Finding Winning Stocks

This article, which comprises two articles, was written some years ago, but is very relevant to today. The charts used to illustrate the text are now somewhat dated, but still relevant for the present purpose of teaching a technique.

As the new financial year approaches, many of us will be reassessing our lives and making some resolutions and maybe some real changes. While our share portfolios should be monitored constantly through the year, with adjustments made as required, there is a strong case for an annual review. In this annual review, we should stand back and look at our portfolio as a whole, to ensure that we clean out the non-performing stocks and recycle the funds into stocks with a stronger outlook.

At first sight, it might appear that we need one set of guidelines for judging what stocks are in the non-performing category and another set of guidelines for identifying stocks with a higher than usual potential. However, this is not so. Every stock in our portfolio should be in the high potential category. No matter how well it might have served us in the past, no stock should remain long in our portfolio unless it has a strong chance of continuing to perform for us. In other words, if we did not own it, we would want to buy it now. So, the criteria for deciding whether to continue to hold a stock, and for deciding whether to buy a stock now, should be the same.

Over the years numerous books have been written outlining ways to find good stocks. Some have proven to work better than others, but most seem to give good returns at least some of the time. There have also been some outstanding investors, who have beaten the market over a long period. However, their methods vary considerably and their results, while remarkable over a long period, have included years when they were not quite so good. This suggests that there are, in reality, many ways to invest successfully, but no perfect method that always beats the market every year.

In order to beat the market consistently every year, we would need to be able to predict what the market and individual stocks will do. Indeed some people set out to try to do this. They tend to fail miserably. It is incredibly difficult to predict the future in almost any area of our lives. Predicting stock markets and individual share prices has proven to be one of the most difficult. So much so, that the best investors have developed methods that do not rely on prediction. Instead they focus on what is possible – identifying situations where there is a higher than usual probability of success.

The key to doing this is really quite simple to explain, even if it requires some level of skill and experience in its application. At the most basic level, we can only grow our capital if we invest in stocks that pay good dividends and increase in price. We cannot succeed if the prices of our stocks fall.

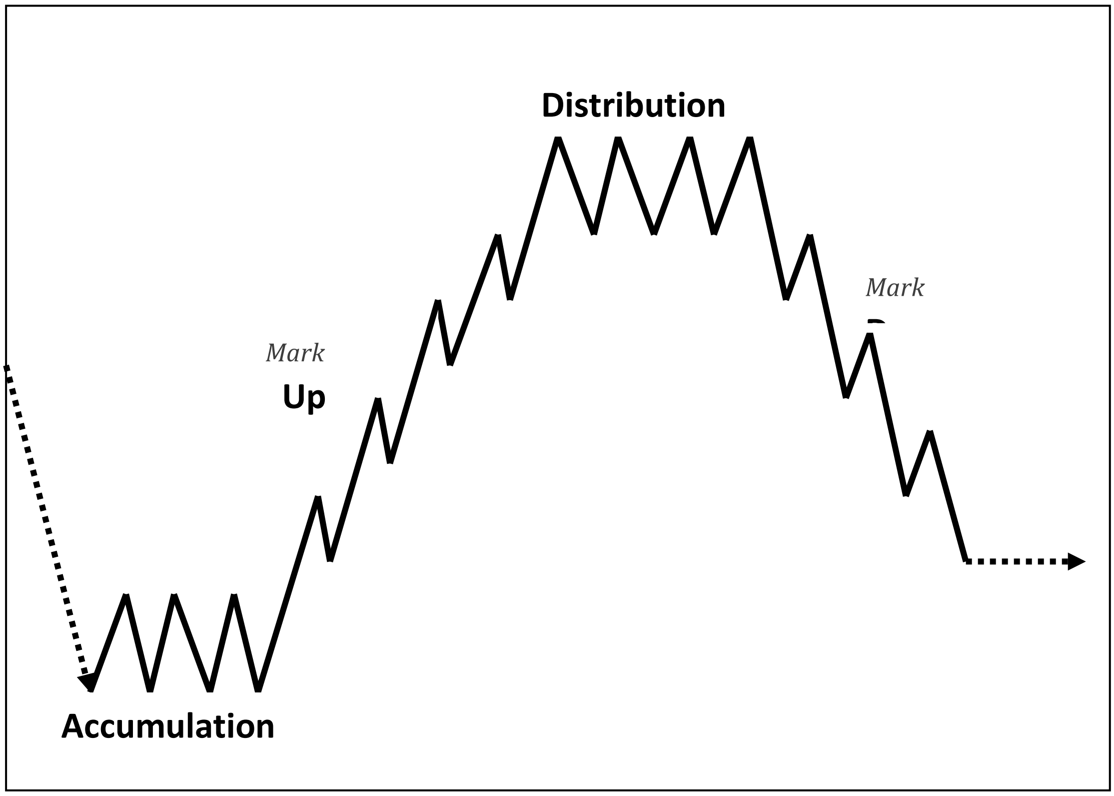
The prices of stocks will rise if the flow of information suggests an improved profit outlook for the companies. So, the trends on their charts indicate the considered opinion of the informed money in the market. We need to be in tune with the insiders and savvy investors. Even if they turn out to be wrong, which they often will, they are our best guide and we may frequently profit from their mistaken belief.

