

# STOCKS, STRATEGIES & COMMON SENSE

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# 1

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **The Five Greatest Stock Market Myths**

#### **Myth #1. PRICE TO EARNINGS RATIOS TELL YOU WHETHER STOCKS ARE CHEAP OR EXPENSIVE.**

P/E ratios are easy to find. Just about every newspaper, magazine and stock report publishes P/E ratios. Everybody seems to talk about them when discussing stocks. So, P/E ratios must be a great way to compare stocks.

Right? Wrong!

If you were told that Fly-By-Nite Industries had a P/E of 7, and Fantastic Plastics Inc. had a P/E of 14, would you buy Fly-By-Nite Industries instead of Fantastic Plastics Inc.? You might, but you shouldn't be comfortable making that decision. Why? Because you need more information. You'd like to know a whole lot of things before you decided which stock to buy. One of the most important things you'd like to know is what the stock is worth, based upon its earnings, profitability and other key financial data. In other words, you'd like to have a sense of the stock's intrinsic value. P/E ratios don't say anything about a stock's value!

What investors need is a Value to Price ratio. With a Value to Price ratio, investors would know immediately whether a stock was cheap, expensive or fairly priced. But this means we have to have a way of computing value. Of course there are theories and formulas for computing intrinsic value. But they are complex and some sophisticated investors even say they are unfathomable. Consequently, most investors (even the Pros), don't begin to look at stock's intrinsic value! They resort to trivial devices like comparing P/E ratios.

#### **Myth #2. YOU MUST ASSUME HIGH RISKS TO MAKE GOOD MONEY IN THE STOCK MARKET.**

A woman recently said to me, "I'm just scared to death of stocks. I can't afford to lose my hard earned money." The perception of high risk in stock investing is not totally without merit. Many investors have lost

substantial sums of money in the market. Visions of investors jumping out of windows back in 1929 are graphic reminders of the risk inherent in stock investing.

More recent events in the market...the Great Crash of October 19, 1987, the Bear Market of 2008, the Flash Crash of May 10, 2010, and the ills of High Frequency Trading have contributed to the casino image associated with stock investing. This is very unfortunate because stock investing is one of the best ways the average person has of accumulating substantial wealth. It just requires a few simple techniques and some discipline. In fact, it can be a lot safer than investing in real estate, collectibles or your own business.

Here's how to make good money in stocks with low risk:

1. Buy stocks with consistent, predictable earnings growth.
2. Buy stocks with earnings growth rates equal to or greater than the sum of current inflation and interest rates.
3. Do not put more than 10% of your money into any single stock.
4. Do not own more than two stocks in the same industry.
5. Do not plunge into the market. Spread your investments over time.
6. Use Stop-Sell orders to limit risk.

Stocks with consistent, predictable earnings growth are the safest stocks you can buy. They represent the best managed companies in the world. A stock portfolio with an average earnings growth rate of at least 14%/yr. has a high probability of doubling in five years. In twenty years, it will have increased by 1,500 percent.

If you bought 10 stocks, and limited your loss on any single stock to 10% by using Stop-Sell orders, your total portfolio risk is only 10%. Your risk on any single stock is only 1% of your total portfolio. How many investments can you think of that have the upside potential of stocks with such limited risk exposure?

**Myth #3.**  
**BUY STOCKS ON THE WAY DOWN**  
**AND SELL ON THE WAY UP.**

There's an old adage that says the way to make money in the stock market is to buy low and to sell high. That, of course, is an irrefutable truth. The only problem is that many investors confuse this bit of conventional wisdom with the assumption that if the price of a stock is going down it is low, and if it is going up it is high. Consequently, they buy stocks on the way down and sell on the way up. There's hardly a worse thing an investor could do.

Stocks are bought on the expectation that they will go up. If a stock is going up in price, it is fulfilling that expectation. When the price is going down, it is denying that expectation. Therefore, it is logical to buy a stock when its price is going up. Moreover, one of the best times to buy a stock is when its price has broken above an old high. At this point there are no unhappy holders who are waiting to dump the stock. If the stock is fairly valued, there should be clear sailing ahead.

**Myth #4.**  
**STOCKS ARE A HEDGE AGAINST INFLATION.**

For many years, stockbrokers and mutual fund salesmen have been saying that stocks are a hedge against inflation. Well, they are and they aren't. It depends on how you look at it.

A true inflation hedge is one that increases in value with higher inflation... like a house, or gold, or collectibles. But, the fact is, inflation is the stock market's number one enemy. When inflation goes up, interest rates go up and two things happen. The first thing is that investors say, "Golly, I can make all that money on high interest rate bonds, so why should I invest in stocks?" So, they take their money out of the stock market, and stock prices go down. The second thing is that the cost of doing business goes up. So, corporate earnings go down and stock prices go down.

So why in the world would anybody say that stocks are a hedge against inflation? It's because they can make money in stocks faster than inflation will eat it up. All they have to do is invest in stocks which have earnings growth rates higher than the sum of inflation and long-term interest rates. When they do that, the price of the stock will go up faster than inflation. And they will be whipping inflation by staying ahead of it.

**Myth #5.**  
**YOUNG PEOPLE CAN AFFORD  
TO TAKE HIGH RISK.**

Of all the myths in the market, this may be the cruelest and the most foolish. Everyone knows that the elderly are not supposed to take risks. They must be very conservative because their earnings power is limited. They can't afford to lose their money! Well, who decided that young people could afford to lose their money?

If any group needed to watch every penny, it's the young. They need money to start a family, buy a house, buy furniture, save for the future and on and on. Furthermore, young people usually are at the low end of the earnings scale. They have precious little disposable income.

Young people have an invaluable asset on their side, however: Time. They don't need to take risk. They can invest in tried and true companies that make money year-in and year-out. At a growth rate of 10% per year, their investments will double every seven years. By the time their baby is off to college, that initial safe investment has increased by a factor of eight.

When you have time, you can afford patience. Patience pays off in the market.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **How to Pick Stocks**

Visit the business section of any decent library. You'll find shelves full of books on how to pick stocks. I've read many of them over the last fifty years, and some are very good. Most are not. It isn't easy, but sorting the good stuff from the not-so-good is absolutely necessary. Anyone who has read John Rothchild's, "*A Fool and His Money*" knows what I mean.

The biggest obstacle to finding a winning stock picking system is that no system works all the time. Even the great Warren Buffett picks bummers once in a while. Nevertheless, there are some simple, common sense rules that can improve anyone's stock picking skills regardless of the system they use. Here they are:

**Rule I: Favor Undervalued Stocks.** The first step in picking stocks is to favor stocks of companies that are making money, lots of money. Study stocks of companies with rapidly growing earnings, and choose stocks of companies that consistently make more money than they did the year before.

The only way to know if a stock is undervalued, is to know what a stock is really worth. I answer this question by calculating a stock's value from its earnings growth rate, profitability and other fundamentals. My formulas for calculating value are described in Chapter 3 of this book, "**How to Value Stocks.**" If a stock's Value is more than its Price, the stock is undervalued. It's a candidate for selection.

Undervalued stocks offer a higher probability of achieving gains, the potential for very large gains and lower downside risk. In other words, under-valued stocks increase the odds of winning, increase the rewards for winning, and decrease the risk of losing, compared to overvalued stocks. So, favor undervalued stocks.

**Rule II: Favor Safe Stocks.** Have you ever noticed that the prices of stocks like Nike and Disney never seem to cause any excitement, yet go up year after year? Stocks like Netflix are always in the news, and go up and down like a yo-yo. There's a very simple reason for this contrast. The former have track records of steady earnings performance, while the latter has an erratic earnings record. Price volatility is a reflection of fear and uncertainty.

Price volatility and risk arise from many sources...rumors, political assassinations, earthquakes and so on. Shareholders with little confidence in their company tend to overreact to rumors and bad news. Consequently, the stock prices of companies with erratic earnings performance suffer more when unfortunate things happen. Stocks of companies with steady, predictable earnings can weather nearly any storm.

Obviously, there's less risk in holding stocks of financially stable companies. Consequently, I analyze the risk factors of stocks very carefully before buying. A discussion of how I assess risk is given in Chapter 7, "**Stock Safety: The Missing Link.**"

The second key factor in picking stocks is to favor safe stocks.

**Rule III: Favor Stocks with Rising Prices.** The hardest thing for most investors to do is buy a stock while its price is rising. Most of us have been taught to wait for a stock to go down before buying it. The idea of buying stock at a lower price makes a lot of sense, but is fallacious.

First of all, you'll miss a lot of good opportunities. Really good stocks usually don't look back once they have started moving upward. Witness the hundreds of stocks that have doubled and tripled over the last few years with nary a downturn.

Even more importantly, you never know where the bottom is when buying a stock whose price is falling. Remember when Netflix went from \$304.79 to \$52.81. Who'd have believed it? I did, because VectorVest did not reflect Netflix as being undervalued or safe before or as it was going down. However, when things turned around and the stock price of Netflix started rising again, VectorVest gave it a buy signal. At that point in time, Netflix had a P/E ratio of 16.1 and a VectorVest value of \$106.75.

Buying stocks on the way down lessens your chances of winning. Most of us dream of buying a stock at its low point and riding it to the moon. It's a great dream, but the chances of doing so are virtually nil. The low points on good stocks don't last long. You have to be very lucky to bag a bottom.

Picking stocks with rising prices not only obviates the above problems, but offers several advantages. First, a stock that is rising in price is already doing what you want it to do. (You don't have to break a rising stock of a bad habit.)

Buying stocks with rising prices does not preclude the idea of buying them right after they hit bottom. Bottom Fishing is a great sport, and I discuss it in **Chapter 15, Bottom Fishing: The Art of Buying Low and Selling High.** You just have to know when the price trend has gone from down to up. I tell you how to know what a stock's price is doing in **Chapter 9, "Timing: The Ultimate Weapon."**

Finally, a stock that is hitting new highs has essentially no overhead resistance. There are no unhappy buyers waiting to get their money back. I especially like to buy stocks hitting their very first 52 week high. These stocks have had plenty of time to consolidate and are showing new signs of life.

It's fun to own stocks with rising prices. So pick stocks with rising prices.

**Rule of Rules: Pick Safe, Undervalued Stocks, Rising in Price.** That's easy to say, but how does one find safe, undervalued stocks rising in price? Try following these steps:

1. Look at the financial section of your local paper, the *Wall Street Journal*, *Investors Business Daily*, *Barrons*, the Internet or whatever. Find the list of stocks that have just hit new 52 week highs. All of these stocks are definitely rising in price.
2. Rank all these stocks in ascending order of Price to Earnings ratio, i.e., P/E ratio. This may take some work, but low P/E ratio stocks, of course, are undervalued.
3. Assess each stock for safety. Since the subject of safety is not touched upon, you'll have to turn to other sources. Take a look at *Value Line* for example, or Standard & Poor's *Stock Guide*.
4. Now, put all the information together in a logical, quantitative, unemotional way. Pick the ones you think are the safest, most undervalued and rising in price the fastest.

Once you have prepared your list of stocks, check them out using VectorVest, which analyzes over 23,500 stocks every day for Value, Safety and Timing. It unifies these factors into a comprehensive indicator called 'VST-Vector.' Stocks with the highest VST-Vector ratings have the best combinations of Value, Safety and Timing.

There's no need to spend hours and hours doing what a computer can do. You can obtain a complete, rank analysis of any list of stocks with the click of a mouse with VectorVest. Our records show that stocks with the highest VST-Vector ratings outperform the market over the long-term.

This comes as no surprise. Common sense and simple logic dictate that picking safe, undervalued stocks rising in price result in above average performance over the long-term.

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## ***STOCKS, STRATEGIES & COMMON SENSE***

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### **How to Value Stocks**

“How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decades?”

These words, spoken on the evening of December 5, 1996 by Dr. Alan Greenspan, former Chairman of the Federal Reserve Board, unleashed a selling frenzy that ripped around the world. Prices plunged in Asia, Europe and England. The mighty Dow Jones Industrial Average fell 145 points the next morning in New York, and closed down 55.16 points for the day.

Indeed, how do we know when stock prices are too high? All serious investors are asking this question. Surely, the Wizards of Wall Street must have the answer. Why, then, was Dr. Greenspan, America’s most powerful financial person at that time, posing the question? Was he just sending a message, or did he really want to know if stock prices were too high?

Our guess is that Dr. Greenspan was sending a message, but our work on stock valuation over the last 35 years said he was wrong.

The theory of stock valuation is relatively simple, but it is terribly difficult to apply. It is described best by the classic “*Dividend Discount Model*” which is theoretically elegant, but not practical. Not only is it based upon a number of assumptions regarding dividend payments, growth rates and risk factors which usually amount to little more than guesswork, but it is mathematically unstable. The answers it gives are usually worthless. How can we get realistic valuations of stocks based upon facts rather than assumptions?

Let’s examine the way the stock and bond markets work. They are driven by three powerful forces: earnings, interest rates and inflation, and they compete ferociously for investors’ money. Investors pour money into stocks when corporate earnings go up and the perception of value has increased. Money flows into bonds when interest rates go up and investors receive higher yields. The converse is also true.

Money goes where money grows. Stock prices go up when corporate earnings go up, and go down when interest rates go up. Stock prices are also affected indirectly by inflation rates. Rising inflation rates drive interest rates up, which, in turn, suck money out of the stock market and pull stock prices down. In summary:

Stock prices go up when:

1. Corporate earnings go up
2. Interest rates go down, and
3. Inflation rates go down.

Given this scenario, how do investors decide where to put their money? Since investors are constantly seeking to maximize their returns, they buy stocks when they think the total return would be more than that of buying bonds. In other words, the stock's price appreciation and dividend payout would be more than the compounded interest payments of bonds. They buy bonds when they think that bonds provide a higher return.

In the case of bonds, it's easy to know exactly what one would need to pay to receive a given return. Simply divide the annual interest payment by the interest yield. This is calculated as follows:

$$BP = 100*(IP/IY) \quad \text{Eq. (3.1)}$$

Where: BP = Bond Price in \$/Share  
IP = Annual Interest Payment in \$  
IY = Interest Yield in Percent

For example: The price of a bond paying an annual interest payment of \$100 and yielding 8.0 percent would be \$1,250.

$$\begin{aligned} BP &= 100*(100/8.0) && \text{Eq. (3.1)} \\ &= 100*(12.5) \\ &= \$1,250 \end{aligned}$$

With stocks, however, there is far less certainty regarding the returns one might receive. Even after a buyer and seller have negotiated a stock's price, neither party knows whether, when, or how long the stock will pay any dividends. Certainly, the potential for receiving dividends from a stock comes from a company's earnings. So, the place to start in assessing the price one should pay for a stock is from its Earnings Yield.

We can find a stock's Earnings Yield by looking at its Price to Earnings ratio, i.e., P/E ratio. This common measure of stock valuation can be found in virtually any newspaper or any financial website. The Earnings Yield for a stock may be obtained from its P/E ratio as follows:

$$EY = 100*[1/(P/E)] \quad \text{Eq. (3.2)}$$

Where EY = Earnings Yield in Percent  
P = Stock Price in \$/Share  
E = Earnings Per Share in \$/Share

For example: The Earnings Yield of a stock with a P/E ratio of 16 would be 6.25 percent.

$$\begin{aligned} \text{EY} &= 100*[1/(16)] && \text{Eq. (3.2)} \\ &= 100*(0.0625) \\ &= 6.25\% \end{aligned}$$

The most important relationship between the stock market and the bond market is that of comparing Earnings Yield, EY, to Interest Yield, IY. Investors put their money where they think it will give them the greatest rate of return. If the P/E ratios of stocks are low and Earnings Yields, EYs, are high, money will flow into stocks. If bond prices are low and Interest Yields, IYs, are high, money will flow into bonds.

When investors are fearful, they will demand that the potential return on stocks be substantially greater than that of bonds. They want to be compensated for the risk they perceive in stocks. The average EY level of stocks in the S&P 500 as of February 13, 2015 was 5.17% and the IY of long-term AAA Corporate Bonds was 2.83%. Investors obviously were fearful at that time and were demanding a 82.7% higher yield on stocks than they were on bonds. The difference between EY and IY is called the Yield Premium, YP. On February 13, 2015, the Yield Premium was equal to  $\text{EY} - \text{IY} = 5.17 - 2.83 = 2.34\%$ .

The relationship  $\text{EY} = \text{IY} + \text{YP}$ , lays the foundation for stock valuation

If  $\text{EY} = \text{IY} + \text{YP}$  Eq. (3.3)

Then:  $100 \times (\text{E}/\text{P}) = \text{IY} + \text{YP}$

If we substitute P, a stock's market Price, with V, its intrinsic value, we obtain:

$$100 \times (\text{E}/\text{V}) = (\text{IY} + \text{YP})$$

Solving for V gives us:

$$\text{V} = 100 \times [\text{E}/(\text{IY} + \text{YP})] \quad \text{Eq. (3.4)}$$

Where: V = Value of a Stock in \$/share  
IY = AAA Corp. Bond Rate in percent  
YP = Yield Premium

This equation is called our "Quick Value Estimate." Let's see what the "Quick Value Estimate" of McDonald's would be as of February 13, 2015. VectorVest's forecast of Disney's 12 month earnings per share was \$4.98. The long term AAA Corporate Bond rate was 2.83 percent and the Yield Premium, as shown above, was 2.34%. Inserting these figures into Eq. (3.4) gives us:

$$\begin{aligned} \text{V} &= 100*4.98/(2.83 + 2.34) && \text{Eq. (3.4)} \\ \text{V} &= 96.32 \text{ \$/share} \end{aligned}$$

Disney's actual closing price on February 13, 2015 was \$104.17 per share.

Equation 3.4 tells us that Disney's stock was worth at least \$96.32 per share based upon earnings and investors' perceived risk. The critical factors of profitability, earnings growth, and inflation still need to be considered. Let's do this now.

The key measure of operating performance is return on capital employed. We measure profitability by using Return on Total Capital, (ROTC). (Total Capital is defined as equity plus long term debt.) If a company's ROTC is higher than the AAA Corporate Bond Rate, its stock's Value should go up, and vice-versa. So, let's include profitability into our equation for Value.

