Finding a Stock Winner: First Step Screening

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Discussion Overview

- A **computerized screening program** can be used to locate/analyze stocks in an organized, systematic and disciplined fashion
- Discuss screening factors that help to highlight winning stocks
  - Value approach
  - Growth approach
- Stock screening resources
  - AAII Stock Screens
  - Top Web Screeners
- Take home a feeling for some of the elements that help to build successful portfolios

Stock Selection Process

Screening Process

- Screening approach should match personal investment philosophy
- Establishing criteria narrow a large universe of stocks into a few that hold promise and warrant further analysis
- Screening system identifies stocks that have common, desirable traits
- Screening system adds discipline to the stock selection and selling process
- Strategies need to be backtested to make sure they work

Valuation Process

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

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What is your investment strategy?

"Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, Margin of Safety."

-Benjamin Graham

Write down what you look for in stocks: earnings growth, return on equity, financial strength, dividends, price-earnings ratio of x, etc.

How long would you say your investment period is?

What is the most you are willing to lose
on an investment?

How much time do you have to spend on research?

Do you care about price momentum?

Are you investing for income? (dividends)

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Stock Strategies

See these on AAII.com

Value
Benjamin Graham, Walter Schloss

Growth
William O'Neil

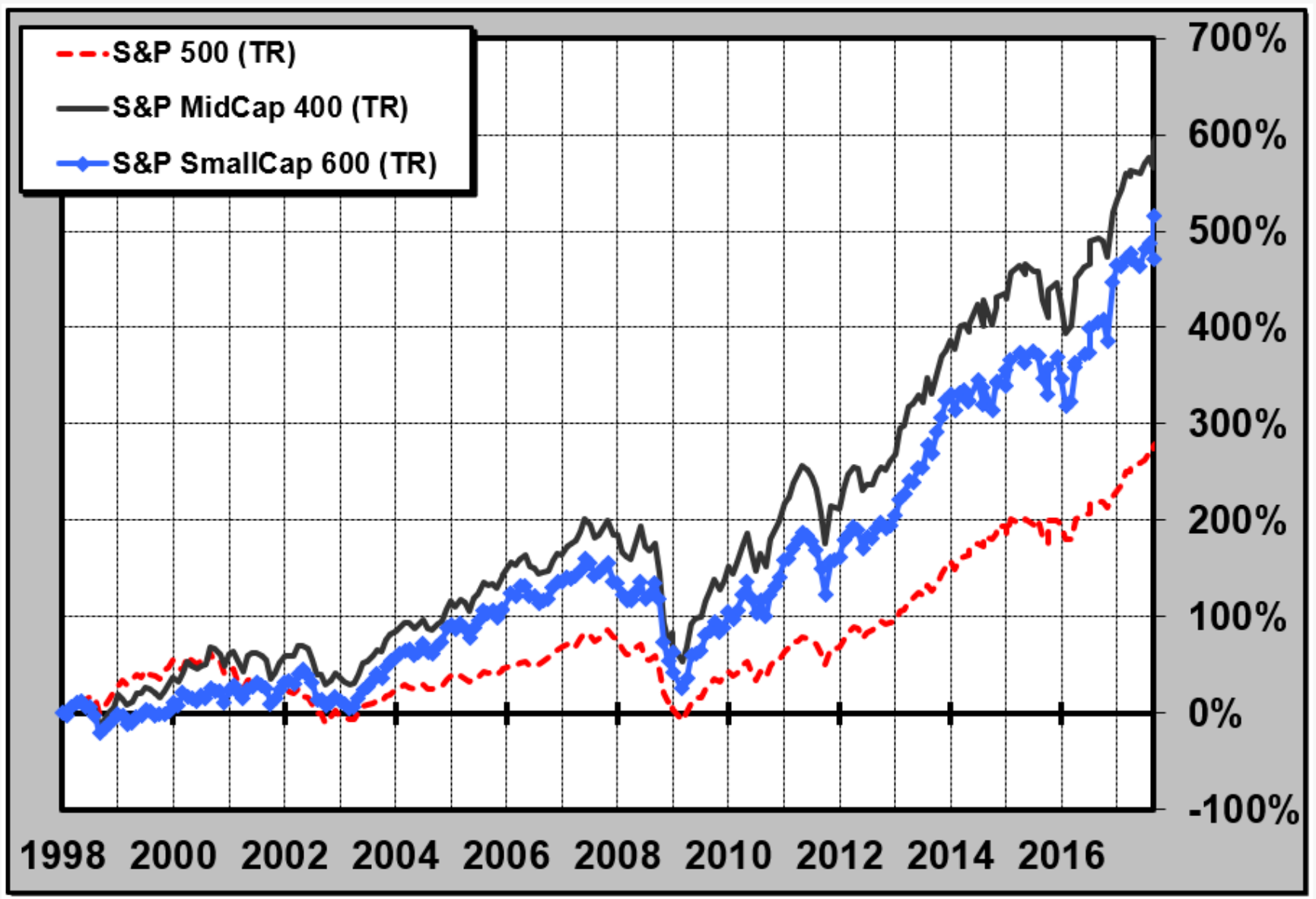
Growth at a reasonable price
Peter Lynch