So, we want to be invested in stocks whose prices are trending upward and to avoid stocks whose prices are trending downward. Some people rely exclusively on that. However, there is a problem. The uptrends in prices do not go on forever. We will do best if we catch them in their early stages. What we want to try to do is to avoid buying into an uptrend just before it ends.

When an uptrend begins, a stock tends to be relatively cheap. By the time a long uptrend ends, the stock will tend to have become relatively expensive. So, we can bias things a little more in our favour if we try to only buy into those uptrends where the stock seems to be relatively inexpensive. This is basic common sense really – we buy good prospects at cheap prices. However, it is easy to say, but requires clear thinking and great discipline to put it into action consistently.

It is useful in this approach to identify the three types of companies found on the stock market:

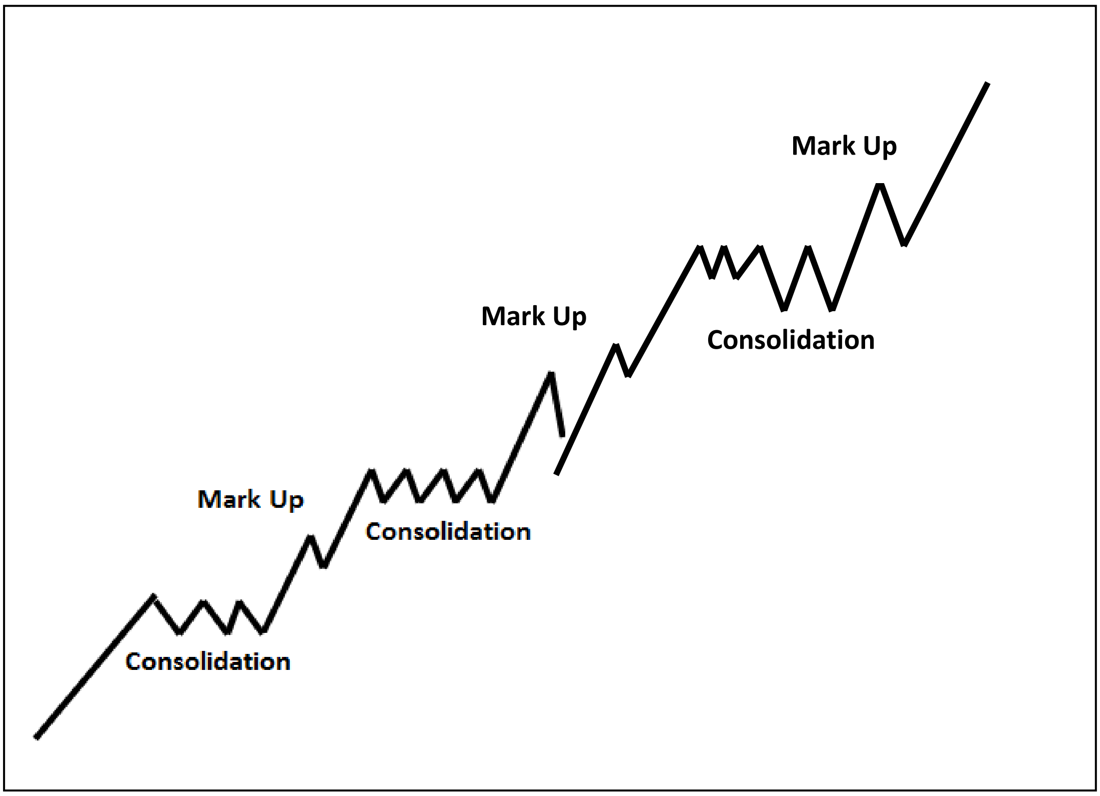
Value stocks. These stocks tend to be solid companies that should be the backbone of most portfolios. Their business does not grow dramatically and may be cyclical, which means it expands and contracts roughly in line with the performance of the overall economy. A typical value stock chart will show a cyclical pattern. In conceptual terms, it will look like the diagram below.