We have found that the effect of profitability is non-linear and reflects reality as shown in the following equations:

$$R = (IY+YP) *SQR(ROTC/(IY+YP)) \quad \text{Eq. (3.5)}$$

Where:  $R$  = Profitability Factor  
 $SQR$  = Square Root of Disney's ROTC of 12.3 percent.

Therefore, starting with Eq. (3.5):

$$R = 5.17*SQR(12.3/5.17) \quad \text{Eq. (3.5)}$$

$$R = 5.17*SQR(2.38)$$

$$R = 7.97$$

Now we can use this number in the following equation:

$$V = 100*(E/(IY+YP))*SQR(R/(IY+YP)) \quad \text{Eq. (3.6)}$$

Substituting all the numbers into Eq. (6) gives:

$$V = 100*(4.98/5.17)*SQR(7.97/5.17) \quad \text{Eq. (3.6)}$$

$$V = 100*(0.96)*SQR(1.54)$$

$$V = 119.19 \text{ \$/Share}$$

Even with the filtered Profitability Factor, Disney's stock Value received quite a boost. Let's proceed.

Earnings growth is the key factor in perceiving future expectations. We need to compare earnings growth to inflation in the same way we compared profitability to interest rates. If a company's earnings growth rate does not exceed the current rate of inflation, it's falling behind and its stock Value should go down. We will also link earnings growth to profitability since profitability determines a company's internal growth rate. Here is how it's done:

$$V = 100*(E/(IY+YP))*SQR[((R+G)/2)/((IY+YP)+F)] \quad \text{Eq. (3.7)}$$

Where  $G$  = Annual earnings growth rate in %/yr.  
 $F$  = CPI inflation rate in %/yr.

Note that the factor,  $SQR[((R+G)/2)/((IY+YP)+F)]$ , is a performance measure of the company's ability to increase shareholder value. If this factor is less than 1.00, the company is losing out to interest and inflation and should be viewed as a questionable investment prospect.

For Disney:  $G = 15.0\%/yr.$ ,  $F = 0.8\%/yr.$ , so:

$$V = 100*(4.98/5.17)*SQR[((7.97+15.0)/2)/(5.17+0.8)]$$

$$V = 100*(0.96)*SQR(11.49/5.97)$$

$$V = 100*(0.96)*1.39$$

$$V = 133.15 \text{ \$/Share.}$$

Inclusion of profitability and earnings growth in the valuation equation increased the calculated value of Disney's stock from \$119.19 per share to \$133.15. Disney's closing price of \$104.17 was between the two values

we calculated earlier. Which value is the better answer? We should opt for the value obtained using Eq. (3.7), i.e., \$133.15. It's the result of a more comprehensive assessment.

Now, let's see how Equation (3.7) works for the 30 stocks in the DJIA. In Table I, we have listed all the data needed to use Equation (3.7), and have also converted the sum of the Values into the VV-DJIA using a divisor of 0.1557159, which we obtained from the *Wall Street Journal*.

**Table I. Realistic Value Estimate of the Dow Jones**

Industrial Stocks as of February 13, 2015. (IY + YP) = 5.17%, F = 0.80%

Stock	Price	EPS	ROTC	GRT	Value
3M Co	\$165.94	8.34	24.9	9	\$172.46
A T & T Inc	\$34.66	2.24	3.8	-2	\$25.55
Amer Express	\$78.08	6.11	8.2	11	\$119.93
Boeing Co	\$149.73	8.43	32.2	14	\$191.94
Caterpillar	\$85.13	5.89	8.3	0	\$67.45
Chevron Corp	\$112.78	8.67	12.6	-6	\$95.39
Cisco Systems	\$29.43	1.94	10.2	3	\$31.60
Coca Cola	\$41.99	2.04	16.3	-4	\$31.70
Disney (Walt)	\$104.17	4.98	12.3	15	\$112.26
DuPont	\$76.18	4.33	15.9	16	\$81.84
Exxon Mobile	\$93.37	6.57	17.4	-5	\$88.02
Gen'l Electr	\$25.15	1.73	3.8	2	\$18.81
Goldman Sachs	\$189.00	18.25	3.1	8	\$214.57
Home Depot	\$111.89	4.84	19.8	14	\$110.07
Intel	\$34.36	2.48	17.0	12	\$49.88
Int'l BusMach	\$160.40	16.5	29.5	0	\$209.17
J P Morgan Chs	\$59.67	5.94	4.1	15	\$82.62
Johnson & Jhsn	\$99.62	6.25	15.8	10	\$134.13
McDonalds	\$95.65	5.25	18.5	-5	\$89.24
Merck & Co	\$58.81	3.04	6.0	5	\$52.44
Microsoft	\$43.87	2.78	20.0	4	\$56.76
Nike Inc. B	\$92.04	3.79	22.3	14	\$91.22
Pfizer Inc	\$34.64	1.93	10.6	1	\$28.72
Proctor & Gmbl	\$85.90	4.09	12.6	0	\$63.81
Travelers Comp	\$108.00	10.07	12.0	9	\$160.95
United Tech	\$121.25	7.39	12.3	9	\$160.95
UnitedHlth Grp	\$109.44	6.42	11.7	7	\$139.54
Verizon Comm	\$49.31	3.45	7.7	8	\$59.56
Visa Inc	\$269.63	10.6	19.8	14	\$217.85
Wal-Mart Strs	\$85.81	5.02	23.6	0	\$72.92

The Values shown in Table I resulted in a VectorVest Industrial Average, VVIA, of 24,044.03. The actual Dow Jones Industrial Average, DJIA, closed at 17,986.86. Clearly Eq. 3.7 gives only ball-park estimates of stock value. Much better answers can be obtained directly from VectorVest, which calculated a VVIA Value of 19,728.00 on February 13, 2015. Does the calculated value of 19,728.00 frighten you? It shouldn't. Taken as a group, the Dow Jones Industrials has never been in better shape.

Eighteen of the stocks in Table I had Value estimates above their February 13, 2015 closing prices and twelve were below. This shows that Equation (3.7) is not biased to give either high or low valuations. Given the relatively high level of year-over-year earnings growth and low interest and inflation rates, the Dow is looking good for the future.

In several cases, the difference between Price and calculated Value was quite large. This means that the stock was either grossly overvalued or undervalued. For example, AT&T, KO and MCD were overvalued with Price well above Value. On the other hand, American Express and Intel were grossly undervalued. Overall, the Table I valuation of 20,044.33 was saying that "irrational exuberance" had not taken hold of the market as of February 13, 2015.

It is also worth noting that as of February 13, 2015 \$37.94 per share, the average Value of all 8,180 stocks in the VectorVest U.S. database compared to average Price of \$38.44 per share. These valuations are reported each week in the Valuation Section of the VectorVest Views.

Our purpose in valuing stocks is not to duplicate actual market prices with a formula. It is to determine what a stock's price ought to be based upon first principles. Equation (3.7) is a good start in this endeavor. Not only does it give us the advantage of knowing whether a stock is over or undervalued, it does the following things:

- It allows us to relate the intrinsic value of stocks to earnings, interest rates and inflation. It is the first and only stock valuation equation to bring these critical factors together in a realistic, usable fashion.
- It explains why highly profitable, high growth stocks command high P/E ratios, and
- It shows why P/E ratios must be assessed in light of prevailing economic conditions.

Over the years, the calculated Value of the DJIA, and the VectorVest Industrial Average, VVIA, has been a trustworthy guide to market performance, as it has signaled impending danger as well as golden opportunities. We are especially proud of how well our model signaled that the market was seriously overvalued in May 1987, six months before Black Monday, October 19, 1987, when the Dow fell more than 500 points.

This prescient behavior was also demonstrated in March 2000, at the height of the Internet bubble. On March 10, 2000, I wrote: "The Price of the VectorVest Composite (VVC) rose again last week, and is now 43.6% above the Value of the VVC. This is pretty scary, but what do we know?" Yes, it was a time of the so-called "new economy" in which earnings didn't matter, but sales growth was the dominant factor in assessing stock value. All I know is that you'll never take any profits to the bank if your sales don't cover your costs.

On February 23, 1996, I wrote a brief essay called, "Riding the VectorVest Rocket." Here's what I said, "Nine months ago, you were invited to ride the VectorVest Rocket to Dow 5,000. It seemed scary then, but lower interest rates and higher earnings powered the mighty Dow to above 5,000, above 5,500 and to an all-time closing high of 5,630. Can the ride continue?"

Indeed it could! The mighty Dow Jones Industrial Average, DJIA, closed above 18,000 for the first time ever on Friday, February 13, 2015 when it closed at 18,019. The VectorVest Industrial Average, VVIA, closed above 18,000 for the first time ever nearly a year earlier, on February 21, 2014 when it closed at 18,258 and the mighty DJIA was at 16,103. It has been an impressive journey and it's not over yet. The VVIA was more than 1,700 points higher than the DJIA on February 13, 2015. Think about the tremendous advantage you have when you know how to value stocks.

# 4

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Stock Valuation and Stock Market Cycles**

There's a terrific battle raging on Wall Street. The Bulls are looking for new highs. The Bears are saying the party's over. Both camps are making their point with a plethora of facts, fiction and fluff. How can we cut through the noise and focus on what's really happening?

The Efficient Market Theory states that it is impossible to "beat the market" because share prices always incorporate and reflect all relevant information as soon as it becomes available. Implicit in this theory is the condition that all market participants receive and act on all relevant information at the same time. Of course, this notion is silly and is not true.

The reality is that market participants certainly would like to be among the first to receive all relevant information, but only a few have the wherewithal to do it. The Pros and high frequency traders can do it, but most of us are among the last to hear any market moving news until it's old hat. So, how can we deal with this disadvantage?

We have to focus on the primary forces driving the market and not get bogged down or misdirected by useless headlines. Astute investors know that three powerful forces drive the stock market. They are known to everyone, but are usually misunderstood. They are related, but independent. They are measurable, but controversial. They convey the effects of all that happens and ultimately determine the fate of the market.

When a major event such as a product introduction, an earthquake or assassination occurs, investors instinctively speculate on whether it will help or hurt corporate earnings. If the event seems likely to help earnings, the perception of stock value rises, so prices rise. Conversely, prices fall when the news is perceived to be harmful to earnings. Corporate earnings is the first powerful force driving the stock market.

The bugaboo of a strong economy and the thing that constantly haunts the market, is inflation. Inflation causes raw material, labor and service costs to rise. Unless a company increases productivity and raises prices,

profit margins narrow and earnings go down. Rising inflation ultimately pushes stock prices down. Inflation is the second powerful force driving the stock market.

Inflation not only lessens the value of financial assets, it erodes the purchasing power of consumers. Left unchecked, inflation destroys monetary stability and leads to a weak economy. The Federal Reserve Board (The Fed) is charged with the responsibility of maintaining monetary stability. It fulfills this task by controlling the money supply. When the Fed sees inflation increasing, it tightens the money supply and interest rates go up.

Ironically, higher interest rates raise costs. High interest rates stifle investment, weaken the economy, hurt corporate earnings and eventually lead to a Bear market. The third powerful force driving the stock market is interest rates.

In summary:

Stock prices rise when earnings go up. Stock prices fall when inflation and interest rates go up.

While most investors are familiar with these basic observations, the stock valuation formula published in Chapter 3 is the only relationship which ties these powerful forces together. This relationship is shown as follows:

$$V = 100 * (E / (IY + YP)) * \text{SQR} [ ((R + G) / 2) / ((IY + YP) + F) ] \quad \text{Eq. (3.7)}$$

Where:

V = Stock Value in \$/Share

E = Earnings Per Share in \$/Share

IY = AAA Corp. Bond Rate in Percent

YP = Yield Premium

SQR = Square Root

ROTC = Return on Total Capital in Percent

R =  $(IY + YP * \text{SQR}(\text{ROTC} / (IY + YP)))$  Eq. (3.6)

G = Annual earnings growth rate in %/yr.

F = CPI inflation rate in %/yr.

Equation (3.7) clearly shows that Stock Value increases when Earnings Per Share, Profitability and Earnings Growth Rate increase. Stock Value decreases when Interest rates and CPI inflation increase. Let's see how Eq. (3.7) can help us understand why and how the market cycles.

First, let's calculate the Value of the S&P 500 stock index to see where it stands today. As of February 13, 2015, the following data was available on the S&P 500:

E = 108.43 \$/Share

IY = 2.83 Percent

YP = 2.34 Percent

ROTC = 10.0 Percent

R = 7.19

Eq. (3.6)

G = 9.0 Percent/yr.

F = 0.80 Percent/yr.

Substituting these figures into Eq. (3.7) gives:

$$\begin{aligned} V &= 100*(108.43/5.17)*\text{SQR}[\frac{(7.19+9.0)}{2}]/(5.17+0.80)] \\ &= 100*(20.97)*\text{SQR}(8.10/5.97) \\ &= 100*(20.97)*\text{SQR}(1.35) \\ &= 100*(20.97)*(1.16) \\ &= 2,441.85 \end{aligned}$$

The S&P 500 closed at 2,096.99 on February 13, 2015. The hypothetical result, which was 16% above the closing value of the S&P 500 on February 13, 2015, indicates that the S&P 500 was undervalued. The race between higher earnings and higher interest and inflation rates was clearly being won by earnings. Earnings were nearly at all-time highs and inflation and interest rates were at historic lows.

Bull markets are born when the economy is very weak, but there's a hint of hope that better days lie ahead. Consider the most recent cycle. The economic outlook in March of 2009 was dismal and earnings were falling. On the morning of March 10, 2009, however, it was reported that Citigroup made money in the first quarter. This was the kind of news that investors were praying for and it sparked a tremendous rally which continues to this very day, February 13, 2015.

Yes, the economy was still very weak, but the prospect of combining rising earnings, low interest and inflation rates along with very low, beaten down stock prices created the buying opportunity of a lifetime.

The power of lower interest rates can be illustrated by noting that our valuation formula indicates that the S&P 500 index would fall 218.15 points or about 9% if the CPI inflation rate rose by only 1.00 percentage point. Obviously, when both interest and inflation rates were very low, the market had extraordinary lifting power. This is exactly what happened in late 2008 and throughout 2009. It was the interest-sensitive phase of the Bull market. Stocks of all stripes soared.

Helped by a very accommodating Fed, the economy began improving in 2009 and earnings began to rise. Inflation and interest rates continued to stay low and the Bull market was in full swing. Stocks in housing, furniture, appliance, and other associated industries were on fire. It was the best of all worlds. The role of Dr. Ben Bernanke, Chairman of the Federal Reserve, during this critical period must be recognized. In order to avoid a global economic meltdown in the 2008 bear market and nurture the economy back to growth, he lowered interest rates to historic levels and flooded the world with dollars. While the global meltdown was avoided, the strong economic recovery he hoped for was not achieved. Stock prices have recovered to all-time highs, but the game isn't over yet.

The economy will improve eventually, and the Fed will begin to raise interest rates. Many analysts believe the Fed will begin to raise interest rates sometime in mid-2015. The Bull market will continue until stocks become overvalued and high interest rates strangle economic growth. The strong dollar and fallen oil prices have affected earnings growth. This is the first sign of an impending bear market. Sooner or later, a Bear market will come and the cycle will begin anew.

# 5

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Earnings Growth: The Golden Touch**

Your job as an investor is to preserve and increase your net worth. Your enemies are spending, taxes and inflation. Spending can be controlled. Taxes may be deferred, sheltered and avoided, but not evaded. Inflation cannot be deferred or evaded, but it can be overcome. One of the surest ways of defeating these enemies is to have a portfolio of solid growth stocks.

**SETTING INVESTMENT OBJECTIVES.** The rate of return needed to cope with taxes, overcome inflation and provide current income varies with economic conditions and your personal circumstances. Only you can decide how much cash you need for spending. Beyond the need for current income, the minimum rate of return you should aim to achieve is equal to the sum of the CPI inflation rate plus the yield on long-term AAA Corporate Bonds. In the early 1980's, this sum was about 20 percent per year. With inflation currently below one percent and AAA Corporate Bonds yielding less than three percent, your hurdle rate is now less than four percent per year. But it won't stay this way forever, so don't forget what you have to do.

Stocks have appreciated historically at an average rate of nine percent per year. The average earnings growth rate for American companies has also been about nine percent per year. This is not a coincidence. Earnings growth is the engine that drives stock prices higher and higher.

The earnings growth rate of your stocks must be consistent with your investment objectives. If you want to double your money every five years, you should have a portfolio of solid stocks growing at least 14 percent per year. When inflation and interest rates increase, it's necessary to adjust your investment objectives accordingly. A thorough understanding of the role of earnings growth, how growth rates are estimated, and the appropriate use of growth estimates will help you select the right stocks.

**THE ROLE OF EARNINGS GROWTH.** Companies must grow to stay alive. They cannot stand still. Spending, taxes and inflation erode a company's wealth, just as they do yours. If a company fails to grow fast enough to stay ahead of these common enemies, it will eventually die. On the other hand, a company will prosper if its earnings grow steadily at a robust rate. Earnings growth is a manifestation of a company's health and future prospects. It is also a key indicator of your portfolio's health and potential.

**ESTIMATING GROWTH RATES.** The concept of earnings growth is very simple, yet estimating growth rates can be terribly difficult. It's like computing the gas mileage of your car. Calculating the MPG on a single tank of gas is very simple. But it can also be very misleading. Obviously, your average miles per gallon varies widely depending upon driving conditions and other circumstances. Companies like Disney and Nike grow earnings at a nice steady pace, so there's very little problem estimating their growth rates. Other companies are like stop and go drivers. Their earnings go up and down in a hopelessly random fashion. Although it's virtually impossible to predict the earnings of these erratic performers, you still need to have an idea of their earnings growth prospects.

Given the variety of factors and circumstances affecting earnings performance, a system of estimating earnings growth is required that virtually tailors growth estimates for each company. Take, for example, the simple step of selecting a time period for computing a growth rate. When should the period begin? Five, ten, fifteen years ago? When should it end? One, three or ten years from now? This single decision makes a major difference in the estimated growth rate you would obtain. Other critical issues like handling negative numbers and dividing by zero make it easy to see why many growth rate estimates may be totally erroneous.

One of the worst examples of misleading growth rates used to appear in a popular financial magazine which published monthly lists of "America's Fastest Growing Companies." These companies were defined as "showing at least a 200% gain in quarterly earnings." Sure, a company's quarterly earnings may increase from one cent to three cents for a 200% gain, but does that mean it's one of America's Fastest Growing Companies? Give me a break!