Contrarian
David Dreman

Value with price momentum
Lakonishok

Recent Performance by Size

Data as of 1/31/2018



The Cross-Section of Expected Stock Returns by Eugene Fama & Kenneth French

The Journal of Finance, June 1992

Average Monthly Returns (July 1963 to December 1990)

		High Price-to-Book Value Ratio								Low
	All	1	2	3	4	5	6	7	8	9	10
All Stocks	1.23	0.64	0.98	1.06	1.17	1.24	1.26	1.39	1.40	1.50	1.63
Size Deciles											
1-Largest	0.89	0.93	0.88	0.84	0.71	0.79	0.83	0.81	0.96	0.97	1.18
2	0.95	0.44	0.89	0.92	1.00	1.05	0.93	0.82	1.11	1.04	1.22
3	1.08	0.66	1.13	0.91	0.95	0.99	1.01	1.15	1.05	1.29	1.55
4	1.07	0.95	1.00	0.99	0.83	0.99	1.13	0.99	1.16	1.10	1.47
5	1.15	0.70	0.98	1.14	1.23	0.94	1.27	1.19	1.19	1.24	1.50
6	1.24	0.88	0.65	1.08	1.47	1.13	1.43	1.44	1.26	1.52	1.49
7	1.19	0.39	0.72	1.06	1.36	1.13	1.21	1.34	1.59	1.51	1.47
8	1.22	0.56	0.88	1.23	0.95	1.36	1.30	1.30	1.40	1.54	1.60
9	1.22	0.43	1.05	0.96	1.19	1.33	1.19	1.58	1.28	1.43	1.79
10-Smallest	1.47	0.70	1.14	1.20	1.43	1.56	1.51	1.70	1.71	1.82	1.92

- The smaller the market cap, the higher the return
- The lower the price/book, the higher the return

