- Companies passing screens and chart of results available on AAll Web site within “AAll Stock Screens” segment in the Portfolios section.

Screens are located within “AAll Stock Screens” segment of Web site.
### Table 1. Performance of Stock Screens on AAII's Web Site.

<table>
<thead>
<tr>
<th>Month</th>
<th>Value Strategies</th>
<th>Growth &amp; Value Strategies</th>
<th>Sector/Strategy</th>
<th>Indexes</th>
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<tbody>
<tr>
<td>YTD* 2004</td>
<td>12.5% 22.2% 31.1%</td>
<td>10.7% 23.1% 43.0%</td>
<td>11.8% 14.0%</td>
<td>17.6% 24.9% 26.5%</td>
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<tr>
<td>2005</td>
<td>12.5% 22.2% 31.1%</td>
<td>10.7% 23.1% 43.0%</td>
<td>11.8% 14.0%</td>
<td>17.6% 24.9% 26.5%</td>
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<td>2006</td>
<td>12.5% 22.2% 31.1%</td>
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<td>11.8% 14.0%</td>
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<td>2008</td>
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</table>

#### Notes
- Unless otherwise stated, figures do not include dividends or transactions costs.
Using the Martin Zweig Approach

Overview

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

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

We’ll take a look at Zweig’s strategy and show how it can be applied using a stock screening approach. For the screening, we use AAII’s Stock Investor Pro fundamental screening and database program. Stock Investor Pro covers a
### Using the Martin Zweig Approach

#### Screening Criteria

- Same-quarter growth in fully diluted earnings from continuing operations between the last fiscal quarter (Q1) and the same quarter one year prior (Q5) is positive.
- Same-quarter growth in fully diluted earnings from continuing operations between the fiscal quarter one quarter ago (Q2) and the same quarter one year prior (Q6) is positive.
- Same-quarter growth in fully diluted earnings from continuing operations between the fiscal quarter two quarters ago (Q3) and the same quarter one year prior (Q7) is positive.
- Same-quarter growth in fully diluted earnings from continuing operations between the fiscal quarter three quarters ago (Q4) and the same quarter one year prior (Q8) is positive.
- Same-quarter growth in sales between the last fiscal quarter (Q1) and the same quarter one year prior (Q5) is positive.
- Same-quarter growth in sales between the last fiscal quarter (Q1) and the same quarter one year prior (Q5) is greater than the same-quarter growth in sales between the fiscal quarter one quarter ago (Q2) and the same quarter one year prior (Q9).
- The current (12m) fully diluted earnings from continuing operations is greater than or equal to the fully diluted earnings from continuing operations for the last fiscal year (Y1).

#### Passing Companies

**Data as of 3/31/2006**

*NOTE: The screens are updated in the middle of each month with prior month-end data.*

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>Exchange</th>
<th>Industry</th>
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<tbody>
<tr>
<td>Eagle Materials, Inc.</td>
<td>EAGL</td>
<td>NYSE</td>
<td>0212 - Construction - Raw Ma</td>
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<td>Fleet Cash Financial</td>
<td>FCSN</td>
<td>Nasdaq</td>
<td>0163 - Retail (Specialty Non-</td>
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<td>J.C. Penney</td>
<td>JCP</td>
<td>Nasdaq</td>
<td>0077 - Retail (Apparel)</td>
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<tr>
<td>Lincoln Electric</td>
<td>LECO</td>
<td>Nasdaq</td>
<td>0218 - Misc. Capital Goods</td>
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<tr>
<td>Virginia Commerce</td>
<td>VCGI</td>
<td>Nasdaq</td>
<td>0727 - Regional Banks</td>
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<tr>
<td>Arch Chemicals, Inc.</td>
<td>ARCH</td>
<td>Nasdaq</td>
<td>0103 - Chemical Manufacture</td>
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<td>O'Keefe Automotive, Inc.</td>
<td>ORLY</td>
<td>Nasdaq</td>
<td>0163 - Retail (Specialty Non-</td>
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</tbody>
</table>
### Martin Zweig

Companies are ranked by Relative Strength 2004 (d).