How does one arrive at these outlandish figures? Simple third grade arithmetic? Brokers merely compare last year's earnings per share with the leading 12-month earnings forecast. The result is misleading and essentially useless information for investors.

Statistical analysis of historical data is required to properly determine earnings growth performance. Earnings performance data may be obtained from a company's annual reports or various financial services. Historical data is necessary but not sufficient. It only reflects the past. The stock market anticipates the future. Extrapolating the past to estimate future growth is a common and foolish mistake. You need forecasted growth rates to know where a company is heading.

VectorVest provides estimated growth rates for over 23,500 stocks every day. It statistically analyzes historical sales and earnings performance, takes into account current quarter-to-quarter changes in sales and earnings and uses forecasted earnings to target future growth. VectorVest analyzes both sales and earnings data because they are linked in the long-term. Sales growth without accompanying increases in earnings growth reflects a loss of margin...a bad sign. Earnings growth without equivalent sales growth reflects cost cutting, productivity improvements, and so on. These are good things, but they can't last forever. Clearly, there's much more to estimating earnings growth than meets the eye.

**USING GROWTH FORECASTS.** Even a perfect growth estimate reflects conditions at a single moment in time. Therefore, it's necessary to use these estimates with three considerations in mind. These are:

1. Sustainability,
2. Trends and
3. Variability.

**SUSTAINABILITY.** The mark of a great growth company is the ability to continue growing at a steady, predictable pace. The law of large numbers, however, dictates that extremely high earnings growth rates cannot be sustained. Due to transformative product innovations, Apple Computer had an unbelievable run of triple digit quarterly gains. It was a great growth company. But triple digit growth rates are no longer happening. The fruits of its own success made it so.

About one-fourth of the companies in our VectorVest database are currently estimated to grow at or above 14 percent per year. Many will still be growing rapidly ten years from now. Others will not. It takes phenomenal products, customer service and management to grow at double digit rates for years on end. Disney, Nike and Sherwin-Williams are prime examples of such great companies. They are literal money machines.

**TRENDS.** The transition from high growth to sustainable growth is a scary experience that usually causes considerable anxiety among investors. The slightest hint of an earnings slowdown causes a stock's price to fall. A failure to meet an earnings forecast by as little as one cent often results in a 30 percent drop in price. No one knows for sure what a company's sustainable growth rate will be or when it will occur. Therefore, VectorVest updates its earnings estimates each week for every stock. VectorVest is the only software which allows you to see these trends on a chart.

We have found that long-term earnings growth trends provide excellent leading indicators of a stock's price performance. Intel is a great company. It was a high growth stock and its price went higher and higher. Intel's stock price peaked in August 2000, when its growth rate began to trend downward. Over the years its growth rate has shown renewed signs of growth, only to retreat again. No one knows whether its sustainable growth rate is 20 or 2 percent per year. Until this has been determined, Intel's stock price will lag the market.

Tracking growth trends may also reveal spectacular turnaround situations before they are generally recognized by the public. An unexpected increase in earnings performance often causes a stock's price to soar. This can happen even if a company loses less money than it did the year before. So, a reduction in negative growth can be just as important as an increase in positive growth.

**VARIABILITY.** The third important consideration in using growth rates is variability. Premier growth companies have a history of consistent, predictable financial performance. It is very easy to estimate the growth rates of companies like Disney and Starbucks. These companies are called "Ruler Stocks," because their quarter-to-quarter earnings increase at a constant rate. You can lay a ruler along a plot of this data. Estimating that these companies will grow as they have in the past entails very little uncertainty.

The way to judge the variability, i.e., risk of a growth forecast, is to examine VectorVest's Relative Safety ratings. Stocks with Relative Safety ratings above 1.00 on a scale of 0.00 to 2.00 have above average financial performance. They also have less variability in their growth forecasts. Less than 7 percent of the stocks in our database have growth rates greater than or equal to 14 percent per year and Relative Safety ratings of 1.00 or over. Your chances of finding a "Ruler Stock" are even less. Let's see how this information can be used to build a variety of growth portfolios.

**HIGH GROWTH STOCKS.** Aggressive investors must deal with high growth stocks. The risks are high, but so are the potential rewards. Here's a list of the five fastest growing stocks in VectorVest's database as of 02/13/2015.

Table I. High Growth Stocks Ranked by Growth Rate in %/year.

Company	Price	Value	RS	GRT	\$DIV	DY
Supernus Pharm	8.80	13.28	0.58	56	0.00	0.00
Cheetah Mobile	20.20	34.95	0.77	52	0.00	0.00
Horizon Pharm	16.84	1.98	0.72	52	0.00	0.00
iDreamSky Tech	11.99	2.28	0.73	51	0.00	0.00
Ring Energy Inc.	10.00	19.73	0.67	51	0.00	0.00

Data reflects 02/13/15 closing prices.

Value = \$/share as computed by VectorVest

RS = Relative Safety

GRT = Earnings Growth Rate in %/year

\$DIV = Dividend in \$/share

DY = Dividend Yield in Percent

Note the wide range of Price to Value comparisons among these stocks. This illustrates the uncertainty in assessing the potential of these companies. The low Relative Safety (RS) ratings also show the risks of dealing with unproven entities.

**GROWTH & INCOME STOCKS.** Conservative investors usually prefer to achieve their target level of total return by combining earnings growth with dividend payout. It's OK to do this, but don't take it too far. High yield without earnings growth is a loser's game. I suggest that the earnings growth rate of your stocks be at least double the dividend yield. For example, a portfolio offering a 12 percent total return would have stocks with at least eight percent growth and four percent yield. In most cases, I tend to favor stocks with higher growth and less yield. Here's a list of solid stocks with at least 12 percent growth and three percent yield.

Table II. Growth & Income Stocks Ranked by VST+YSG.

Company	Price	Value	RS	GRT	\$DIV	DY
Alliance Resc	39.29	62.45	1.03	16	2.60	6.62
Waddell & Reed	49.94	74.90	1.02	15	1.72	3.44
R P C	13.36	16.54	1.24	13	0.42	3.14
DuPont Fabros	31.83	24.41	1.03	25	1.68	5.28
LaSalle HtlPpy	41.14	32.79	1.00	25	1.50	3.65

Data reflects 02/13/15 closing prices.

Unlike the stocks in Table I., each of these stocks has a solid track record of financial performance as reflected by the Relative Safety, (RS), values which are equal to or greater than 1.00. Each company pays a dividend. The average sum of GRT for these stocks is 23.23% and the average DY is 4.43%. A lot of money managers would give their right arm to do as well.

**RULER STOCKS.** As noted above, the consistency and predictability of the earnings performance of "Ruler Stocks" is so good, that you can draw a straight line through their quarter-to-quarter twelve months earnings performance. They're easy to find with VectorVest. We simply use VectorVest's 'Ruler Stocks' scan to instantly identify stocks having an  $RS \geq 1.40$  and  $GRT \geq 14$ .

Table III. "Ruler Stocks" Ranked by RS\*GRT

<b>Company</b>	<b>Price</b>	<b>Value</b>	<b>RS</b>	<b>GRT</b>	<b>\$DIV</b>	<b>DY</b>
Gilead Sciences	101.90	218.95	1.43	44	0.00	0.00
Skyworks Soltn	81.85	121.64	1.45	28	0.52	0.64
Southwest Air	43.30	76.00	1.40	24	0.24	0.55
Centene Corp	118.18	140.72	1.42	24	0.00	0.00
Shire PLC	239.82	337.14	1.40	22	0.62	0.26

Data reflects 02/13/15 closing prices.

Note that these phenomenal stocks are ranked by RS \* GRT. (Only VectorVest can perform this search for you). Also note only one of the five stocks is selling at a premium Price compared to Value and the remaining four are well below their Value. Why are they worth buying? The answer will be given in Chapter 6, "High Growth vs. Low P/E Stocks." All of these stocks have favorable upside potential compared to an investment in AAA Corporate Bonds. Imagine seeing your money grow at an average rate of 28.4% a year with stocks in some of America's best managed companies!

**PREMIER GROWTH STOCKS.** Prudent investors want the best of all worlds...high growth and low risk. This marvelous combination can be found in premier growth stocks. These companies have exemplary records of above average, consistent, predictable earnings growth. Some pay dividends, some do not. Here's a short list of my favorites:

*Table IV. Premier Growth Stocks Ranked by Growth Rate in %/year.*

<b>Company</b>	<b>Price</b>	<b>Value</b>	<b>RS</b>	<b>GRT</b>	<b>\$DIV</b>	<b>DY</b>
VASCO Data Sec	27.86	23.07	1.25	31	0.00	0.00
Alexion Pharm	182.29	169.35	1.37	30	0.00	0.00
Illumina, Inc	198.54	96.42	1.28	28	0.00	0.00
Actavis	285.37	240.85	1.26	24	0.00	0.00
Regenrn Pharm	402.40	244.71	1.32	23	0.00	0.00

Note that the Price of each stock is greater than Value. That's why we call them "Premium Growth Stocks." Investors are willing to pay a premium price for these stocks because of their rare combination of high growth and outstanding financial performance. None of these stocks pay a dividend. They are relatively young companies and are focused on using every cent of capital at their disposal on growth. With an average growth rate of 27.2%/year, this portfolio of stocks has a good chance of doubling in three years. That's not a bad deal when you consider the relatively low risk of owning them. Each is a leader in its field.

Coming up with lists such as this is easy with VectorVest, but it is the result of a lot of hard work. Fortunately, VectorVest has done the work. All I had to do was ask VectorVest.

When it comes to preserving and increasing your wealth, go with consistent, predictable growth. It's the Golden Touch.

# 6

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **High Growth vs. Low P/E Stocks**

High growth stocks offer the promise of the future. Low P/E stocks provide the certainty of today. There are strong arguments for and against buying either type of stock. Which stocks are best for you?

Many successful investors, including the legendary Peter Lynch, say a growth stock is fairly valued as long as its earnings growth rate is greater than its P/E ratio. David Dreman, the high priest of low P/E stocks, says that low P/E stocks provide better profits with less risk. These views are very interesting, but how can we tell which choice is best?

Consider the following questions:

A. If someone were to offer you \$500 now or \$1,000 in three years, which would you take?

B. If someone offered to sell you a \$1,000 note payable in three years, how much would you pay for it?

In regard to question (A), a lot of people would take the \$500 now even though receiving an additional \$500 in three years is very attractive. For whatever reason, \$1,000 three years hence is deemed by these people to have a Present Value of only \$500. Don't they know that \$500 would have to grow at a compounded rate of 26% per year to become \$1000 in three years? Maybe, but they want the money now. They are the kind of people that buy low P/E Stocks.

In regard to question (B), a lot of people would gladly pay \$500 to receive \$1,000 in three years. Compounding money at 26 percent per year is not chopped liver. That's what buying high growth stocks is all about.

Ah, but what about risk? Doesn't it play a role in making these decisions? Of course it does. It plays a very important role. That's why buying a stock simply because it has a high earnings growth rate or a low P/E ratio is not only naive, it's silly.

Unless one has a way of taking risk into account, they will never know how to make the best investment decisions. Discounted cash flow analysis provides the tools for doing this. It allows us to:

1. Calculate exactly how much money we should be willing to accept now (Present Value) in lieu of a future payment (Future Value) depending upon our desired rate of return and risk premium (Discount Rate),
2. Determine how much an investment should be worth in the future, and
3. Compute the Discount Rate for an investment, given its Present and Future Values.

Let's apply these concepts to stock analysis.

When thinking about buying a stock, we're trying to judge how high its price will go when there is risk involved. In essence, we want to know if the price appreciation potential is worth the stock's current price and risk.

Here's how to get the answer:

**I. COMPARE PRICE TO VALUE.** In Chapter 3, we learned how to calculate the value of stocks. This calculation did not take risk into account or attempt to determine a stock's future worth. However, it provided the necessary starting point for assessing a stock's price appreciation potential.

One of the most speculative, high growth stocks on the market today is that of Tesla Motors, (TSLA). As the name implies, Tesla Motors makes electric cars. Although several electric cars have been put on the market by a variety of manufactures, none has captured the imagination of investors like Tesla has.

TSLA broke out to an all-time high of \$43.93 per share on April 1, 2013. VectorVest gave it a "Buy" rating on April 18, 2013 as it closed at \$45.59. It soared to \$193.37 by September 30, 2013 before it pulled back and got a "Sell" rating at \$155.45 on November 6, 2013. Of course, it got a series of Buy, Sell, Hold ratings as it sawed its way to an all-time high of \$286.04 on September 4, 2014. It closed at \$203.77 with a "Hold" rating on February 13, 2015. The highest Value Tesla ever got from VectorVest was \$71.93 on November 10, 2014. It had a Value of \$64.95 on February 2, 2015. So, why were investors chasing the stock?

Tesla Motors is an exciting company that produces premium electric cars. It is making a huge bet on the future and the potential rewards are enormous. Is it worth \$203.77 per share to buy this stock? We need to take risk into account to make a proper assessment.

**II. ASSIGN RISK.** VectorVest performs a complete risk analysis on over 23,500 stocks each day based upon their financial condition, operating performance, stock price history and volatility. Taking these and several other factors into account, VectorVest awarded Tesla a Relative Safety rating of 0.84 on February 13, 2015. This is below average, but not terrible on a scale of 0.00 to 2.00. Therefore, it was assigned a moderately high risk.

**III. APPLY EARNINGS GROWTH TO PRICE APPRECIATION.** We make the assumption that a stock's price appreciation will be consistent with its earnings growth over the long-term. For Tesla, the forecasted earnings growth rate was 35% per year as of February 13, 2015.

**IV. COMPUTE FUTURE VALUE.** Given the Price to Value spread of \$134.60 per share, earnings growth rate of 35%/yr, and Relative Safety of 0.84, we computed the Price of Tesla's stock three years into the future. It turned out to be \$223.78 per share.

**V. DISCOUNT FUTURE VALUE TO A NET PRESENT VALUE.** This computation results in a number we call Relative Value. We use this term because Relative Value compares the price appreciation potential in Tesla's stock, (\$20.60 per share in three years), to the gain one would obtain from an alternative investment in AAA Corporate Bonds yielding 2.83% (The interest rate of 2.83% is our Discount Rate).

Since an investment in AAA Corporate Bonds would appreciate 1.087% in three years, the Relative Value of Tesla's stock as of September 13, 2015 is:  $(\$223.78/203.77)/1.087 = 1.01$ .

A Relative Value of 1.01 says that an investment in Tesla's stock, with a forecasted growth rate of 35%/yr, Relative Safety of 0.84 and P/E ratio of 81, would appreciate only 1.00% more in three years than a comparable investment in AAA Corporate Bonds with an extremely low interest rate of 2.83%.

Contrast the analysis of Tesla with that of Travelers Companies, (TRV). Travelers closed at \$108.00 per share on February 13, 2015 with a forecasted earnings growth rate of 9%/Yr, and a P/E of 10.7. With a Relative Safety of 1.45 and a dividend yield of 2.04%, it's a nice boring stock. It also had a favorable RV of 1.35.

Note that Tesla would fail both Mr. Lynch's test of Growth/(P/E) being greater than 1.00, (actually 0.43), and Mr. Dreman's test of having a low P/E ratio, i.e., 81.

It is also worth noting that Relative Value makes it possible to compare all stocks on a consistent basis. Stocks with Relative Value ratings above 1.00 have favorable price appreciation potential. Those with RV values below 1.00 are either glamour stocks selling at a premium, overpriced, have low or non-existent earnings, and/or low growth rates.

If you want to have some fun and improve your profits, use VectorVest to examine the Relative Value and growth rates of the stocks you own. Discover whether you prefer high growth or low P/E.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Stock Safety: The Missing Link**

Several years ago, I received a thing in the mail called the “Hot Stocks Review.” Phrases like “may even double again in the next twelve months,” and “could have you crowing all the way to the bank” riveted my greedy eyes. Never one to pass up great investment opportunities, I decided to look into these “Hot Stocks.” The blurb gave an 800 number to call for more information, but I prefer to do my own research.

The first thing I did was check my VectorVest database. Only two of the 29 stocks recommended by the “Hot Stocks Review” were covered by VectorVest. This was not too surprising since only eight of the 29 stocks are traded on American exchanges. Both of the stocks covered by VectorVest had a below average Safety rating. Neither had a Buy recommendation.

I checked Standard & Poor’s Stock Guide, which covers more than 8,000 stocks, and found only one stock. It was not ranked in terms of earnings and/or dividend quality.

Obviously, if one were to invest in any of these stocks, one would have to believe the promotional material touting the stocks, or use the information sent by the companies. There are two problems here. First, it takes a lot of time and effort to analyze a company’s financial statement, and I wasn’t sure I wanted to do this even for the eight stocks traded on the NASDAQ. Secondly, the investment caveats cited in company literature and prospectuses are designed to protect the seller, not the buyer.

Of course, the publication featuring the “Hot Stocks Review” included the usual disclaimers that “all investments carry risks,” and made it clear that “the publisher nor anyone else involved would be liable for any investment decision resulting from their recommendations.” That’s fine, but how does one get a handle on finding out how risky a stock is, anyway?

Risk has two parts:

- a. The probability of an unfavorable outcome, and
- b. The consequences derived from that unfavorable outcome.

Simply put, investment risk entails the probability of losing money, and the pain associated with the loss.

Each of us needs to know how much money we can afford to lose on any single investment. Even though the risk is extremely high, we may be very comfortable with buying a lottery ticket because we can afford the loss. Buying stocks, however, is a lot different. We're using serious money when investing in the market...money that can make a difference in the way we live. Once we have established our "tolerance for risk," we can focus on assessing the risks involved with individual stocks.

Good information on stock safety is hard to find. Maybe that's because it's the last thing anybody wants to think about. Even the few credible sources that provide some form of risk analysis, do so subjectively. Consequently, most investors do little more than plug intuition into their investment decisions. It's the missing link in assessing stocks.

Knowing how safe (or risky) a stock is can make the difference between making you a winner or loser as an investor. Here are the key factors used by VectorVest in assessing stock safety.