Value stocks tend to go through the four stages shown on the diagram: Accumulation, Mark-up, Distribution and Mark-down. We should look to buy them on the breakout from the Accumulation stage and in the early stages of the Mark-up stage. For value stocks that are in the Mark-up stage, we can try to avoid buying into the late stages, by only buying those that are relatively undervalued.

The most effective initial screens for undervaluation are the dividend yield and the price earnings (PE) ratio. For value stocks, we would look for dividend yields that are significantly higher than the market average and PE ratios that are significantly lower than the market average.

Growth stocks. These are fast growing businesses. They are often emerging companies, which may become value stocks once their business or industry reaches a mature stage. However, they are also prone to stumbling along the way. A typical growth stock chart will show a steadily rising trend pattern. In conceptual terms, it will look like the diagram below.



Growth stocks tend to progress through successive consolidation and Mark-up stages as shown on the diagram. We should look to buy them on the breakout from the Consolidation stages and in the early stages of the Mark-up stages. We can try to avoid buying into the late part of the Mark-up stages by only buying those stocks that have not already reached extremes of over valuation.

As with value stocks, the best guides to relative valuation are dividend yield and PE ratio. The guideline is that the ratios should not be too extreme – the closer they are to the market average, the better, however, dividend yields less than half the market average and PE ratios more than double the market average should be viewed with suspicion.

Speculative stocks. These are high risk enterprises. They will be start-up industrial businesses, or explorers in the areas of resources or technology. If their business plan works, or if they find what they are looking for and can develop it successfully, there may be great rewards. Most will exhaust their capital before they succeed and disappear. Since they have no track record, everything depends on the perilous art of forecasting. They are therefore not investment grade stocks and are best left to those who understand and can tolerate the risks.

In the rest of this article, we will look at how to apply these ideas.

There are many ways to go about finding stocks with a higher than usual potential in the coming year using the general ideas from the preceding part of the article. In an uncertain market environment, it is attractive to focus on value stocks rather than growth stocks.

Since this is simply a first screen, it was decided to arbitrarily use a PE ratio of 10 and a dividend yield of 5%, compared to the average PE ratio for the general market of 15.89 and average dividend yield of 4.01.