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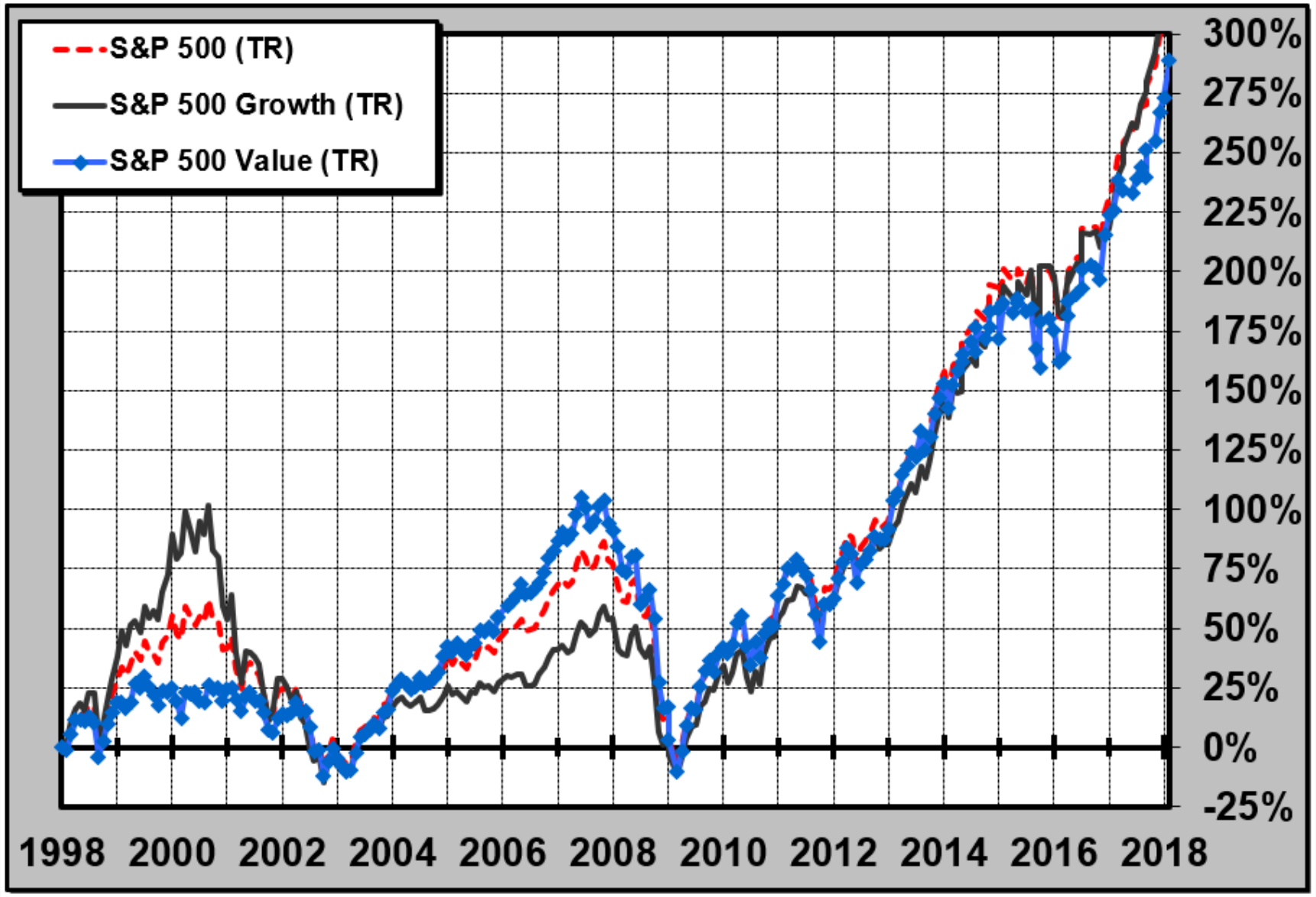
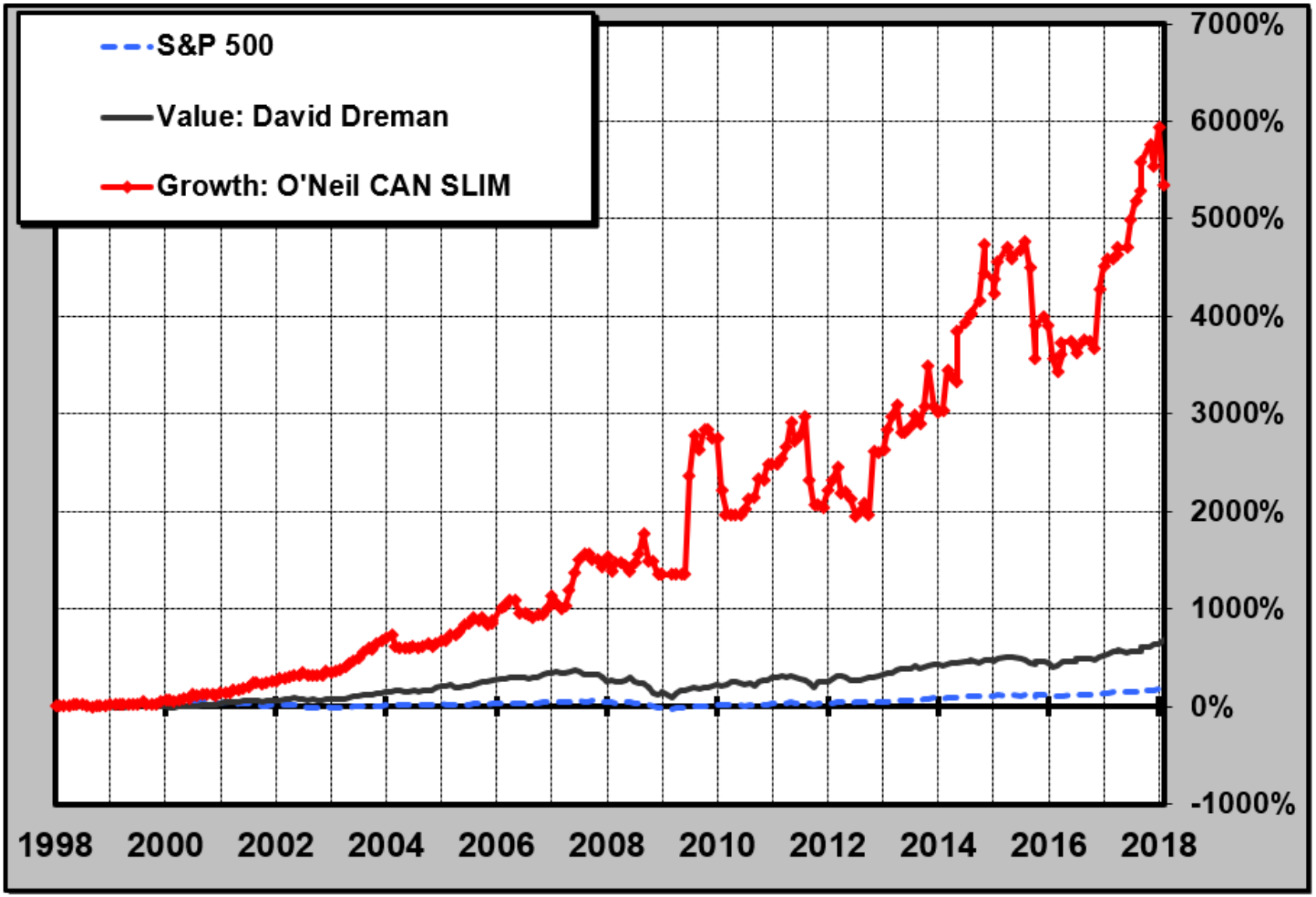
Recent Performance by Style