**EARNINGS CONSISTENCY.** The largest risk that shareholders have is that the company fails to meet earnings expectations. Experienced investors know that the moment of truth comes each quarter for every publicly traded American company. If a company fails to meet analysts' earnings estimates, its stock's price often drops 30% in a single day. Therefore, the single most important factor in assessing stock safety lies in quantifying the probability that quarterly earnings will meet investor's expectations. If a company has a well established record of consistent, predictable earnings performance, it is much more likely to meet the market's expectations.

Companies like Sherwin-Williams, Old Dominion Freight, and Nike have exemplary records of consistent, predictable earnings performance. These stocks have very high Safety ratings in the VectorVest system of analysis.

**COMPANY SIZE.** It is true that the stocks of large companies generally are safer than those of smaller companies. Many fund managers are forbidden to invest in companies with less than a billion dollars in annual sales. Obviously, larger sized companies aren't going to disappear overnight. Investors should not assume, however, that the shares of a company are safe just because they belong to big companies. Size is not nearly as important to an equity investor as knowing where the company's earnings are heading. It is virtually impossible to forecast the earnings of companies in cyclical industries with any degree of accuracy. Therefore, the VectorVest safety ratings on these stocks are below average.

**PRICE BEHAVIOR.** The classic measure of price volatility is given by "Beta." Beta reflects the statistical movement of a stock price compared to that of the market. If a stock's price moves up and down exactly in sync with the market, it will have a Beta of 1.00. If a stock's price consistently moves up 10% more than the market and down 10% more than the market, it is more volatile than the market, and it has a Beta of 1.10.

Fair enough. High Beta stocks are more volatile than the market and less predictable. Therefore, they are riskier than the market. Ironically, they are not necessarily riskier than some low Beta stocks. Certain stocks, such as gold stocks, are very volatile, but tend to move counter to the market. These stocks may have low or even negative Betas. Given this dilemma, I use Betas with a grain of salt. I prefer to analyze absolute price behavior to measure risk.

Absolute price behavior not only provides an unequivocal measure of volatility, but it allows one to assess risk in relation to the stock's price history. Since all things tend to move toward a mean, stocks which are well

above their price moving averages are more likely to move down, and stocks which are well below their price moving averages are more likely to move up. Therefore, a stock which has moved well above its price moving average is riskier than one which has moved well below its price moving average.

**LONGEVITY.** It's better to deal with the devil you know, than with the one you don't. All other factors being equal, there's less risk in dealing with a company with a long track record than one which is brand new. Young companies offer some of the best investment opportunities, but they also bear potential pitfalls that could be fatal. Regardless of how good a stock looks, it's risky if it hasn't been traded for at least five years.

**DIVIDEND HISTORY.** A company doesn't have to pay a dividend to have a very safe stock. But if it does pay a dividend, it must maintain or increase the dividend without exception. A cut in dividend is a black eye for any company and reflects poorly on its management and stock safety.

**DEBT/EQUITY RATIO.** The US government allows companies to deduct interest payments as a business expense. That's nice, but some companies overdo a good thing. They load up on debt beyond the point of being able to report any net earnings. Sprint is a classic example of such a company. Its businesses are very good, but its balance sheet is a mess. Its Relative Safety rating in the VectorVest system is below 1.00 on a scale of 0.00 to 2.00.

Beware of companies with excessive debt. Don't be fooled by the line about valuing a company based upon its cash flow. A company that can't report positive earnings after interest and tax payments is in big trouble no matter how you slice it. Safe stocks belong to companies with low debt/equity ratios.

**OTHER FACTORS.** The items cited above are only a short list of the many things that may be considered in assessing stock safety. Anyone who has studied accounting or read Benjamin Graham's book, "The Intelligent Investor," knows that there are many other things to look for. Regardless of how one might assess stock safety, it is important to do it systematically. Services such as VectorVest, Value Line and Standard and Poor's use systematic approaches to assessing stock safety. Investors should always factor risk into their investment decisions.

**USING STOCK SAFETY.** Mr. Graham spends a lot of time in his book, "The Intelligent Investor," discussing the difference between investing and speculating. Basically, this difference is a matter of using knowledge to reduce risk to the point where the odds of winning are in your favor. Mr. Graham approaches the reduction of risk by advocating the purchase of undervalued stocks.

I approach valuation and safety as separate issues; then tie them together. In the previous chapter, High Growth vs. Low P/E stocks, I showed how valuation and stock safety are linked together in assessing a stock's long term investment potential. Both factors also play key roles in establishing Buy, Sell, Hold recommendations. Intelligent investment decisions cannot be made without including an assessment of stock safety. Do not let stock safety be your missing link.

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## STOCKS, STRATEGIES & COMMON SENSE

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### **America's Safest Growth & Income Stocks**

Bull markets don't last forever. As the market changes with the economic cycle, investors constantly adjust their focus on how the primary forces of inflation, interest rates and earnings affect stock prices. When favorable inflation and interest rate trends turn sour, investors look to stocks with consistent earnings and dividends. Knowing which factors are driving the market is key to achieving outstanding long-term performance.

Ironically, the market performs best when the economic climate is at its worst. Consider the Bull market cycle since 1991. Corporate earnings were terrible in 1991, but it was a great year for stocks. Why?

The weak economy in late 1990 and all of 1991 alleviated inflationary pressures, and allowed the Federal Reserve Board to lower interest rates. This caused money to flow from fixed income securities and saving accounts into stocks. Investors were anticipating, i.e., discounting, the arrival of better earnings. Stock prices soared. This was the "Discounting" phase of the Bull market. It lasted from October 1990 to February 1992.

Once the economy began to improve, investors became more selective. They began turning away from consistent, predictable stocks such as foods and beverages to cyclical stocks that would see tremendous earnings gains. This marked a change in investor's stock choices and is called the "Transition Phase." It lasted until February 1993.

The final phase of the Bull market was the "Capital Goods Phase." This occurred when the economy was gaining a full head of steam. The housing and automotive industries were running flat-out and corporate earnings were soaring. It ended when everything looked great...on February 4, 1994.

The market topped on that day in February and a new reality began to set in. As the Federal Reserve Board tightened money supply, investors could no longer count on lower interest rates to inflate stock prices. Just any old stock wasn't going to make it any more. As interest rates increased, it became increasingly difficult to find stocks that would hold up in the new environment. What kind of stocks performed best in the 1994 environment?

Studies have shown that undervalued stocks with solid dividends hold up best in down markets. Over the long-term, dividends account for over 50 percent of the profits made in the stock market. Shrewd investors know that re-investing dividends is the surest way to accumulate wealth in the long-run. (See “Why Dividends Matter” by Mortimer and Page, Fund Co-Managers, GUINNESS ATKINSON Funds.)

The best of all worlds...collecting dividend checks while the prices of your stocks go up, comes from finding solid growth stocks that pay dividends. VectorVest is ideally suited to find these babies.

VectorVest analyzes and ranks over 8,000 U.S. stocks every day according to 14 measures of Capital Appreciation and six measures of Dividend Analysis.

VectorVest’s stock analysis and ranking is especially useful to investors seeking growth and above average capital appreciation. Stocks with the highest VST-Vector ratings are deemed to have the best combinations of Value, Safety and Timing.

VectorVest’s proprietary dividend analysis and retirement scans are of primary interest to investors seeking current income and long-term profits. Stocks with the highest YSG-Vector ratings are deemed to have the best combinations of dividend Yield, Safety and Growth.

VectorVest ties these indicators together via our UniSearch scanning tool so that any of the above parameters can be used to screen, sort and rank stocks. We used it to find the safest, growth and income stocks in our database.

We asked UniSearch to find stocks with the following characteristics:

- Relative Safety  $\geq 1.40$
- Dividend Yield  $\geq 1.00$
- Earnings Growth  $\geq 10$
- Dividend Growth  $\geq 10$

In the VectorVest system, stocks with Relative Safety ratings of at least 1.40 on a scale of 0.00 to 2.00 have outstanding financial performance. A Dividend Yield of at least 1.00 percent was selected to eliminate stocks with only token dividend payments. Earnings growth of at least 10 percent per year keeps us well ahead of the current sum of current inflation and interest rates, and finally, we wanted dividend growth to be at least equal to earnings growth.

We also asked UniSearch to rank these stocks by the sum of VST-Vector + YSG-Vector. Stocks with the highest VST-Vector have the best combinations of Value, Safety and Timing. Stocks with the highest YSG-Vector have the best combinations of dividend Yield, Safety and Growth. Stocks with the highest total VST-Vector + YSG-Vector should give us the best of both worlds. The top 10 stocks found by VectorVest as of February 13, 2015 are shown in Table I.

**Table I. America's Safest Growth & Income Stocks**

Ranked by VST-Vector + YSG-Vector

Company Name	Symbol	Price	Value	%DY	VST	YSG
Apple, Inc.	AAPL	127.08	184.06	1.48	1.46	1.20
CVS Corp.	CVS	102.63	113.40	1.36	1.35	1.23
Alaska Air	ALK	62.56	100.28	1.28	1.34	1.22
Starbucks	SBUX	91.58	87.66	1.40	1.40	1.16
Disney	DIS	104.17	112.26	1.10	1.33	1.22
Polaris Inds	PII	156.00	196.81	1.36	1.36	1.19
Union Pacific	UNP	122.60	151.26	1.79	1.32	1.22
Blackrock Inc.	BLK	376.04	471.26	2.32	1.31	1.20
Cummins Inc.	CMI	139.04	207.77	2.24	1.26	1.24
Western Digital	WDC	107.61	149.97	1.86	1.28	1.22

Price = Closing Price as of 02/13/15.

Value = Intrinsic Value in \$/Share.

%DY = Dividend Yield in percent.

VST = VST-Vector (Rating above 1.00 is good).

YSG = YSG-Vector (Rating above 1.00 is good).

Some highlights regarding the stocks in Table I. are as follows:

- Nine of the ten stocks listed above are currently undervalued. The Portfolio's average Price of \$138.93 is well below its current Value of \$177.65.
- Upside potential is excellent. The average Relative Value (not shown) of 1.40 is high on our scale of 0.00 to 2.00.
- Dividend Yield is good. The average DY of 1.62 percent is above the S&P500's average yield of 1.43 percent.
- Earnings consistency and predictability is outstanding. The average Relative Safety (not shown) of 1.43 is excellent on our scale of 0.00 to 2.00.
- Price performance is above average. The average Relative Timing (not shown) of 1.20 was well above the overall market which was at 1.02.
- Average earnings growth is forecast to be 15%/yr.
- Dividend Safety is excellent. The average DS (not shown) value of 93 ranks very high on our scale of 0-100.
- Dividend Growth is outstanding with an average DG (not shown) of 16%/yr.
- Dividend Risk is Low. The earnings pay-out is less than 50%.

In summary, this portfolio provides an enticing combination of low risk stocks with above average earnings growth, dividend yield, dividend safety and dividend growth. In our book, it represents a fine list of America's Safest Growth and Income Stocks.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Timing: The Ultimate Weapon**

“Desert Storm” was a piece of cake. By the time the Allied attack on Iraq was launched in February 1991, American reconnaissance had sliced and diced Iraq 80 ways to Sunday. Every significant target was identified and programmed into computers. The attack was spearheaded by “smart bombs.” These guided missiles knew where to go and what to do. They epitomized the Allied force’s supremacy in planning and running a high tech war.

The first truly successful smart bomb was an air-to-air missile called the “Sidewinder.” It homed in on a heat source such as the exhaust of an airplane engine, and pursued it relentlessly. Very few targets escaped its destructive intent. For a while, it was the ultimate air combat weapon.

Just as military strategists search for weapons that can reliably seek and destroy enemy targets, investors look for sure-proof methods of buying and selling stocks. Many investors apply the concepts of fundamental analysis. They analyze a company’s business, its financial data, the economy and other factors. They buy a stock when they are convinced they have found a bargain. These investors are called “Fundamentalists” or “Value” investors. They believe that undervalued stocks are recognized ultimately by higher prices and are willing to wait a long time to be proven right.

Other investors are far less patient. They don’t care a whit about a company’s fundamentals or holding a stock for the long-term. They just want to buy low and sell high. They want to buy when a stock’s price is about to go up and sell when it’s about to go down. How can they possibly expect to do this?

By reading the market. The market “tells a story,” they say. The story is told by analyzing charts of price formations and patterns. The ability to read these formations and patterns, they claim, allows them to tell whether prices will rise or fall. These individuals, called technicians, strive to predict future price behavior from historical relationships. If investors had a “guidance system” that would tell them when to buy or sell their stocks, they would, in fact, have the ultimate weapon.

A perfect timing system does not exist. But this is not to say that technical analysis is without merit. Quite to the contrary, technical analysis plays a larger role in short-term stock market movements than fundamental analysis.

I have discussed the application of fundamental analysis to stock valuation and stock safety in prior chapters. So far, however, I have not mentioned technical analysis. While an understanding of stock value and safety are vital for appropriate stock selection, a knowledge of technical analysis and timing is essential for knowing when to buy and when to sell.

Designing a stock timing system is quite the same as designing a smart bomb. You need an analytical device that recognizes its target and a decisional mechanism to trigger an output. A stock timing system's analytical device, such as a chart, must recognize certain pricing patterns, and its decisional mechanism must produce an output signal to indicate whether the stock's price is rising or falling.

Exactly how one interprets historical price data and produces an indicator depends upon their buy/sell philosophy. My philosophy is to buy a stock when it is going up in price and sell when it is going down.

This philosophy may sound strange to many people, but it is grounded on the principle that stocks going up in price, tend to continue going up and stocks going down in price, tend to continue going down. This philosophy is also consistent with the buying patterns of most investors. Investors flock to the market when it is going up and shy away when it is going down. Favoring stocks which are rising in price is at the root of Value Line's celebrated timing system. It is also inherent in the "Relative Strength" approach to timing.

Relative Strength is simply a measure of a stock's price performance compared to the market. High Relative Strength stocks are those which are out-performing the market. Many extremely successful investors use Relative Strength as their primary timing system.

The trick with all timing systems is in knowing when a stock's price is going up or down. One of the simplest ways to analyze a stock's price behavior is to compare its price pattern to a moving average of its previous prices. If a stock's price is above its moving average price, and is moving away from the moving average, the stock is in an uptrend. The reverse is also true. VectorVest provides charting and moving average capabilities on over 8,000 U.S. stocks.

Investors who use moving averages to time their buy and sell transactions can do very well. However, they will never "get in at the bottom," or "get out at the top" because of the nature of moving averages. On the other hand, good chartists can capture 70 or 80 percent of a move and can avoid disastrous losses. And that isn't bad.

VectorVest computes (13 week) moving average prices for over 8,000 stocks each day. It publishes a Stop-Price for each stock based upon its moving average. Thus, if one sees that a stock's price is above its Stop-Price, they will know that the stock's price is above its moving average. But they would not be able to tell whether the stock is in an up or down price trend. This is done with an indicator called "Relative Timing."

VectorVest's Relative Timing, (RT) indicator analyzes the direction, magnitude and dynamics of a stock's price movement. It is reported on a scale of 0.00 to 2.00. When RT is above 1.00, the stock's price is in an uptrend. When RT is below 1.00, the stock's price is in a down-trend.

RT has all the characteristics of a guided missile system. Consistent with modern technology, it is extraordinarily fast. Once it locks in on a stock, it tracks the stock relentlessly. It explodes upward from bottoms and dives from tops. It can see things not visible to the naked eye and automatically returns to 1.00 when a stock's price flattens out.

Since RT works within a framework of 0.00 to 2.00, all stocks may be searched, sorted, screened and ranked on a consistent basis. Day-to-day or week-to-week comparisons of RT are easily done with VectorVest's UniSearch tool, helping investors discover many great winners just as they are beginning big moves.

No level of fundamental analysis could find these stocks at the critical point of eruption. They need not necessarily be undervalued or of low risk. Investors must employ technical analysis and timing to complete their stock selection arsenal. Timing, it's the ultimate weapon.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Stop-Prices: Are They For You?**

A Stop Price is like a pane of glass. Once it gets hit, it's broken. The use of Stop-Prices is one of the most controversial and misunderstood methods of selling stocks. Stop-Prices are double-edged swords. They can cut losses and protect profits, or result in high turnover and lost opportunities. Are they for you?

Selling is a crucial part of successful investing. Yet, it is avoided like the plague. The reasons are clear. Buying a stock is fun, a positive event. It's the beginning of a hopeful relationship.

Selling is a negative experience, the end of the relationship. Hope of future profits is gone and losses become reality. Tax consequences must be addressed and the proceeds need to be re-deployed. Selling is not fun, but it must be done.

While there are no hard and fast rules for selling stocks, each investor eventually makes decisions to sell. The need for funds, tax considerations and a myriad of other factors enter into these decisions. Whatever the reasons, the primary purposes of selling are:

1. To control losses, and
2. To protect profits.

Stop-Prices are ideally suited to do both.

**STOP-PRICES.** The term "Stop-Price" comes from the practice of selling stocks falling to specified prices. For example, if one of your stocks were at \$27 a share, and you were concerned that it was going to go down in price, you could place a "stop-loss" order to sell the stock at a specified price, say \$25. In this case, the Stop-Price is 25. Your broker would enter a "stop-loss" order to sell the stock if it fell to 25.

A "stop-loss" order does not guarantee that your order will be executed at the Stop-Price. The price at which your stock is sold depends upon market conditions. In severe downturns, stocks may be sold well below Stop-Prices. It is also important to know that "stop-loss" orders can be executed on exchange-traded stocks, e.g.,

New York and American stock exchanges, but may or may not be executed on over-the-counter (OTC) stocks, depending upon your broker.

Many advisors suggest that Stop-Prices be set at 10% below purchase prices. I have found that the Stop-Price of a stock should be based upon its safety, fundamentals and price trend. Safe stocks with solid fundamentals should have “looser” Stop-Prices than those with weak fundamentals. These considerations allow investors to stay with solid stocks longer and get out of weak stocks faster.

One of the major arguments against using Stop-Prices is that they result in excessive trading and expose one’s positions to “whip-sawing.” The likelihood of experiencing these events depends upon the type of stocks one owns. Safe, steady performers rarely hit their Stop-Prices, while risky, highly volatile stocks often break their Stops.

Table I., shows the relationship between portfolio turnover rate in percent and stock safety.