A search was made of all ASX stocks to identify all those with a PE ratio equal to, or less than, 10 and a dividend yield equal to, or greater than, 5%. The search found 32 stocks. Our task was then to reduce the number to a handful that would be examined closely. All but five stocks were eliminated as follows:

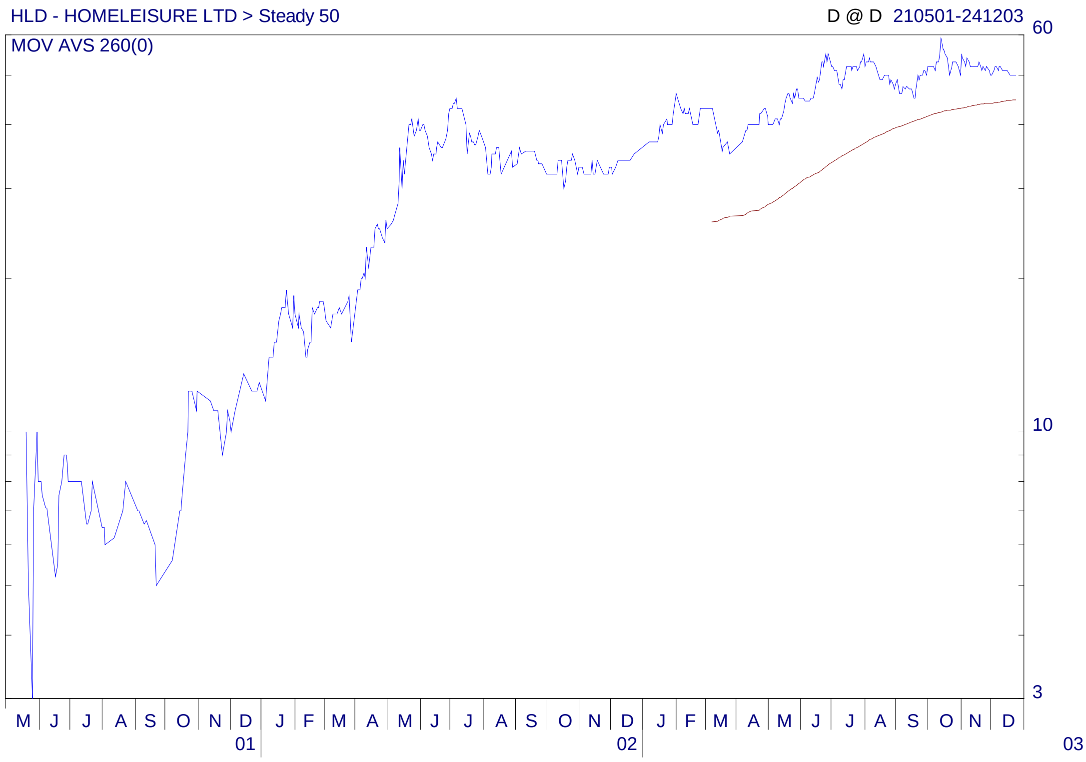
- Resources stocks BSG, BSO, KCN and ILU were eliminated. This method does not strictly apply to resources stocks because they are exploiting a wasting asset.
- Likewise, trusts ABP, AIX, CPA, JFM, PBD, PRX and SLF were eliminated. This method does not strictly apply to trusts because that corporate structure is used primarily to distribute an income stream.
- Thinly traded stocks LMC, TLT and UOS were eliminated as unsuitable for most investors.
- Property stocks ALZ, AVJ, CEQ, DVN, VWD and WTP were eliminated due to higher than normal cyclical risk at present.
- Two stocks, CSR and JYC, with insufficient history, were eliminated because of concerns about the ability to adequately analyse their charts.
- Four stocks, ATG, CRG, FCL and IAS, that were below their 260-day moving average were eliminated because they were not clearly trending up.