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>Exchange</th>
<th>Industry</th>
<th>EPS Earnings Growth from Q1 to Q2 (%)</th>
<th>EPS Earnings Growth from Q2 to Q3 (%)</th>
<th>EPS Earnings Growth from Q3 to Q4 (%)</th>
<th>Sales Growth (%)</th>
<th>PE Ratio</th>
<th>ROE %</th>
<th>Industry LT Debt equity ratio (%)</th>
<th>Industry LT Debt equity ratio (%)</th>
<th>Relative Strength 2004 (%)</th>
<th>Web Address</th>
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<tbody>
<tr>
<td>Eagle Materials, Inc.</td>
<td>EAGL</td>
<td>NYSE</td>
<td>Construction - Raw Materials</td>
<td>35.3</td>
<td>35.4</td>
<td>35.4</td>
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<td>52</td>
<td>4.4</td>
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<td>First Cash Financial Services</td>
<td>FCFS</td>
<td>NASDAQ</td>
<td>Retail (Specialty Non-Apartment)</td>
<td>27.8</td>
<td>26.7</td>
<td>26.7</td>
<td>20.5</td>
<td>26.3</td>
<td>14.3</td>
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<td>NASDAQ</td>
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<td>Ash Chemicals, Inc.</td>
<td>ASHC</td>
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<td>ORLY</td>
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<td>LFIN</td>
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<td>Construction &amp; Agricultural Machinery</td>
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<td>29.1</td>
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<td>29.1</td>
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<tr>
<td>Dennytr Resources Inc.</td>
<td>DNR</td>
<td>NYSE</td>
<td>Oil &amp; Gas Operations</td>
<td>152.6</td>
<td>71.7</td>
<td>71.7</td>
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<td>51.7</td>
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<td>Ross Companies, Inc.</td>
<td>ROCK</td>
<td>NYSE</td>
<td>Oil Well Services &amp; Equipment</td>
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<td>NYSE</td>
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</tr>
</tbody>
</table>

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**Using the Martin Zweig Approach**

**Performance Chart**

**NOTE:** The screens are updated in the middle of each month with prior month-end data.

**Screen Links**
- Screen Overview
- Screening Criteria
- Passing Companies
- Performance Chart

**Related Links**
- FAQs
- Disclaimer
- Performance Charts
Common Elements

- Reasonable Value
  - Low P/E, P/Sales, P/Book, high yield, etc.
  - Low P/E relative to growth

- Consistent Growth
  - Emphasis on consistency of growth in earnings, sales, or dividends

- Unique Niche

- Strong Financials

- Price Momentum

- Earnings Revisions

- Disciplined Investment Approach

Data as of 4/29/2005
Top Screening Systems

AAII’s Guide to the Top Investment Web Sites
- Appears annually in September Journal
- Available at AAII Web site
Stock Investor

- (800) 428-2244 - www.aaii.com/stockinvestor
- Systems: Windows
- Price: $99 - $198/year (AAII Member) $148 - $247/year (Non-AAII Member)
- Universe: 8,700+
- Number of data fields: 1,000 - 2,000
- Fields for screening: 1,000 - 2,000
- Data Source: Market Guide, I/B/E/S
- Frequency: Quarterly, Monthly (Weekly Web)
- Distribution: CD-ROM + Internet

Stock Investor Pro

![Stock Investor Pro interface screenshot]

...
MSN Money

- (800) 373-3676 - moneycentral.msn.com
- Price: Free; registration required
- Universe: 8,000+
- Number of data fields: 1,500+
- Fields for screening: 190+
- Data Source: Media General, Zacks
- Frequency: Daily
- Distribution: Internet
Morningstar.com Premium

- www.morningstar.com
- Price: Free to $135 per year
- Universe: 8,000+
- Number of data fields: 800+
- Fields for screening: 450+
- Data Source: Morningstar
- Frequency: Daily
- Distribution: Internet
**Reuters Investor - PowerScreener**

- **investor.reuters.com**
- Price: Free to $299 per year
- Universe: 8,900+
- Number of data fields: 1,000+
- Fields for screening: 650+
- Data Source: Reuters
- Frequency: Daily
- Distribution: Internet
SmartMoney Select

- **www.smartmoney.com**
- **Price:** $5.95 to $19.95 per month
- **Universe:** 8,000+
- **Number of data fields:** 1000+
- **Fields for screening:** 140+
- **Data Source:** Hemscott, Zacks, Thomson, ComStock, Breifing.com
- **Frequency:** Daily
- **Distribution:** Internet