*Table I. Portfolio Turnover Rate in Percent per Year as a Function of Relative Safety.*

<b>Percent Turnover</b>	<b>Relative Safety</b>
10	1.50
25	1.25
50	1.00
100	0.75
200	0.50

In the VectorVest system of analysis, stocks with a Relative Safety rating of 1.00 or higher are above average in safety. Prudent and Conservative investors dealing in safe stocks would experience lower turnover while Aggressive and Speculative investors would have much higher turnover rates.

VectorVest analyzes over 8,000 U.S. stocks each day for Value, Safety and Timing and calculates a Stop-Price for each stock. These Stop-Prices are based upon 13 week moving averages of closing prices and they are fine-tuned according to each stock’s safety, fundamentals and price trend.

A stock’s price behavior and future performance can become vividly clear by observing the difference between a stock’s price and its Stop-Price. If a stock’s price is above its Stop-Price, and the price difference is getting wider on a day-to-day or week-to-week basis, the stock is behaving favorably and will likely continue to perform well. If the reverse is true, the stock is heading for trouble. This is when you need to be on guard.

VectorVest alerts its users to these conditions by adjusting its Buy, Sell, Hold ratings in the following manner:

- A stock gets a “B” or an “H” rating if its price is above its Stop-Price and it gets an “S” rating if its price is below its Stop-Price.
- The distinction between a “B” and “H” rating is made on the basis of safety, fundamentals and price trend. Strong stocks receive “B” ratings much more readily than weak stocks.

With this background in mind, let’s see how Stop-Prices can be used to control losses and protect profits.

**USING STOP-PRICES TO CONTROL LOSSES.** The cardinal rule of investing is to keep your losses small. This goal may be achieved by virtue of the stock market's tremendous liquidity. It allows investors to specify both a buying price and a selling price at the same time. The best time to make these decisions is before buying a stock.

Investors should be aware that the period of highest risk is at the time of purchasing a stock. Taking commissions into account, you're already starting with a loss. If the stock heads down in price, the loss increases. The name of the game, at this point, is to control further losses. Stops provide the discipline to do this.

Let's consider our old friend, Disney. Suppose we wanted to buy Disney and it closed at \$104.17 on February 13, 2015. VectorVest gave it a "B" rating and a Stop-Price of \$91.87. If we were to buy this stock at \$104.17, we could also place a "stop-loss" order to sell it at \$91.87. This would limit our downside risk to \$12.30, or 11.8% of our purchase price, not counting commissions. There are very few investments in which both a buying price and a selling price may be specified in advance.

The Stop-Price should be raised if the price of the stock goes up. Once the Stop-Price is above the purchase price, your risk of a loss virtually has been eliminated. Isn't that nice?

**USING STOP-PRICES TO PROTECT PROFITS.** As the price of a stock rises or falls, VectorVest automatically raises or lowers its Stop-Price. This is called a "Trailing Stop" and it is commonly used to protect profits in a variety of ways.

**1. THE RATCHET STOP.** The most conservative and, perhaps, the most common use of Stop-Prices, is to raise the Stop-Price as the price of a stock goes up. If one never lowers the Stop-Price, it moves only in one direction like a Ratchet. This system ensures that most of the profits gained from a price rise will be captured. It is, however, susceptible to premature selling and "whip-sawing." Consequently, the "Ratchet System" of using Stop-Prices does not necessarily lead to the best overall profit performance. This is the price one pays for reducing risk.

**2. THE TRAILING STOP.** A slightly less conservative method of using Stop-Prices is that of allowing the Stop-Price to float up and down as the price of the stock fluctuates. This is very easy to do with VectorVest since new Stop-Prices are calculated every day. While this approach allows a Stop-Price to drift downward, it reduces turnover, commission costs, and the probability of getting "whip-sawed." While it may or may not provide higher profit performance than the Ratchet-Stop System, I prefer this method of using Stop-Prices.

When using the Trailing Stop, one should never let the Stop-Price go below their purchase price once it has gone above the purchase price. Why encounter a loss when you had a profit?

**3. THE GUIDANCE SYSTEM.** Many investors prefer to use Stop-Prices as a guide to selling, rather than a trigger for selling. They feel that Stop-Prices are too mechanical.

This approach to using Stop-Prices is perfectly satisfactory for investors who follow their stocks closely. Investors who work full-time or are traveling, however, are vulnerable to bad news. In today's age of instantaneous communication and electronic trading, a stock may drop 30% in an afternoon. The guidance system of using Stops is the least conservative method of managing one's portfolio. For the right investors, it may be the most profitable.

**USING MENTAL STOP-PRICES.** Many investors use Stop-Prices, but do not use stop-loss orders. They want more control over deciding when a stock is sold. This practice, called using “mental stops,” is not the same as using the Guidance System of setting Stop-prices. For example, one may use the Ratchet Stop as a method of setting mental Stop-Prices, and decide to use closing prices to trigger sell orders. This approach provides close rein over their portfolios, yet reduces excessive trading due to intra-day volatility.

Other investors use mental Trailing Stops on a week-to-week basis. They generally have a long-term view of the market, but are also concerned about controlling losses and protecting profits.

Whether you are a Prudent investor seeking an extra margin of safety or a Speculative investor looking for trading profits, Stop-Prices can help control losses and protect profits. Are they for you?

# 11

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Investment Styles & Strategies**

Fifty-five years ago, my wife and I attended our very first investment seminar. The speaker was from a large brokerage firm, and his mission was simple: inspire us to become stock investors.

He spoke glowingly of Xerox, IBM and Texas Instruments, the great success stories of the late fifties. But he advocated buying low price-to-earnings ratio stocks. “Look how much more you get for your money by buying Ford with a P/E of 6,” he said, “than you would if you bought Avon Products with a P/E of 40.” It made sense to us, so we bought Ford. Six months later, Ford was down and Avon Products was up.

I talked to my broker about this and he said that I should forget about buying individual stocks. I was new to the market and should go into mutual funds. He suggested Techno Fund, a brand new fund chartered in the State of Ohio. He said Techno Fund was ideal for me since I was an engineer and it was investing in emerging technology stocks. It made sense to me, so I bought Techno Fund.

Eighteen months later, Techno Fund was defunct. The stock was worthless! Meanwhile, my brother had tripled his money in Erie-Lackawana, a bankrupt railroad, and my neighbor was bragging about how he was sending his kids through college by trading 1,000 share lots of stocks for profits of two or three dollars a share.

Through all of this, my instinct said that even I could make money in stocks. All I had to do was define my goals and put together a plan on how to do it. I knew I could not afford to be a speculator and I didn't have the time to be a trader. I needed to buy stocks that I could live with. It wasn't easy, but eventually, things came my way.

The moral of this story is that every investor needs to define a realistic set of goals, the amount of risk they can handle and a feasible investment plan. In my case, I wanted to double my money every five years, I was willing to accept modest losses and I was going to invest in quality growth stocks.

Every investor has an intuitive sense of their own risk/reward profile. They feel it in their bones, and it dictates their investment patterns. Speculators and traders thrive on volatility and savor the thrill of making a fast buck. Conservative investors cringe at the thought of a capital loss and patiently reap small rewards. Without

knowing it, each of us has an investment style which is distinctly our own. A key to becoming a successful investor is in recognizing your investment style and buying stocks which are consistent with that style.

The VectorVest system of stock analysis identifies four basic investment styles. These are arranged in the following Strategic Investment Matrix:

**STRATEGIC INVESTMENT MATRIX**

<b>R E W A R D</b>	<b>High</b>	<b>Prudent</b>	<b>Aggressive</b>
	<b>Low</b>	<b>Conservative</b>	<b>Speculative</b>
		<b>Low</b>	<b>High</b>
		<b>R I S K</b>	

**PRUDENT INVESTOR.** Prudent investors want the best of all worlds: High reward and low risk. They are interested in outperforming the market over the long-term and achieving annual returns greater than the sum of long-term interest rates and inflation. The best way to meet these stringent requirements is to buy undervalued stocks with consistent, predictable earnings. How can we find them?

In the VectorVest system, these stocks are characterized by high Relative Value (RV) and high Relative Safety (RS). All stocks in the VectorVest system are rated on a scale of 0.00 to 2.00. Investors buying high RV, high RS stocks are virtually certain of making money and outperforming the market in the long-term. A sample of these stocks is shown in Table I.

*Table I. Selected Stocks for Prudent Investors (Ranked by VST-Vector)*

<b>Company Name</b>	<b>Price</b>	<b>RV</b>	<b>RS</b>	<b>RT</b>	<b>VST</b>	<b>GRT</b>	<b>REC</b>
Skyworks Solutions	81.85	1.63	1.45	1.48	1.51	28	B
Gilead Science	101.90	1.91	1.43	1.16	1.49	44	H
Apple Inc.	127.08	1.47	1.47	1.43	1.46	15	B
Centene Corp	118.18	1.50	1.42	1.44	1.45	24	B
Taiwan Semi ADS	24.84	1.51	1.40	1.45	1.45	17	B

*Price = Closing Price as of 02/13/15.*

- RV =Relative Value
- RS =Relative Safety
- RT =Relative Timing
- VST =VST-Vector
- GRT =Earnings Growth Rate in %/yr.
- REC =Recommendation

B =Buy  
H =Hold

Each of the stocks in Table I have an RV and RS well above 1.00. This means that each stock has favorable potential for price appreciation and an above average history of consistent financial performance.

- **Skyworks Solutions** is a powerhouse. It has the best combination of Value, Safety and Timing as indicated by the highest VST-Vector of 1.51.
- **Gilead Science** has excellent upside potential and an outstanding record of consistent, predictable financial performance as shown by its RT and RS values above 1.40.
- **Apple Inc.**, and **Centene** have excellent metrics in every respect with RV, RS, RT and VST above 1.40.
- **Taiwan Semi** is also a very strong stock with excellent metrics.

**AGGRESSIVE INVESTOR.** Aggressive investors want high performance, e.g., capital appreciation of greater than 20 percent per year and are willing to take substantial risk to achieve it. They are looking for big gainers and stocks with high upside potential. They typically like high growth stocks that are skyrocketing in price. These stocks are characterized by high Relative Value (RV), low Relative Safety (RS) and high Relative Timing (RT). Aggressive Investors are often associated with the “momentum” style of investing. Due to the volatility of high RV, low RS stocks, Aggressive Investors may substantially outperform or underperform the market over the long-term.

A sample of these stocks is shown in Table II.

**Table II. Selected Stocks for Aggressive Investors (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	VST	GRT	REC
Freescale Semi	37.53	1.40	0.82	1.96	1.50	33	B
Mattson Tech	4.04	1.55	0.89	1.77	1.47	34	B
Enphase Energy	15.15	1.54	0.95	1.73	1.46	48	B
United Ins Hldg	27.40	1.43	0.97	1.68	1.40	21	B
Rite Aid Corp	8.34	1.24	0.82	1.83	1.39	25	B

*Price = Closing Price as of 02/13/15.*

Each of the stocks shown in Table II has favorable price appreciation potential, but above average risk.

- **Freescale Semi** has the best combination of Value, Safety and Timing with the highest VST-Vector rating and was in the strongest price uptrend with an RT of 1.96.
- **Mattson Tech** has the highest long-term price appreciation potential with an RV of 1.55.
- **Enphase Energy** has the highest forecast earnings growth rate, with a GRT of 48%/Yr.

**CONSERVATIVE INVESTOR.** Conservative investors buy stocks, but do not like to take much risk. They are primarily interested in capital preservation and are delighted to settle for average market returns. They typically buy low growth, steady performers, which pay solid dividends. These stocks are characterized by low Relative Value (RV) and high Relative Safety (RS). Conservative Investors are virtually certain to make money over the long-term, but may not outperform the market. A sample of these stocks is shown in Table III.

**Table III. Selected Stocks for Conservative Investors (Ranked by Dividend Safety—DS)**

Company Name	Price	RV	RS	DY	DS	DG	YSG
Sigma Aldrich	138.20	0.92	1.50	0.67	99	13	1.22
Dentsply Int'l	52.74	0.96	1.33	0.51	95	11	1.15
ACE Limited	113.05	0.95	1.41	2.30	93	15	1.24
Intuit Inc.	90.25	0.77	1.44	1.11	93	13	1.17
Valmont Inds.	124.24	0.80	1.29	1.21	89	16	1.15

Price = Closing Price as of 02/13/15.

Each of the stocks shown in Table III. has a well above average RS, but below average RV. Every stock has a modest Dividend Yield, (DY in %), high Dividend Safety, (DS on a scale of 0 to 99) and excellent Dividend Growth, (DG in %/Yr). The Dividend Yield-Safety-Growth Vector, (YSG on a scale of 0.00 to 2.00), of each stock is above 1.00 which is favorable.

**SPECULATIVE INVESTOR.** Speculative investors are looking for big gains without regard to risk. The fundamentals of value and safety mean nothing to them. They buy stocks on hype and rumor and are excited by price activity and volatility. Stocks with low Relative Value (RV) and low Relative Safety (RS) are unpredictable and volatile. Many of them are priced under \$10. Nimble investors can make high profits in these stocks if they pay close attention to Relative Timing (RT) and Stop-Prices. Without a keen sense of when to buy and sell, most speculators lose money over the long-term. A sample of these stocks is shown in Table IV.

**Table IV. Selected Stocks for Speculative Investors (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	VST	GRT	REC
Aeropostale	3.63	0.72	0.80	1.87	1.31	-9	B
Esperion Therapeutics	67.13	0.14	0.88	1.93	1.30	3	H
Pfenex Inc.	12.45	0.07	0.69	2.00	1.30	-9	H
Agean Msrine	14.92	0.91	0.82	1.78	1.29	7	B
Bebe Stores	3.90	0.67	0.85	1.85	1.29	2	B

Price = Closing Price as of 02/13/15.

Low RV and RS values indicate that each of the above stocks is highly priced compared to its inherent value and has an erratic or unproven track record of financial performance.

- The stocks shown above with a “B” rating have high Relative Timing, RT values, with poor, but acceptable fundamentals.
- **Pfenex’s** price is soaring, but is still rated “H” because of unacceptable fundamentals.

- **Pfenex's** low RV means it has little chance of outperforming AAA Corporate Bonds over the long-term and its low RS means it has an erratic financial track record. The negative GRT means it has a dismal earnings growth rate. Yet, its Price is soaring higher. Go figure.

Prudent, Aggressive, Conservative, Speculative? Which of these investment styles rings your bell? Are your stocks consistent with your investment style and strategy?

# 12

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## ***STOCKS, STRATEGIES & COMMON SENSE***

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### **Managing Your Portfolio**

The players make the game. Everyone knows it...the owners, the players and the fans. Baseball is a good example.

Regardless of how good managers are, they are not able to cause mediocre teams to perform like champions. The best that managers can do is to help their teams fulfill their potential. Even with genuine major leaguers, most managers fall far short of achieving championship status because of poor execution and bad decisions. In the end, the managers are no better than the players.

In the same light, many stock investors fail to achieve their goals for the same reasons. They buy losers, sell winners, make small profits and suffer large losses. And they constantly underperform the market. How can we avoid these pitfalls, and make higher profits with lower risk?

**STOCK SELECTION and TRADING TACTICS.** Good portfolio management starts with selecting the right stocks. Just as major league scouts look for the best talent for their teams, investors should select the best stocks for their portfolios. This may sound like motherhood and apple pie, but the type of stocks you buy will dictate the manner in which you must manage your portfolio.

You cannot expect to outperform the market with conservative, overvalued stocks. Nor can you practice a “Buy and Hold” strategy with speculative, volatile stocks. The compatibility of your stocks with your management style is crucial to your long-term success. It is described best by using our Strategic Investment Matrix.

*(See Strategic Investment Matrix graphic at the top of the next page.)*

**STRATEGIC INVESTMENT MATRIX**

<b>R E W A R D</b>	<b>High</b>	<b>Prudent</b>	<b>Aggressive</b>
	<b>Low</b>	<b>Conservative</b>	<b>Speculative</b>
		<b>Low</b>	<b>High</b>
		<b>R I S K</b>	

This matrix was discussed at some length in the last chapter, “Investment Styles and Strategies.”

The Reward/Risk coordinates of the matrix are defined quantitatively by VectorVest’s Relative Value and Relative Safety indicators. Relative Value relates to Reward by indicating a stock’s long-term price appreciation potential and Relative Safety relates to Risk by reflecting the consistency and predictability of a company’s financial performance. These indicators were also described in chapters 6 and 7.

For a variety of reasons, most investors prefer to “Buy and Hold” stocks for the long-term. Some of the advantages of holding stocks for the long-term include lower commission costs and fewer tax consequences. But, it is not always the best thing to do. Bear markets are inevitable and even the best stocks go down in price. Perhaps other stocks in your portfolio should have never been purchased and should be sold. How can we select stocks that can be held for the long-term?

Identify companies that do well in good times and bad. These companies have long records of consistent, predictable financial performance, low debt, high profitability and solid earnings growth. Because of these characteristics, their stocks are very stable. These stocks all have high Relative Safety ratings in the VectorVest system of analysis. As shown in Table I., Relative Safety provides the key to how long one might expect to hold a stock.

*Table I. Portfolio Turnover Rate in Percent per Year as a Function of Relative Safety.*

<b>Percent Turnover</b>	<b>Relative Safety</b>
200	0.50
100	0.75
50	1.00
25	1.25
10	1.50

Investors dealing in speculative, highly volatile stocks with low Relative Safety ratings should expect to experience turnover rates well over 100 percent per year. Those investors buying low-risk, high Relative Safety stocks will have very low turnover rates. Let’s look further into the relationships of stock selection and trading tactics.

**CONSERVATIVE STOCKS.** Stocks falling into the Conservative quadrant of our Strategic Investment Matrix are ideally suited for “Buy and Hold” investors. These stocks belong to well established, dividend paying companies. They have below average Relative Value ratings, but are above average in Relative Safety.

**Table II. Selected Stocks for Conservative Investors (Ranked by Relative Safety–RS)**

Company Name	Price	RV	RS	DY	DG
Sigma Aldrich.	138.20	0.92	1.50	0.67	13
Public Storage	202.61	0.90	1.47	2.76	16
Intuit Inc.	90.25	0.77	1.44	1.11	13
ResMed Inc.	66.25	0.91	1.44	1.69	13
Abbott Labs	46.09	0.88	1.42	2.08	18

Price = Closing Price as of 02/13/15.