It should be stressed that these stocks were eliminated on various grounds for convenience in quickly getting to high probability prospects and some of them may still repay careful and skilled research. The five remaining stocks were:

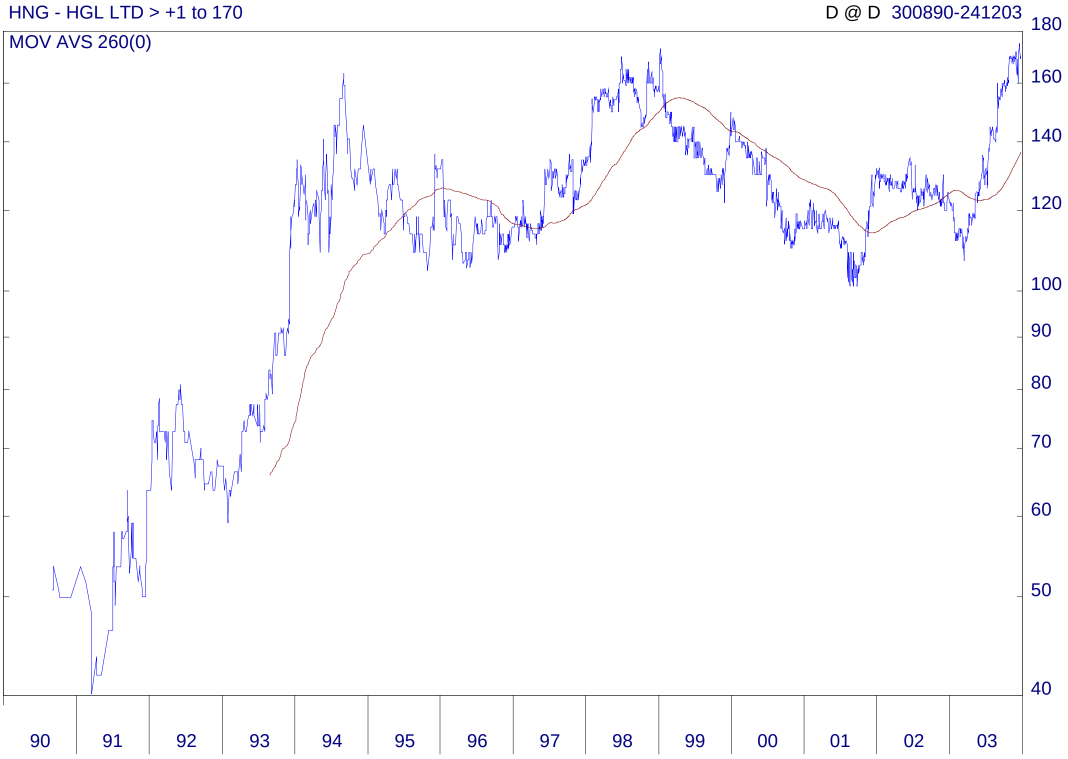
Stock	PE Ratio	Div Yield
Ausdrill (ASL)	6	5.3
HomeLeisure (HLD)	8.3	5.5
HGL (HNG)	8	5.1
Integrated Group (IWF)	10	5.5
Oroton Group(ORL)	7.3	7.9

Ausdrill (ASL) began its listed life in 1994 at $1.64. The volatility of this value stock was demonstrated by the plunge to 37c in early 1995 and then the steady ascent to hit $2 in the early days of 1997. However, this was merely a prelude to the dizzy descent to a low of only 6c in September 2001. Since then, Ausdrill has been rising again and had progressed to 76c and is still clearly trending upwards.

At this price, Ausdrill still represents good value with a historical PE ratio of only 6 times and a dividend yield over 5%. However, it might well have been excluded from our list arbitrarily, because it is a supplier to the cyclical mining industry. Readers who find this stock worthy of further research will need to consider the relevance of this risk factor to their investment plan.



HomeLeisure (HLD) is a relatively new entrant to the ASX, joining it only in May 2001 at 10c. Although there was a brief dip to 3c, the pattern for HomeLeisure has been a steady uptrend. This was at quite a good clip through to mid-2002, but since then it has slowed appreciably. However, it is still clearly trending upward and a move above the October 2003 high of 60c would be very positive. There is insufficient price history on the chart to judge whether we are looking at a value stock or an emerging growth stock. In either case, this interesting smaller stock may prove to be a fascinating research target. However, it will not be suitable for all readers due to its size and lack of track record.