Data as of 1/31/2018



Strong-Performing Growth & Value Screens



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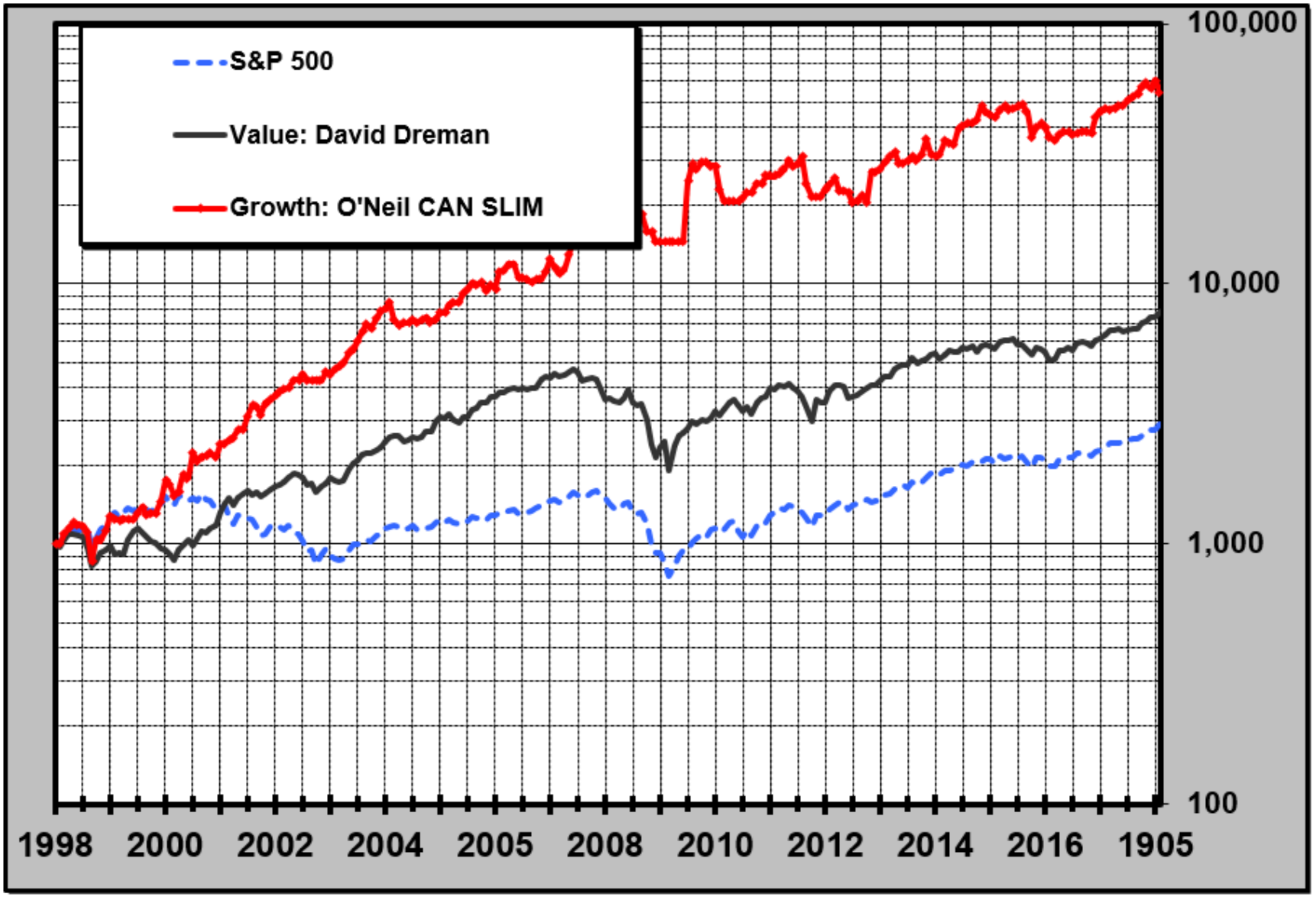
Growth of $1,000 (Semi-Log Chart)