**RV** =Relative Value on a scale of 0.00 to 2.00.

**RS** =Relative Safety on a scale of 0.00 to 2.00.

**DY** =Dividend Yield in Percent

**DG** =Dividend Growth Rate in %/yr.

These steady, predictable stocks seldom receive a Sell recommendation. Investors buying Conservative stocks will experience low turnover and low commission costs. Generally, however, they will also experience below average portfolio performance.

**PRUDENT STOCKS.** Prudent stocks offer above average capital appreciation potential, along with above average safety. Investors buying Prudent stocks tend to hold them for the long-term, but also sell lackluster performers to improve profits. Therefore, their turnover is somewhat higher than a Conservative investors, but their portfolio’s performance is much better. Examples of Prudent stocks are shown in Table III.

**Table III. Selected Stocks for Prudent Investors (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	GRT
Apple, Inc.	127.08	1.47	1.47	1.43	1.46
Centene Corp	59.09	1.50	1.42	1.44	1.44
Biogn Idec, Inc.	391.66	152	1.39	1.37	1.42
Southwest Air	43.30	1.66	1.40	1.18	1.40
Starbucks	91.58	1.39	1.42	1.37	1.40

Price = Closing Price as of 02/13/15.

**AGGRESSIVE STOCKS.** Aggressive stocks have high upside price appreciation potential, but tend to be quite volatile. Investors dealing with these stocks must be willing to Sell when necessary to protect profits and/or minimize losses. The use of Stop-Sell prices is advocated strongly when managing stocks with Relative Safety ratings of less than 1.00. Portfolio turnover and commission costs can be substantial, but so can the profits. Some of our favorite Aggressive stocks are shown in Table IV.

**Table IV. Selected Stocks for Aggressive Investors (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	VST
United Ins Hldg.	27.40	1.43	0.97	1.68	1.40
1800Flowers.com	10.33	1.12	0.97	1.75	1.36
Spansion Inc.	35.99	1.08	0.88	1.79	1.35
Diamond Resorts	31.26	1.53	0.90	1.46	1.32
Mallinckrodt	115.01	1.19	0.92	1.64	1.31

Price = Closing Price as of 02/13/15.

**SPECULATIVE STOCKS.** These stocks are extremely volatile and demand close scrutiny and frequent trading. In my view, the use of Stop-Sell prices is mandatory when dealing with Speculative stocks. Turnover and commission costs will be high for traders, but the losses can also be high if one chooses not to sell when necessary. Table V. shows examples of some very Speculative stocks:

**Table V. Selected Stocks for Speculative Investors (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	VST
Cambrex Corp.	32.96	1.00	0.83	1.73	1.29
GoodTimes Rstr	8.23	0.75	1.00	1.75	1.29
SunEdison Semi	22.21	0.98	0.85	1.75	1.29
Radius Health	50.37	0.12	0.85	1.90	1.28
Sorrento Thera	11.41	0.67	0.82	1.84	1.28

Price = Closing Price as of 02/13/15.

**DIVERSIFICATION and INVESTMENT TACTICS.** It makes no sense for the average investor to try putting their eggs in a single basket and watching them carefully. There are just too many uncontrolled variables in the stock market. Moreover, the average investor is normally the last to hear about bad news when it happens. I recommend that investors reduce risk by diversifying. This may be done by investing in a variety of different stocks in different industries and by investing over a period of time. Don't plunge into the market all at one time. It pays to diversify.

The amount of money to put into any single stock depends, of course, upon your personal circumstances. As a rule of thumb, I like to see between ten and twenty stocks in a portfolio. Invest approximately equal dollar amounts into each of the stocks you buy. This is called "dollar weighting." It ties in with reducing risk by diversifying. While diversification is good, too much diversification will dilute your portfolio's performance and add to commission costs.

Don't be afraid to use margin. When used properly, margin can increase the profitability of your portfolio substantially. If one used prudent stock selection and effective trading tactics, the use of margin should not pose a problem.

**THE BEST STRATEGY.** When one takes into account the difficulty of picking winners, commission costs and tax consequences, the best strategy for the average investor is to create a diversified portfolio of high Relative Value, high Relative Safety stocks which require little or no trading. These stocks combine the best of all worlds, above average rewards and below average risk.

# 13

## STOCKS, STRATEGIES & COMMON SENSE

### The Case For Using Earnings Yield

There is a very important number out there. But you won't find it in the Wall Street Journal, Barron's or Investors Business Daily. Even Standard & Poor's doesn't provide this magic number. What is it and what can it tell us?

The number is Earnings Yield, the kissing cousin of Dividend Yield. It's not used much in this country, so hardly anyone knows about it. But it's a dandy. It can be used to find forecasted earnings per share, assess dividend safety, calculate earnings growth rates and determine intrinsic value. Let's learn more about it and see how it can be applied.

**EARNINGS YIELD VS. P/E RATIOS.** A long time ago, a little gnome in a green eyeshade created Price to Earnings, (P/E) ratios. Gnomes love to think of everything in terms of ratios and he was very proud of this one. This little gem, he thought, would tell investors exactly what they needed to know about the true cost of stocks. A \$10 stock with a P/E of 18, for example, actually cost more than a \$50 stock with a P/E ratio of 12. P/E ratios tell buyers how much they are paying for each dollar's worth of earnings. And that's what really counts... the bang for the buck. Obviously, the higher a stock's P/E ratio, the more expensive the stock. What could be better than that?

Consider Earnings Yield, for example. Earnings Yield tells you how much in earnings you're buying per dollar of investment, but it doesn't have any of the problems of P/E ratios. Yes, there are some problems with P/E ratios, which we'll discuss. First, however, let's see what Earnings Yields are all about.

Earlier, I said that Earnings Yield is the kissing cousin of Dividend Yield. Everyone knows what Dividend Yields are. They're published in all the papers and investors use them to help make their investment decisions. Just for the sake of clarity, however, let's note that Dividend Yield is defined as the annual dividend payment in dollars per share divided by stock price expressed in percent, i.e.,

$$DY = 100 * (\$D) / P \quad \text{Eq. (13.1)}$$

Where: DY = Dividend Yield in percent.  
\$D = Annual dividend in \$/Share  
P = Price in \$/share.

Our old friend, Disney, closed at \$104.17 per share on 02/13/15 and pays an annual dividend of \$1.15 per share. Its Dividend Yield is:

$$DY = 100*(1.15)/104.17 = 1.10\%$$

The Earnings Yield for Disney based on a 12 month forecasted earnings of \$4.98 per share is:

$$EY = 100*(\$E)/P \quad \text{Eq. (13.2)}$$

$$EY = 100*(4.98)/104.17$$

$$EY = 4.78\%$$

Where: EY = Earnings Yield in percent  
 \$E = Earnings in \$/Share  
 P = Price in \$/Share

Obviously, there are no problems with calculating Dividend Yield and Earnings Yield for Disney. There is no problem in calculating its P/E ratio either. It's simply  $104.17/4.98 = 20.92$ .

Is it any harder to think in terms of buying 4.98 cents of earnings for every dollar of Disney stock than it is to think of paying \$20.92 per dollar of earnings? Maybe. But there are problems in getting P/E ratios for a lot of stocks. The first problem is that the P/E ratio of a stock with zero earnings is infinite. Now, that's a serious problem. So, the papers don't report it.

Why not report Earnings Yields instead? The Earnings Yield of a stock with zero earnings per year is 0.0%. This is very easy to understand. It clearly indicates that a company isn't making any money. Another problem with using P/E ratios is that stock with negative earnings would have a negative P/E ratio. I can live with that, but it seems the papers can't. So, they don't report anything on stocks with negative earnings, either.

Does that mean, then, that every stock whose P/E ratio is not reported in the papers has zero or negative earnings? Definitely not. It seems that a stock has to trade for at least a year before the papers start showing its P/E ratio. This is unfortunate because new stocks often provide the best investment opportunities.

When everything is said and done, the P/E ratios of about thirty to forty percent of the stocks are not reported in the papers. This lack of completeness isn't necessary because the use of Earnings Yields would solve all the problems mentioned above. Table I. shows examples of how Earnings Yield provides vital information when P/E fails.

**Table I. Comparison of Dividend Yields, Earnings Yields and P/E Ratios of Selected Stocks.**  
*(Ranked by Earnings Yield in %)*

Company Name	Price	\$Div	DY	EPS	EY%	P/E
K B Home	14.39	0.10	0.69	4.64	32.24	3.10
Autohome Inc.	38.44	0.00	0.00	6.97	18.13	5.52
Disney	104.17	1.15	1.10	4.98	4.78	20.92
Netflix Inc.	466.10	0.00	0.00	5.27	1.13	88.44
Radius Health	50.37	0.00	0.00	-2.90	-5.76	-17.37

*Price = Closing Price as of 02/13/15.*

\$DIV = Annual Dividend Payment in Dollars  
DY = Dividend Yield in Percent  
\$EPS = 12 Month Leading Earnings Per Share  
EY = Earnings Yield  
P/E = Price to Earnings Ratio as Reported by VectorVest.

A final problem with relying on P/E ratios is that P/E ratios are typically based upon trailing twelve month earnings. While this is better than not having any information at all, the market is not driven by trailing earnings. It is driven by earnings forecasts. Wouldn't it be nice to know what the earnings forecasts are for the stocks you own?

**EARNINGS YIELD AND EARNINGS FORECASTS.** A number of services provide information on earnings forecasts. Getting this information can be expensive, however. Not getting it could be even more expensive. So, I buy the information and use it in VectorVest to compute earnings growth rates, assess dividend safety and calculate stock value. However, I don't use raw earnings forecasts. I tailor them to meet my needs.

Earnings estimates are usually rolled into a calendar year or fiscal year. These estimates are subject to change and cause variation in our assessments. So, I created an estimate of leading 12 month earnings, which reduces variations and is more reliable than using raw forecasts.

VectorVest publishes Earnings Yields based upon leading 12 month earnings estimates for over 8,000 U.S. stocks. All that one needs to do to get a 12 month leading earnings estimate from Earnings Yield as reported by VectorVest is use the following equation:

$$\$E = (P * EY) / 100 \qquad \text{Eq. (13.3)}$$

Where      \$E = 12 Month Leading Earnings  
              P = Price in \$/Share  
              EY = Earnings Yield in Percent

The Earnings Yield for Disney, as reported by VectorVest on 02/13/15 was 4.78%. Given a Price of \$104.17 per share, DIS would have a 12 month leading earnings estimate of \$4.98 per share.

This valuable bit of information can be used in several ways. It can be used in assessing dividend safety, estimating growth rates and stock valuation. We'll illustrate how these things can be done in the next chapter when we complete **THE CASE FOR USING EARNINGS YIELDS.**

# 14

## STOCKS, STRATEGIES & COMMON SENSE

### **The Earnings Yield: The Magic Number**

If there's one thing you should know about a stock, it's Earnings Yield. This vital bit of information leads to several important and revealing insights. It's the magic number.

In the last chapter, we presented "The Case for Using Earnings Yield." We discussed the advantages of using Earnings Yield compared to P/E ratios, and showed how to get earnings forecasts from VectorVest's Earnings Yield data. Now, we will illustrate how Earnings Yield may be used to assess dividend safety, estimate earnings growth rates and analyze stock value.

**ASSESSING DIVIDEND SAFETY.** You may recall that we referred to Earnings Yield as the kissing cousin of Dividend Yield. Since Earnings Yield reflects the amount of money a company is making and Dividend Yield reflects the amount of money being paid out to shareholders, Earnings Yield provides an ideal tool for assessing dividend safety. It's simply a matter of comparing one to the other.

All investors should realize that a company's dividend payments are no safer than its earnings performance. Dividends cannot be paid out of thin air. Eventually, they must come from earnings. If the Dividend Yield exceeds the Earnings Yield, there's trouble in River City. The best way, then, of judging the viability of a company's dividend payments is to measure the percentage of earnings being paid out as dividends.

The proportion of earnings paid out as dividends is called the Dividend Pay-out. This is determined as follows:

$$DP = (DY/EY)*100 \qquad \text{Eq. (14.1)}$$

Where: DP = Dividend Payout in Percent  
DY = Dividend Yield in Percent  
EY = Earnings Yield in Percent

A Dividend Payout of about 35% is considered to be normal, safe and reasonable. Anything above 50% is usually regarded as excessive and less likely to be maintained. Let's use VectorVest to examine the Dividend and Earnings Yield relationships of some stocks and industry groups.

VectorVest allows us to sort, screen, search and rank over 8,000 U.S. stocks and over 200 industry groups by Earnings Yield and Dividend Yield. It also provides a dividend risk assessment of Low, Medium or High for each stock. Here's a summary of a few interesting selections ranked in ascending order of Dividend Payout.

**Table I. Selected Stocks Ranked by Dividend Payout.**

Company Name	Price	\$Div	DY	EY	%DP	Risk
Carlisle Cos.	94.14	1.00	1.06	5.27	21.37	Low
Steelcase	18.43	0.42	2.28	4.99	45.69	Med
Kraft Foods Grp.	64.42	2.20	3.42	5.78	59.17	Med
Otter Tail Corp.	31.27	1.23	3.93	5.79	67.87	High
Seaworld Ent.	18.83	0.84	4.46	5.05	88.31	High

Price = Closing Price as of 02/13/15.

\$Div = Annual Dividend Payment in Dollars

DY = Dividend Yield in Percent

EY = Earnings Yield in Percent based upon 12 Month Leading Earnings Estimate

DP = Dividend Payout in Percent

Risk = Risk Assessment as determined by VectorVest

Obviously, there is a direct correlation between Dividend Payout and Dividend Risk. With a low Dividend Payout, **Carlisle Cos.** is virtually certain to maintain or increase its dividends while **Otter Tail Corp.** and **Seaworld Entertainment** may very well do the opposite.

There's a lot more to assessing dividend safety than comparing Earnings and Dividend Yields, but it's a good place to start. Consider the Security and Safety Business Service Industry, for example.

The 37 Security and Safety Business Service companies which we track have an average Dividend Yield of 2.76%, and an average Earnings Yield of 0.08%. They are paying out an average of \$0.35 of dividends with an average of \$0.01/share of earnings. Where will they get the money to keep paying that level of dividends and still stay in business? Something has got to give and it's probably going to be the dividend payments.

**ESTIMATING EARNINGS GROWTH RATES.** A pretty good estimate of a company's earnings growth rate can be made by using Earnings Yields based upon 12 month leading earnings and P/E ratios based upon 12 month trailing earnings. The computation is very simple:

$$\text{EGR} = (100 * (\text{LE} - \text{TE}) / \text{TE}) \quad \text{Eq. (14.2)}$$

Where: EGR = Earnings Growth Rate in %/Yr

LE = 12 Month Leading EPS

TE = 12 Month Trailing Earnings

$$\text{LE} = (\text{P} * \text{EY}) / 100 \quad \text{Eq. (14.3)}$$

Where: P = Leading Price in \$ per Share

EY = Leading Earnings Yield in %

$$TE = P/(P/E) \quad \text{Eq. (14.4)}$$

P = Trailing Price in \$ per Share

P/E = Trailing Price to Earnings Ratio

Using the data shown for Disney in Table I of Chapter 13:

$$\begin{aligned} LE &= (104.17 \times 4.78) / 100 && \text{Eq. (14.3)} \\ &= 4.98 \% \end{aligned}$$

Using Disney data from 02/13/14

$$\begin{aligned} TE &= 77.90 / (19.14) \\ &= 4.07 \% \end{aligned}$$

the Earnings Growth Rate (EGR) for Disney is:

$$\begin{aligned} \text{EGR} &= (100 \times (4.98 - 4.07) / 4.07) && \text{Eq. (14.5)} \\ \text{EGR} &= (100 \times (0.91) / 4.07) \\ &= 22.4 \% / \text{Yr.} \end{aligned}$$

Considering how easy it is to make this calculation, this estimate, 22.4%/Yr., is somewhat higher than VectorVest's 02/13/15 estimate of 15.0 percent per year, but it is reasonable. Try it on a few stocks of your own. You'll be amazed how well it works.

**ESTIMATING GROWTH TO P/E RATIOS.** The biggest and best of professional money managers, including Peter Lynch, used Growth to P/E ratios (GPE) as a measure of valuation. When the GPE is above 1.00, a stock is deemed to be undervalued. When GPE is less than 1.00, it is deemed to be overvalued.

Consider the GPE ratio for Disney. Given the Estimated Growth Rate, EGR, of 22.4% shown above and a leading P/E ratio of 20.92. The Growth to P/E is:

$$\text{GPE} = 22.4 / 20.92 = 1.11$$

The GPE ratio of 1.11 indicates that Disney's stock is undervalued by 11 percent. It very well could be, but our studies show that GPE's are overly simplified measures of valuation. Our calculations of Relative Value (RV) are far more sophisticated measures of valuation. The RV for Disney on February 13, 2015 was 1.38. Why is RV so much higher than GPE? Low inflation and interest rates. (See Chapter 6 for more on this subject).

We're not done using Earnings Yield yet. Let's examine another simple, but better method of estimating inherent value.

**ESTIMATING INHERENT VALUE.** In Chapter 3, we illustrated the use of a “Quick Value Estimate” equation for calculating inherent value. It simply requires one to divide annual earnings per share by the AAA Corporate Bond rate + Yield Premium. Thus:

$$V = 100*(E/(IY+YP)) \quad \text{Eq. (3.4)}$$

Where:     V = Value of a Stock in \$/share  
          E = Earnings in \$/share  
          IY = AAA Corporate Bond Rate in Percent  
          YP = Yield Premium

Since       E = 4.98 \$/Share  
          IY = 2.83%  
          YP = 2.34%

The Quick Value for Disney on February 13, 2015 is:

$$\begin{aligned} V &= 100*(4.98/(2.83+2.34)) \\ &= 100*(4.98/5.17) \\ &= 96.32 \text{ \$/Share} \end{aligned}$$

By golly, this is 92.5% of Disney’s February 13, 2015 closing Price of \$104.17 compared to the 1.11% level obtained from the GPE analysis. Maybe Disney isn’t undervalued after all.