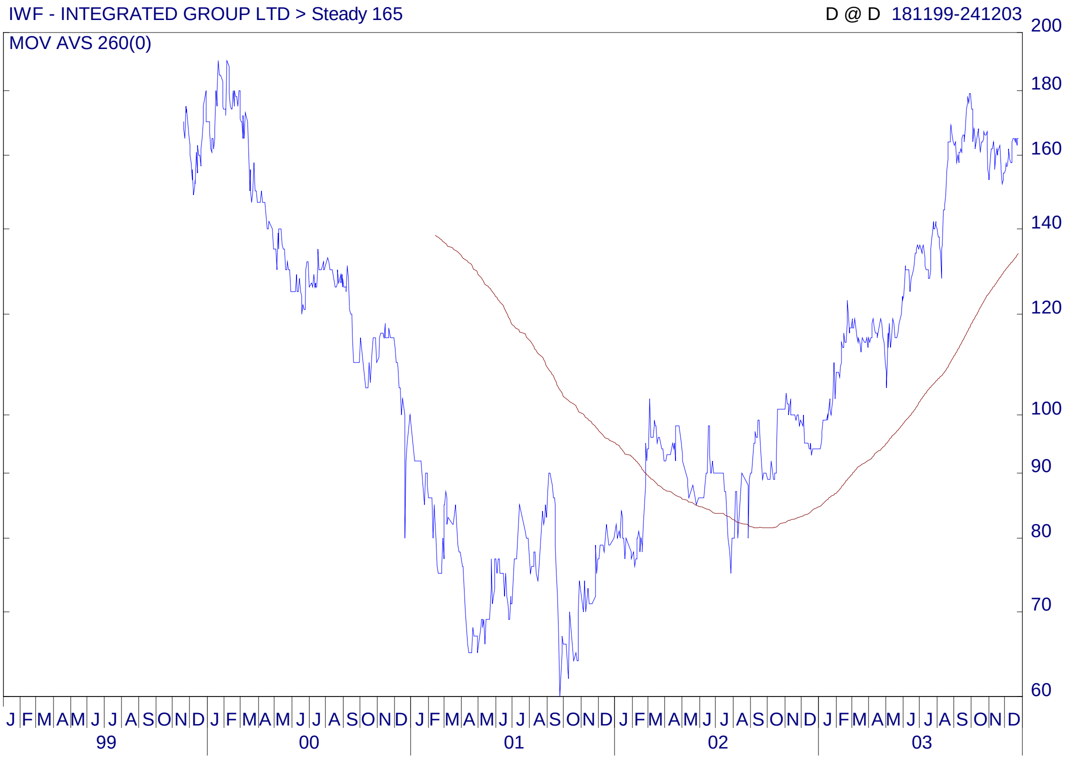


HGL (HNG) is a stock with a fascinating chart. From the low of 40c in 1991, its rise to a peak of $1.64 in 1994 looked more like a growth stock than a value stock. However, the price action over the ensuing nine and a half years looks more like a value stock pattern. Where the fascination comes in is that it just may be that HGL has been forming a large consolidation zone over the last nine and a half years and will, at some point, perhaps soon, break upward in a new mark-up stage.

This is interesting speculation, but at best it only makes it an attractive research target and warrants close monitoring. With recent price action near its all-time high, it would be well to keep it on our radar screens, especially as it is still trending up strongly and is far from overvalued on superficial historical ratios.