Common Elements of Successful Screens

- Reasonable value
  - Low P/E, P/Sales, P/Book, high yield, etc.
  - Low P/E relative to growth
- Consistent growth
  - Emphasis on consistency of growth in earnings, sales or dividends
- Strong financials
- Price momentum
- Earnings revisions
- Disciplined investment approach
- Unique niche

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Value

Buy Low, Sell High

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

Growth

Buy High, Sell Higher

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

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Screening Process

1) Construct and refine primary criteria

- Identify your universe of stocks
- Quantitative filters that identify the type of investments matching your investment objective
  - Value example: low price relative to earnings
  - Growth example: high growth in earnings relative to competitors

2) Construct secondary criteria to determine if companies passed the screen for the right reasons

- Value example: strong financial strength, dividends
- Growth example: expanding profit margins, growth in earnings, sales, cash flow

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Understand what each metric *means*.

Liquidity/Financial Health

Availability to meet near-term obligations

Current ratio, quick ratio, financial leverage, cash ratio

Efficiency

Is the company managing its assets effectively?

Receivables turnover, inventory turnover, asset turnover

Solvency/Leverage

How is the company's debt relative to its assets and equity?

Debt to assets, debt to equity, interest coverage

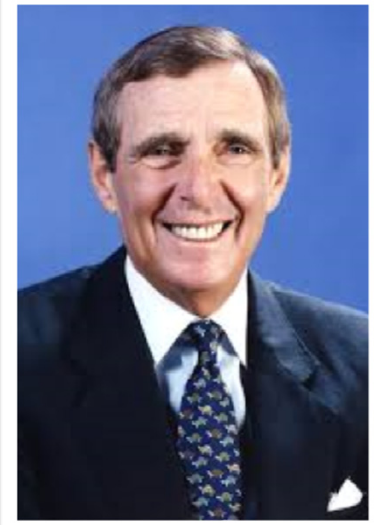
Profitability

Firm's use of assets and control of expenses to generate acceptable rate of return

Return on assets, return on equity, return on invested capital, operating margin, profit margin

What does it mean and why would you use it?

Value Screen: David Dreman



His name is synonymous with “contrarian”

“Psychology and the Stock Market” 1970
“Contrarian Investment Strategy –
The Psychology of Stock Market Success” 1979
-revised in 1982 under the title
“The New Contrarian Investment Strategy”
“Contrarian Investment Strategies: The Psychological Edge” 1998

Psychological biases interfere with sound investment decisions.