Wow! The extremely low interest rates prevailing in 2015 make stocks look like the bargains of a lifetime. Let’s summarize what Earnings Yield can do for us. Earnings Yield gives us something that:

- 1 Is more informative than P/E ratios,
- 2 Can give us 12 month leading earnings estimates,
- 3 Can be used to assess Dividend Safety,
- 4 Can be used to estimate Earnings Growth Rates,
- 5 Can be used to get Growth to P/E ratios, and
- 6 Can be used to get an estimate of Intrinsic Value.

It’s hard to believe you can do all of this from one number. It must be magic.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Bottom Fishing: The Art Of Buying Low and Selling High**

With high-frequency traders driving stock prices higher and higher, how can we find low-priced bargains? By bottom fishing, of course! It's the art of buying low and selling high, and a great way to get rich. Why isn't everybody doing it?

Buying low and selling high is not as easy as it sounds. No one knows for sure which stocks are "low," and which are "high." A stock that seems "low," may go lower. One that seems "high," may go higher. How can we tell which is likely to do what?

Clearly, history can be our guide. A stock whose price has fallen from a peak is "low" relative to that peak. A peak may reflect the highest price a stock has ever attained or it may reflect an intermediate high over the last 52 or 13 weeks. Whatever the case may be, investors perceive that stocks are "low" when their prices are down from former levels and "high" when prices have risen from lower levels.

Ideally, one would like to buy good stocks that have been beaten down in price and are poised to rise. Here's how to play the game.

**I. IDENTIFY STOCKS THAT ARE "LOW" IN PRICE.** When I first wrote this book, it was necessary to refer to financial newspapers or magazines to consult lists of stocks hitting new Price lows. Now, however, computers provide the most convenient and efficient way of finding stocks hitting new lows. You can go to any number of financial websites to find lists of stocks hitting new 52 week lows. But, that's not the best way to find stocks that have been really beaten down in Price.

The best way to find these stocks is to use VectorVest's Relative Timing, RT, indicator. VectorVest allows you to force rank thousands of stocks by RT with click of a mouse. The stocks with the lowest RT values have been so beaten down in Price, they could be taken for dead. But, they invariably shoot up the fastest with the greatest percent gains when the market rises from a bottom.

**II. SELECT STOCKS MOST LIKELY TO REBOUND.** This task gets to the heart of one's bottom fishing skills. The key here is to use a few critical criteria, such as good fundamentals and low RT, to find good stocks that have been beaten down to bargain prices. Another objective of this selection process is to winnow a large number of stocks to a manageable few which can be tracked on a watch list.

VectorVest has a unique combination of indicators that make it extraordinarily easy to find the best stocks with the best fundamentals. One of our favorite sorts is VST/RT. This sort ranks stocks with the highest Value-Safety-Timing Vector, VST, and lowest RT at the top of the list. "Jail Break," one of VectorVest's most popular bottom-fishing searches, produced a stunning return of 1,369% gain from March 9, 2006 to February 13, 2015.

Many investors suggest that investors favor stocks with the lowest Price to Earnings, P/E, ratios. This is not a bad place to start, so let's see how well it works. When we used the "Jail Break" search criteria and sorted the stocks by P/E Asc., the VectorVest search engine, called, "UniSearch" returned stocks that gained 224% from March 9, 2009 to February 13, 2015. That's not bad, but it's not great either.

If you're really interested in buying good stocks at bargain Prices, just sort the "Jail Break" search by VST/Price Desc. This sort ranks stocks with the highest Value-Safety-Timing Vector, VST and lowest Prices at the top of the list. It gained 1,014% from March 9, 2009 to February 13, 2015. Now, that's great!

The lesson here is clear: Beaten down stocks with good fundamentals, i.e., high RV and high RS, go up sooner, faster and further than stocks with weak fundamentals. I, personally, used the "Jail Break" search, to go bottom fishing on the morning of March 10, 2009. And our subscribers did too. This was not a stroke of luck. On Friday, March 6, 2009, I wrote an essay entitled, "Itching to Rally." We said an explosive rally was imminent and gave our subscribers six bottom-fishing searches to chose from. The explosive rally I anticipated began on March 10, 2009. All seven searches produced fantastic gains.

**III. BUY STOCKS THAT ARE RISING IN PRICE.** This may sound like a contradiction, but it's the most important part of bottom fishing. Never buy stocks on the way down! Nobody knows how low they will go or how long they will stay down. Yahoo! hit an intraday, split-adjusted high price of \$125.03 on January 4, 2000, and bottomed at a low price of \$4.01 on September 27, 2001. Nearly 14 years later, it closed at \$44.42 on February 13, 2015. How can we tell when a stock has stopped going down in price? Wait until it starts going up...that's not a joke. You may not be able to see it with the naked eye, but a graph of Price and RT will show you when downward Price momentum has dissipated and when Price has begun to go up.

One would love, of course, to buy stocks at exact bottoms. VectorVest has come close to doing it on many occasions and we actually did it on March 10, 2009. This was not a stroke of luck. We track the market and analyze its trend very carefully. We do not predict the market. Our market timing system is explained in Chapter 20 of this book and it is, perhaps, the most important factor in making money in stocks. Every thing begins with market direction. Consider the following sequence: On November 2, 2007, I warned our subscribers that "The Confirmed Down signal that we received yesterday could be the entrée to a long Bear market," and I advised them to buy Contra ETFs. Those who heeded my guidance made money and/or avoided losing their money in the severe bear market of 2008 and bought stocks, in the opportunity of a lifetime, on March 10, 2009. This experience reflects the art of bottom-fishing at its best.

We have found that bottom fishing not only provides opportunities for outstanding profits, but it also reduces downside risk. It makes one believe that bargains still abound, and that bottom fishing is, indeed, the art of buying low and selling high.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Teeny Boppers: Low Price Stocks with Explosive Price Appreciation Potential**

On January 20, 1995, I published a list of 50 Buy rated stocks called “High Performers.” This list included **Micron Technology**, which went from \$22.63 to \$94.75; **US Robotics**, from \$23.50 to \$179; and **Ascend Communications**, from \$6 to \$62. My favorite, however, is **Iomega**, which went from a split adjusted \$1.69 to \$66, up a fantastic 3,800 percent! How did I find these stocks?

The same way I find similar stocks today. I was tracking stocks that were hitting new 52 week highs and ranking them according to a certain system I have. Before getting into that, however, let’s step back a minute.

Why was I tracking stocks that were hitting 52 week highs? In the last chapter on “Bottom Fishing,” I extolled the virtues of buying low and selling high and suggested the idea of tracking stocks that were getting beaten down on price. Now, I’m saying the opposite. Have I lost my marbles?

Not really. The approach we described works very well, but it’s not the only way to make money in the stock market. In fact, the method of finding low-priced stocks having explosive price appreciation potential described in this chapter has a lot in common with the last chapter.

In both cases, we’re tracking stocks which are deviating significantly from their normal patterns, i.e., they’re making 52 week lows or 52 week highs. These stocks are screaming for attention. They’re telling us that something significant, good or bad, is happening. We ought to be able to take advantage of these situations.

Another common point, and a very important one I might add, is that I advocate buying stocks that are rising in price whether you are bottom fishing or not. A critical key to successful Bottom Fishing is buying these stocks AFTER they have stopped going down. I never buy a stock on the way down. If you’re good, you can catch depressed stocks just as they have started going up...usually within 5-15 percent of their lows.

An easier game to play, however, is buying stocks that are hitting new highs. Think of this: **Iomega** didn't go from \$1.69 to \$66 without hitting new highs, time after time. It was screaming for attention. All we had to do was listen to it.

Many studies show that one of the surest ways of making money in the stock market is to buy stocks hitting new highs. A lot of people, however, don't like to do this because they think these stocks are "over-bought" or "over-extended." Nonsense. I've seen too many stocks take-off and never return to their so called buying ranges. I especially like to buy low-priced stocks with the potential to become 10-baggers, i.e., go up 1,000%. I call these stocks "Teeny Boppers."

Teeny Boppers remind me of teenagers. They are full of energy, vigor and ambition. They have new ideas and different ways of doing things. They represent the wave of the future, but are untested. They're risky and many fail to fulfill their promise. But, many succeed. When they do, they become our new leaders. **Iomega** was a classic Teeny Bopper. Here's how to find the next **Iomega**.

**I. FIND LOW-PRICED STOCKS HITTING NEW HIGHS.** There are no hard and fast rules for defining low-priced stocks, but let's restrict our discussion to stocks under \$5.00. These stocks can easily be found by using the Teeny Bopper search in VectorVest. This search is located in the Price-Volume folder in the UniSearch tool and finds stocks between \$1.00 and \$5.00 per share that are hitting new 26 week highs with a 50-day average daily volume > 25,000 shares per day. It sorts the stocks by VST/Actual Price Desc.

On January 17, 2003, I wrote an essay called, "Hard to Beat." It was meant to show that VectorVest's Stop-Prices are, in fact, very good. So, I ran a series of five back-tests, each with a different exit signal, using the Teeny Boppers search, week-to-week, from 01/05/96 to 01/10/03. The results were incredible, producing gains of 436%, 648%, 2,150%, 4,083% and 4,596%. The largest gain was obtained when I used VectorVest's Stop-Prices to exit my positions, but the exit criterion wasn't the only important factor in achieving these gains.

The Teeny Boppers search itself was an extremely important factor! It found China Yuchai, CYD, on 05/24/02 at \$3.40/share and it closed at \$36.45 on 11/07/03. On 06/28/02, it found Sohu.com, SOHU, at \$1.70/share and Sina Inc., SINA, at \$1.75/share. SOHU closed at \$42.68 on 07/14/03 and SINA closed at \$48.25 on 01/26/04. Subsequently they went on to hit new highs again and again and again. As you go through a weekly routine of running the Teeny Boppers search, you'll notice that many of these stocks will appear a second, third or more times. It is not necessary for a stock to hit new highs in consecutive weeks, but once a stock has hit a new high several times, give it a shot.

**II. ANALYZE YOUR SELECTIONS AND MAKE YOUR FINAL CHOICES.** In order to select the most promising stocks, it pays to study their graphs. Look for steady price patterns. I especially like to see a stock flat-line; then breakout on high volume. Don't under estimate the importance of high volume. It reflects the conviction of the buyers who are driving the stock's price higher and higher. You have to recognize that they probably know something you don't. Therein lies your risk. Analyzing low-priced stocks on the basis of fundamentals is usually an exercise of faith. Most low-priced stocks have very weak fundamentals. So, try to learn all you can about the stocks you select.

VectorVest makes it quite easy to get scads of data on every stock it analyzes. All you have to do is right click on the stock from any Viewer, and click on "View Stock News." This will take you to the research section

of a Yahoo! Finance, Financial Times, or Reuters website. VectorVest allows you to select the website of your choice. You may also access VectorVest's full stock analysis report from the right click menu.

The clearest and most important information you'll ever receive about Teeny Bopper stocks comes from the market. **Iomega** was still losing money long after it had doubled, tripled and quadrupled in price. But, its new Zip drives were flying off the shelves. Informed investors knew that. They knew that big profits were just around the corner and were pushing **Iomega's** price higher and higher. So, if a Teeny Bopper's price keeps going higher and higher over a period of months, buy it even though the fundamentals have not yet materialized.

Another Teeny Bopper, screaming for attention back in 2004, was **Nutri System**, NTRI. Our Teeny Boppers search, sorted by VST Desc., found it on 12/02/04 at \$2.79/share. It found it again on 12/03/04 and 12/06/04. It found NTRI 14 more times in January 2005 and five more times in February, before it went above five dollars per share. It closed at an all-time high of \$74.86 on 05/11/06.

It's not hard to find these stocks and it doesn't take a long time to do. I simply run the Teeny Boppers search at the end of each week and graph the top 100 candidates, if there are that many. I look for a long consolidation period; then a break-out on high volume. When I see a chart pattern I like, I put it into WatchList via the right click button. A good example of a recent winner is **Handy and Harman**, HNH. I found it on 04/09/10 at \$3.66/share. It has made a reasonably smooth climb since then and hit an all-time closing high of \$48.17 on 02/03/15.

**III. MANAGING YOUR PORTFOLIO.** Let there be no mistake, dealing with Teeny Boppers is a high-risk strategy. One way to mitigate this risk is to spread your bets in equal dollar amounts over at least 10 stocks. With this many stocks, you can begin to tolerate the wild price swings that are normal for Teeny Boppers. High volatility is the blessing and the curse of Teeny Bopper stocks. You have to be willing to accept rapid price swings of 20 to 30 percent with these stocks, but you also need to know when to get out. Normally, one would exit a stock that drops 10 percent, but that would get you whipsawed over and over again. I would suggest that you use the VectorVest Stop-Price as your first line of defense. Sell the stock when you get an "S" rating; then buy it back when it hits a new high.

Take **Sina, Inc.**, for example. You could have bought it at \$1.75/share on 06/28/02. It rose to \$10.38 by 01/24/03. Then it dropped rapidly over the next 13 trading days to \$6.32 and it got an "S" rating on 02/12/03. Two months and two weeks later, it closed at a new high of \$10.88 on 04/21/03. Thereafter, it rose to a high of \$43.57 on 10/28/03 and corrected to \$35.26 and got an "S" rating on 11/11/03. You could have bought and sold this stock all the way up to **Sina's** all-time closing high of \$142.83 set on 04/20/11. The same technique could have been used with **Sohu.com**. It closed at an all-time high of \$106.28 on 04/28/11.

The name of the game with Teeny Boppers is to keep plugging. Although you may find that many of your selections lose money, one ten-bagger will more than make up for a lot of little losses. That's the beauty of buying low-priced stocks with explosive price appreciation potential.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **High Performers: Where Profits Reign Supreme**

In the last chapter, I referred to a list of 50 stocks that I published on January 20, 1995, called “High Performers.” You may recall that this list contained sensational winners such as **US Robotics**, **Ascend Communications** and **Iomega**. This portfolio of stocks gained 20.3% from January 14, 1995 to April 14, 1995, for an annualized gain of 80.9%.

From January 14, 1995 to May 30, 1997, the 43 stocks still being traded gained an average of 173% for an annualized rate of return of 133.9%. Twenty-two of the 50 stocks gained more than 100% and only four of the 43 actively traded stocks were showing losses. How can you find these guys?

The key to selecting “High Performers” is to start with a list of stocks hitting new 52 week highs. Stocks hitting new highs are deviating from normal pricing behavior in a very special way and deserve special attention. These stocks are identified in all the papers, so it’s easy to begin your selection process. The hard part comes in shrinking this list to the most probable winners. Here’s how to do it:

#### **BUY STOCKS WITH THE BEST COMBINATIONS OF VALUE, SAFETY AND TIMING**

Every investor needs to know what a stock is really worth, how safe it is, and when to buy, sell or hold. I like to buy safe, undervalued stocks that are rising in price. Sounds good, but let’s examine these criteria more closely:

**VALUATION:** When the Price of a stock is less than or equal to its intrinsic value, you’re buying stock in a company that is making money and that’s very important. In a hyper-inflated market, hundreds of stocks are selling at ridiculously high P/E ratios and they are bound to crash someday. Stocks of companies with solid earnings have a better chance of prevailing in good times and bad.

**SAFETY:** Stocks of companies with consistent, predictable financial performance are well managed and will outperform the market in the long-term. They are more likely to fulfill your expectations of earnings growth and price appreciation. That's what stock safety is all about.

**GROWTH:** Stocks with earnings growth rates above 12 percent per year are likely to demonstrate above average performance. Stocks with low earnings growth rates have little to look forward to, even if they have recently hit new highs. Safe, undervalued stocks with above average growth rates are the *crème-de-la-crème*. These stocks tend to make new highs year after year. What could be better than that?

**PRICE PERFORMANCE:** If you want to own stocks with rising prices, buy stocks with rising prices. This idea is very hard for many investors to accept, but the best thing that can happen to your portfolio is to own a group of stocks which are hitting new highs.

Screening your original list of stocks hitting new 52 week highs with these criteria will result in a "short-list" of final candidates for purchase. This would take a ton of work and hours of time to do manually. Not to fear. VectorVest is here.

The "High Performers" cited at the beginning of this chapter were selected by VectorVest's search engine in less than 5 seconds. VectorVest searched over 8,000 stocks for stocks hitting new 52 week highs, and ranked them by VST-Vector, a proprietary indicator which I developed. My approach to assessing Value, Safety and Timing has been discussed in previous chapters of this book. I combine my proprietary indicators, RV, RS and RT into a master indicator called VST-Vector. Stocks with high VST-Vector values have the best combinations of Value, Safety and Timing.

Each week, VectorVest runs a search which finds all the stocks hitting new 52 week highs and puts the top 100 ranked by VST-Vector into a WatchList, called "Best New Highs." We ran five tests, starting from one to five years ago through 02/13/15, we compared the price appreciation performance of the top twenty VST stocks in the Best New Highs WatchList to the performance of the SPX over the same periods. The total gain of the top VST stocks was 310.03% compared to the total gain of the SPX tests 259.82%. Outperforming the SPX over these time periods is no small feat, since the S&P 500 Index has been on a record setting rampage over the last five years. This data supports our belief that high VST stocks gives investors a steady flow of High Performers: Where Profits Reign Supreme.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Super Star Stocks**

What does it take to be a Super Star? Performance. Outstanding performance. Not for a day, a week or even a year. It has to be done over a period of years.

Everyone knows that Michael Jordan, Joe Montana, and Jack Nicklaus were Super Stars. Their performances were visible and well documented. They were outstanding for a long period of time. Keeping score in the world of sports is straightforward, but it's not so easy with stocks. There are no universally accepted standards for measuring stock performance. Even if there were, the criteria would be less certain. So, how can we identify Super Star Stocks?

One might be tempted to use price performance as the only characteristic of a Super Star Stock. But, I've seen too many miserable stocks get pushed up by hype and fluff to be impressed by price performance. So, let's go behind the scenes and look at the bottom line.

In the world of business, making money is the key measure of performance. Making money is the difference between winning and losing, prospering or struggling, surviving or dying. But making money is not enough to spawn a Super Star. A company has to make more money quarter after quarter for a long time. Companies which consistently generate higher and higher earnings at tremendous rates create Super Star Stocks.

It's terribly difficult to grow earnings at high rates over a period of years. It requires a rare combination of superb management, quality products and exceptional services. Consider the following story.