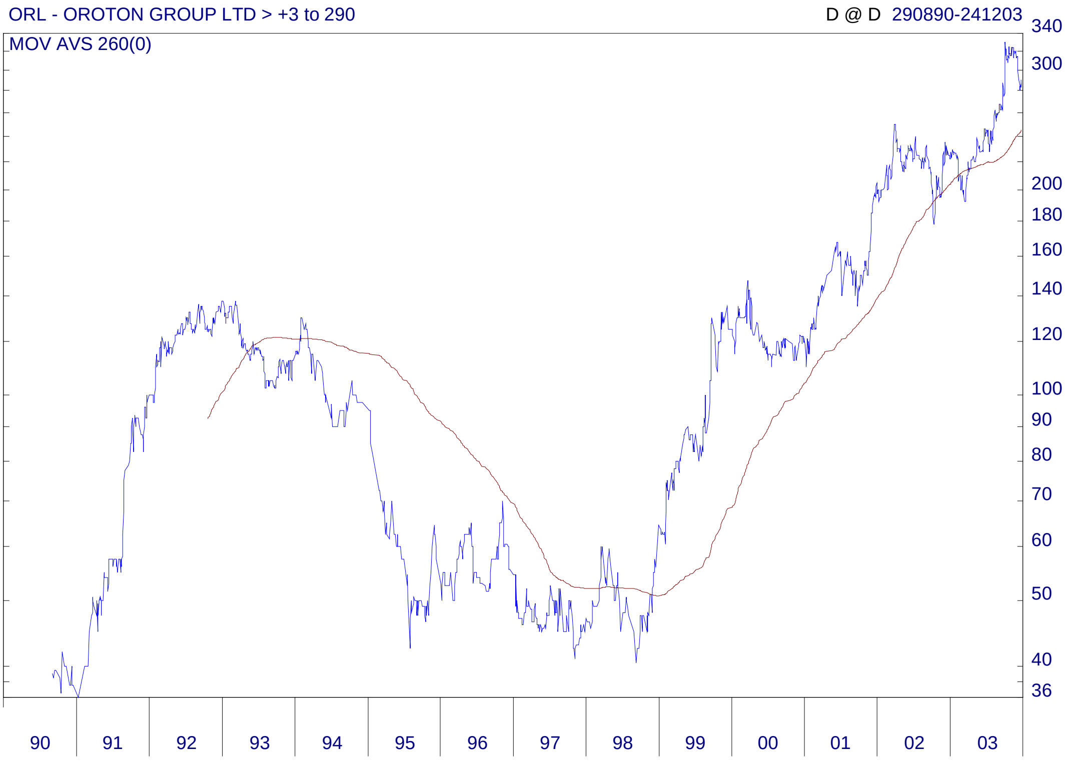
The puzzle then, is what to do? For those readers for whom this stock deserves a place in their investment plan, one approach to consider is to buy some on a strong move above the all-time high of $1.75. Then build the position as a continuing uptrend is confirmed.

Integrated Group (IWF) is another interesting smaller company. It listed on the ASX in November 1999 in the final wild stages of the tech and Internet bubble. After reaching a peak of $1.90 in early 2000, it fell disconcertingly to a low of 60c in September 2001 as the market shied away from new listings and smaller companies in particular. Since then, Integrated Group has shown that it has a potentially bright future with a sparkling uptrend, so far carrying it as high as $1.80 in September 2003. This has occasioned some selling as the stale bulls from 1999-2000 take the opportunity to get out roughly even after several years of financial pain.



The all-time highs will be a severe test for Integrated Group. Should it manage to rally strongly into clear air, its ratios indicate that it may have some scope for significant further appreciation. It is clearly worth researching to assess its suitability for readers' portfolios and then monitoring closely for a signal to start building a position.

Oroton Group (ORL) seemed to have a chart that fell squarely in the value mould for ten years from 1990 though 2000. From a low of 36c in early 1991, it surged to a high of $1.38 in late 1992. From there it fell just as swiftly to around 50c in mid-1995. Oroton then spent three and a half years forming a classic accumulation pattern, from which it broke upwards in early 1999:



The test for the uptrend was in the vicinity of the 1992 highs. However, by mid-2001, they were being left behind in an uptrend that was still extant on Christmas Eve 2003. This strong chart presents an almost irresistible research opportunity for many readers.