I was peacefully working on a quiet Sunday morning in July 1989 when my computer was jolted by a tremendous surge of electricity. The picture on my monitor spiraled into a black hole. Everything stopped in an eerie silence. I sat there stunned and dumbfounded.

Of course, I was well aware of the damage a power surge could do to delicate electronic equipment. I had experienced the nuisance of power outages during storms and typically unplugged my computer when I was away from home. Never, however, did I expect to be zapped on a clear, blue Sunday morning.

Fortunately, my surge protector sacrificed itself, and limited the damage to the computer. The hard drive survived and so did I. But I learned a lesson. The next day I bought a back-up system and an auxiliary power supply.

The manufacturer of the auxiliary power supply was **American Power Conversion Incorporated**, a young company with the right product at the right time. Did it have the management to become a success?

**American Power Conversion** (APC) was formed in 1985 and went public in 1988. Earnings turned positive after one year of operation and increased at a tremendous rate. Its stock price soared and the stock split five times. One hundred shares in 1988 became 3,200 shares by June 1995.

Skeptics abounded, and APC's stock became a favorite target of short-sellers. Could APC maintain its blistering pace of sales and earnings growth? Indeed it could. Sales rose from \$17 million in 1988 to \$413 million in 1996. Per share earnings rose from 5 cents per share in 1988 to 77 cents in 1996. Earnings increased for 25 consecutive quarters. APC consistently demonstrated outstanding performance. It was a Super Star Stock.

VectorVest defines a Super Star Stock as one having a Relative Safety rating of 1.25 or more and a forecast earnings growth rate of at least 20 percent per year. As of March 15, 2013, only 33 of over 8,000 stocks in our database met these requirements. Table I. below shows five Super Star stocks ranked by Value-Safety-Timing Vector.

**Table I. Selected Super Stocks (Ranked by VST-Vector)**

Company Name	Price	RV	RS	RT	VST	GRT	REC
Skyworks Solutions	81.85	1.63	1.45	1.48	1.51	28	B
Gilead Science	101.90	1.91	1.43	1.16	1.49	44	H
Centene Corp.	118.18	1.50	1.42	1.44	1.45	24	B
Biogn Idec Inc.	391.66	1.52	1.39	1.37	1.42	24	B
Skechers USA	66.09	1.61	1.27	1.38	1.42	32	B

Price = Closing Price as of 02/13/15.

RV = Relative Value\*

RS = Relative Safety\*

RT = Relative Timing\*

VST = Value-Safety-Timing Vector\*

GRT = Earnings Growth Rate in Percent Per Year

REC = Recommendation (B = Buy)

\*Values above 1.00 are Favorable

Each of the companies listed in Table I has strong upside price appreciation potential, as reflected in the high RV values. They have extraordinary long-term records of financial performance, as shown by the RS values above 1.20 and they are in strong upward price moves. Of course, they all have forecasted earnings growth rates of 20%/year or more. Because of their super performance, they are all rated a Buy. They are all Super Star Stocks.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **The Election Cycle**

Earnings are the single most powerful factor affecting the stock market. As sure as the moon causes ocean tides to rise and fall, earnings cause stock prices to do the same. Stock prices go up when earnings go up and fall, when earnings go down.

There is another powerful force, however, that comes along every four years that overrules earnings. It's The Presidential Cycle. It doesn't matter whether earnings are rising or falling, the stock market usually goes up during the last two years of a presidential administration.

This phenomenon is neither coincidental nor accidental. It is the result of political forces striving to boost the economy. A prosperous economy and a booming stock market virtually guarantee reelection of an incumbent administration.

According to Jeffery and Yale Hirsch, Editors of the *2015 Stock Trader's Almanac*, "the last two years of the 45 administrations since 1833 produced a total net market gain of 731.3% compared with a 299.6% gain of the first two years of these administrations. The average gains were 16.2% and 6.7%, respectively."

Clearly, incumbent administrations not only strive to look good in the last two years in office, but they make the hard decisions, such as raising taxes, during the first two years.

Consequently, the first year of a presidency has shown the worst performance with an average gain of 2.5%, as measured by the Dow Jones Industrial Average and the second year performance has also been relatively weak with an average gain of 4.2%.

As campaign spending and re-election promises begin to take form, investors sense that better days lie ahead, so it's not surprising that third year performance showed the best performance with an average gain of 10.4%. Fourth year showed the second best performance with an average gain of 5.8%.

Contrary to historical precedent, the worst performance for any year, -52.7%, came in 1929 during Herbert Hoover's third year in office and the best performance for any year, 66.7%, came in 1930 during Franklin Delano Roosevelt's first year in office.

In his book, "Strategic Investment Timing," Mr. Dick A. Stoken states that, "The really juicy part of the election cycle is the fifteen-month period beginning in early October, two years before the election, and lasting until early January of the election year." In other words, the juicy part of the 2016 election cycle will start early in October 2014 and end early in January 2016.

While studying historical phenomenon such as The Presidential Cycle is fun, one would be better served by staying with fundamentals. And that's exactly what we do. VectorVest tracks and analyzes two measures of inflation, three measures of interest rates and the 50-day moving average of S&P 500 earnings each and every week and reports whether the stock market is bullish or bearish. This information, which is published in the Investment Climate section of the VectorVest Views, was instrumental in alerting our subscribers on November 2, 2007 of the possible onset of a long bear market. Here's what we said:

#### ***A WORD TO NEW SUBSCRIBERS***

***"The Confirmed Down signal that we received yesterday could be the entrée to a long Bear market. We aren't there yet because earnings are still rising according to our method of analysis. Yet, we no longer appear to have the support of an accommodative Fed and that can make things very bad for the stock market. So don't be deceived by the endless parade of experts who will appear on TV and other places telling you to buy stocks. This is not the time to buy stocks. Just follow our Market Timing System and it will tell us when to go long again. At that time, we should be getting some wonderful bargains."***

The most interesting thing about this call is that we saw it coming and it happened in the third year of President George W. Bush's second term...just as we were completing the "juicy part" of the 2008 Presidential Election Cycle.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Timing the Market: A System that has Never Failed**

Being on the wrong side of the market is the worst thing that can happen to an investor. It doesn't have to happen to you.

Old Joe Granville always said the market tells its own story. All you have to do is read what it is saying. Unfortunately for him, he didn't take his own advice.

Joe Granville was one of the pioneers of technical analysis. He used several novel methods of "reading the market." The most popular of which is "On Balance Volume." Initially, he was quite successful and became the market "Guru" of the early 1980's. He was so influential, that his forecasts became self-fulfilling prophecies. Then, he missed the call on the great Bull market of the 1980s and '90s. On August 16, 1982, the market broke out of a steep slump and Joe Granville said it was a folly. He said that it was a Bull trap, rising stock prices were like balloons that were about to burst. He remained a Bear for over 14 years while the market soared. What went wrong?

Mr. Granville's fatal error is that he went from timing the market to forecasting it. There is an enormous difference between the two. Market timers are messengers. They study indicators of market activity to determine whether it is rising or falling and communicate their conclusions on market direction.

Forecasters consider economic factors and whatever else they think is important to predict what the market will do. Market timers need never fail. All forecasters will fail eventually.

Theoretically, forecasting the market is far more powerful than timing. Everyone would like to know what the market is going to do, when it will happen and by how much. In the real world, however, nobody has a crystal ball. Forecasting deals with the unknown and eventually, error is certain. The landscape is full of forecasters who have gone wrong. Their stories are well documented and they were viewed as stars when they were right. Now they are viewed as losers. Joe Granville? He just happened to be the most flamboyant of the bunch. He finally turned Bullish in 1993, but nobody cared what he said anymore.

This chapter is not about forecasting the market. It's about timing, i.e., reading our indicators and letting them tell us when the market is rising or falling. It's about sensing turning points and knowing when to invest aggressively and when to take defensive actions. We want to buy within five percent of a bottom and sell within five percent of a top. Can we do it? It's really very simple.

The market timing system described below was discovered in March 1995 and depends upon two key indicators:

1. The Price of the VectorVest Composite, and
2. The VectorVest Buy/Sell Ratio.

Both indicators were developed by VectorVest, a stock analysis system which analyzes over 8,000 stocks each day for Value, Safety and Timing and gives a Buy, Sell or Hold recommendation on each stock each day.

The Price of the VectorVest Composite, VVC, an arithmetic index of all the stock prices in the database, is the most important indicator used in timing the market. When the Price of the VVC has moved in a given direction, you can bet that the market has moved in the same direction.

The VectorVest Buy/Sell Ratio, BSR, is the second most important indicator used in timing the market. It responds to the directional movement of the Price of the VVC and increases as the market moves higher and decreases as stock prices move lower. This indicator is amazingly sensitive to the inner movements of the market. When the ratio of Buys to Sells is above 1.00, the market is robust. Correspondingly, the market is weak when the Buy to Sell Ratio is below 1.00.

From the very beginning, (1988), we recognized the measured pulse of the market and it was used to help guide our thoughts on the direction of the market. But, it was not until March of 1995, that we discovered how the Price of the VVC replicated the direction of the market. We examined our data back to April 1991 (the time when we first began computing the VVC), and found that tracking the direction of the market with the Price of the VectorVest Composite was incredibly simple and reliable.

Here's how the system works:

If the Price of the VVC moved in a given direction, up or down, over a five-day trading period, it gave a preliminary signal of the market's direction. This signal is called the Primary Wave. If the Primary Wave is followed by another five trading-day move in the same direction, the preliminary signal was reinforced, but not confirmed. We must turn to the BSR for confirmation of the market's direction.

A Confirmed Up, C/Up, is given when the Price of the VVC has gone up for two consecutive five trading day periods, closes higher than the previous day and the BSR is above 1.00.

A Confirmed Dn, C/Dn, signal is given when the Price of the VVC has gone down for two consecutive five trading day periods, closes lower than the previous day and the BSR is below 1.00.

Although we discovered this timing technique in March 1995, the first major C/Dn signal given in "real time" did not occur until 09/22/95. The market had just completed a marvelous Bull rally, lasting 39 weeks. Signs of weakness had begun to appear in July, but the market did not peak until 09/08/95. Two weeks later, we got the C/Dn signal. Here's what we said on 09/22/95: "The Price of the VVC has now gone down for the second

week without an intermediate up move. Our studies have shown that this event signals a market correction. The still favorable investment climate suggests, however, that it will be only a mild correction.”

From September 22nd on, we tracked the correction week-by-week, until it bottomed on January 12, 1996. Two weeks later, we said, “The Price of our VectorVest Composite rose for the second week in a row, signaling that the market’s correction is over. Although the green light has not been confirmed by the BSR, it’s OK to buy high VST-Vector “B” rated stocks. It’s a good time to go Bottom-Fishing. For a FREE copy of our Special Report “**Bottom-Fishing: The Art of Buying Low and Selling High,**” call 1-888-658-7638.”

As of the current time, February 13, 2015, we had just received a C/Up signal the prior day. Here’s what I wrote as my weekly Strategy guidance, “The Price of the VectorVest Composite (VVC) gained \$0.54 per share since last Friday and released a Confirmed Up, C/Up, signal on Thursday, February 12, 2015. I was skeptical that the Price of the VVC had truly broken above the upper jaw of the Wicked Wedge last Friday and became fearful of another drawdown on Monday. But the Bulls took charge on Tuesday and finally broke out of the Wicked Wedge, to the upside, on Thursday. Today’s follow-up rally and a confirmed green light in the Price column of the Color Guard gives us hope that this rally has legs. With three green lights and an UpUp situation, the Color Guard is Bullish. Prudent Investors may buy rising stocks as the market rises. Aggressive Investors and Traders should play the market to the upside.”

You might believe that the market moves in a random fashion. It does not. While there are periods where the market moves up and down from week to week, it always happens within the framework of an underlying trend. This system of timing the market has never failed to signal a major move...and it never will. The reason is quite simple: we don’t predict the market, we track it. Big moves start with little moves. Since we keep track of every little move the market makes, we will never miss a big move. Even the apparently abrupt crash of October 1987 occurred nearly two months after the market peaked in late August 1987.

We warned our readers to take profits at the very top of the bull market on March 10, 2000, to go long at the beginning of a new bull market on March 21, 2003, and we issued a strong warning at the onset of the bear market on November 2, 2007. We also nailed the beginning of the current bull market at the very bottom on March 6, 2009. What more could you ask for?

The drama of the market’s moves is vividly displayed on the Home page of the VectorVest software in a clear, easy to understand tool called The Color Guard. There’s no guesswork. Green means the market is Bullish. Red means the market is Bearish and Yellow means the market is in transition.

You may call 1-888-658-7638 or log on to [www.vectorvest.com](http://www.vectorvest.com) to order a Special 5-Week Trial to VectorVest. Databases are available for the following markets: United States, Canada, United Kingdom, the Euro Zone, South Africa, Singapore, Hong Kong and Australia. You’ll receive FREE technical support and instructional material.

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## *STOCKS, STRATEGIES & COMMON SENSE*

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### **Knowledgeable Investors**

Knowledge is power. Power is the ability to get things done. Knowledgeable investors have the power to know when to buy, what to buy and when to sell. They keep risk under control and manage their portfolios for persistent profits.

Knowledge comes from experience and information. Experience cannot be purchased. There's a price to pay for experience, however, and it does not come cheaply. The price we pay is time and the agony of learning from our failures. Experience comes only from one's personal involvement.

Information, on the other hand, can be purchased. It comes from others. Herein lies a problem. What we take as information may or may not be valid. Information is often misrepresented. Investors are often fooled into thinking they have purchased information when they actually have purchased data. Data and information are distinctly different. Data is a commodity, a mute documentation of the past. Information is a value added product. It speaks to the future.

Information comes from the analysis of data and is only as good as the data and the analysis from which it came. A thousand investors may read the same annual report. Each will analyze the report and draw a different view of company's performance. Those with greater experience, special skills or training are more likely to make a proper assessment of the data/information. The others are more likely to be wrong in their assessments and make unfortunate decisions.

Investors are starved for information. They read books, magazines and newspapers, watch TV, attend seminars and belong to investor groups to learn as much as they can. It seems that the world is awash in information. But, good information is hard to find.

Knowledgeable investors know that information is unlikely to be reliable unless the cause and effect relationships within the data have been tested and verified. Statistical analysis is a powerful tool for analyzing data. But, it's not the only one. Common sense is your most important asset.

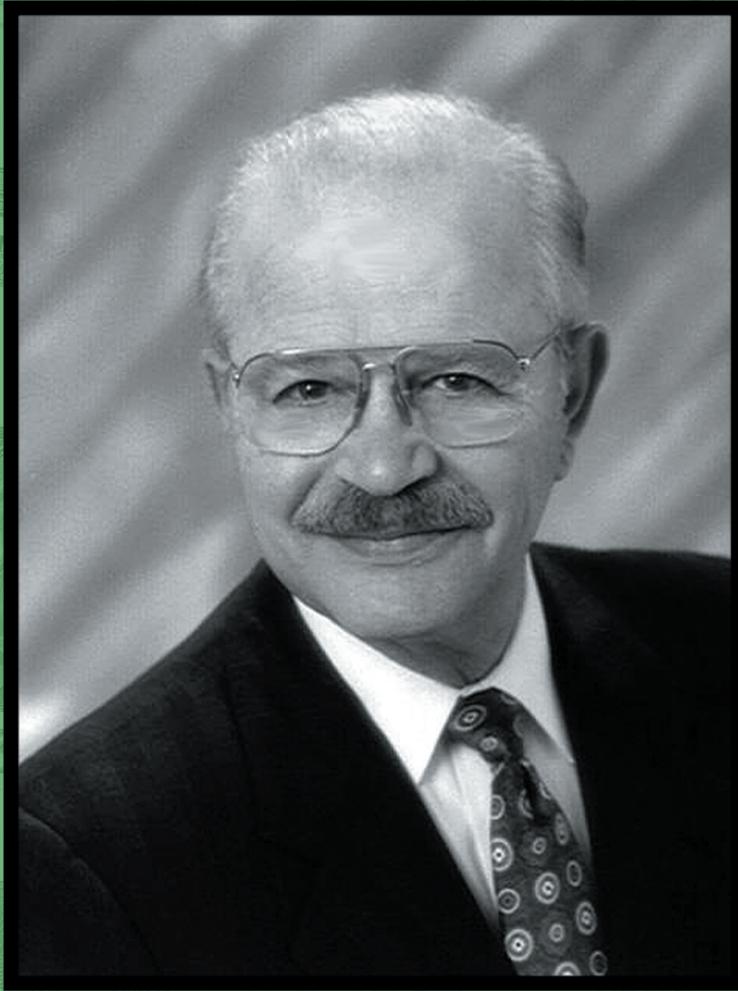
Most of what we receive as information is not reliable. This so called “information” is flawed, either by improper or insufficient analysis or by deliberate design to separate you from your hard earned money. Buyer beware holds especially true in the financial markets.

In selecting stocks, your primary job is that of assessing information. Many investors, however, feel qualified and prefer to analyze data. This is fine as long as they have the time, resources and skills to produce reliable results. Knowledgeable investors can save time, and get excellent results by asking the right questions. Can you answer the following questions about the stocks in your portfolio?

- \* Is the company making money?
- \* What is the stock really worth?
- \* Is the stock over or undervalued?
- \* How safe is the stock?
- \* Is its price rising or falling?
- \* What are its forecast earnings per share?
- \* What is its estimated earnings growth rate?
- \* What is its growth to P/E ratio?
- \* What are its dividends per share?
- \* How safe are the dividends?
- \* How fast are dividends growing?
- \* Does this stock meet my risk/reward objectives?
- \* Should I buy it now?
- \* When should I sell it?

VectorVest answers all of these questions systematically, objectively and unemotionally. Compare these answers with those of other reliable sources. It’s the right thing to do. Using VectorVest with other sources gives you more power to pick the right stocks and make the right decision. This will help you manage your portfolio for persistent profits. When you combine experience with good information, you’ll have what it takes to join that elite class of Knowledgeable Investors.

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**Bart A. DiLiddo, PhD, has over forty years of experience as an engineer, business executive and investor. Bart was Executive Vice President of a Fortune 500 company, and graduated from MIT's Sloan School of Management.**

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