The Dreman Approach

1. Choose from a universe of medium- to large-sized companies

Primary criterion

2. Buy low price-earnings ratio stocks

   -bottom 40% of stock universe

3. Hold equal amounts of 15 to 20 stocks that are in 10 to 12 different industries ***

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Dreman Approach

Secondary criteria

- High dividend yield that can be maintained or, preferably, raised (above 1.5% in the screen)
- Liabilities to assets equal to or below sector median
- Growth in earnings per share above median of stock universe
- Estimated earnings are greater than current and last reported fiscal year's earnings

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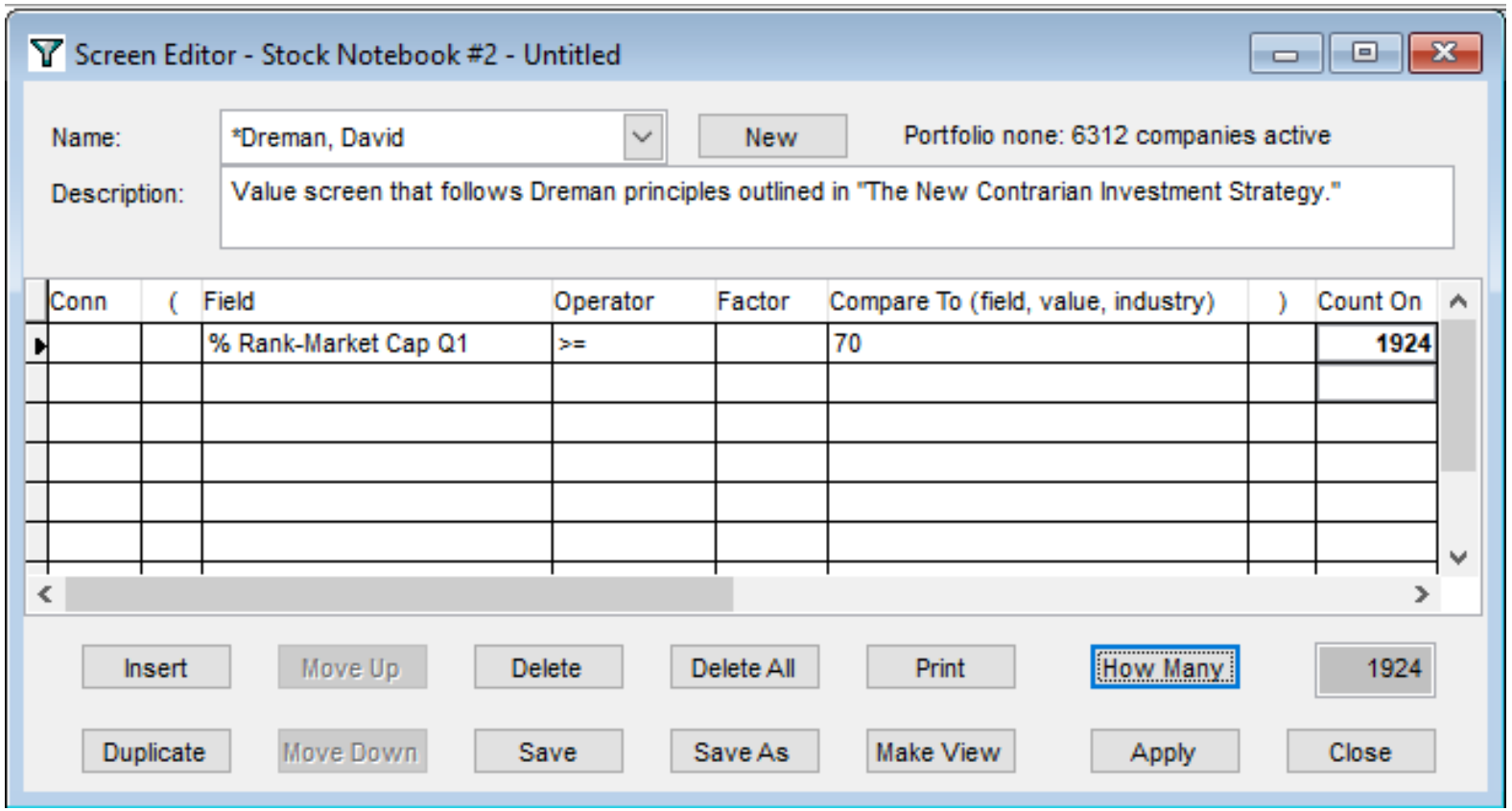
Market cap in the top 70% of the entire database

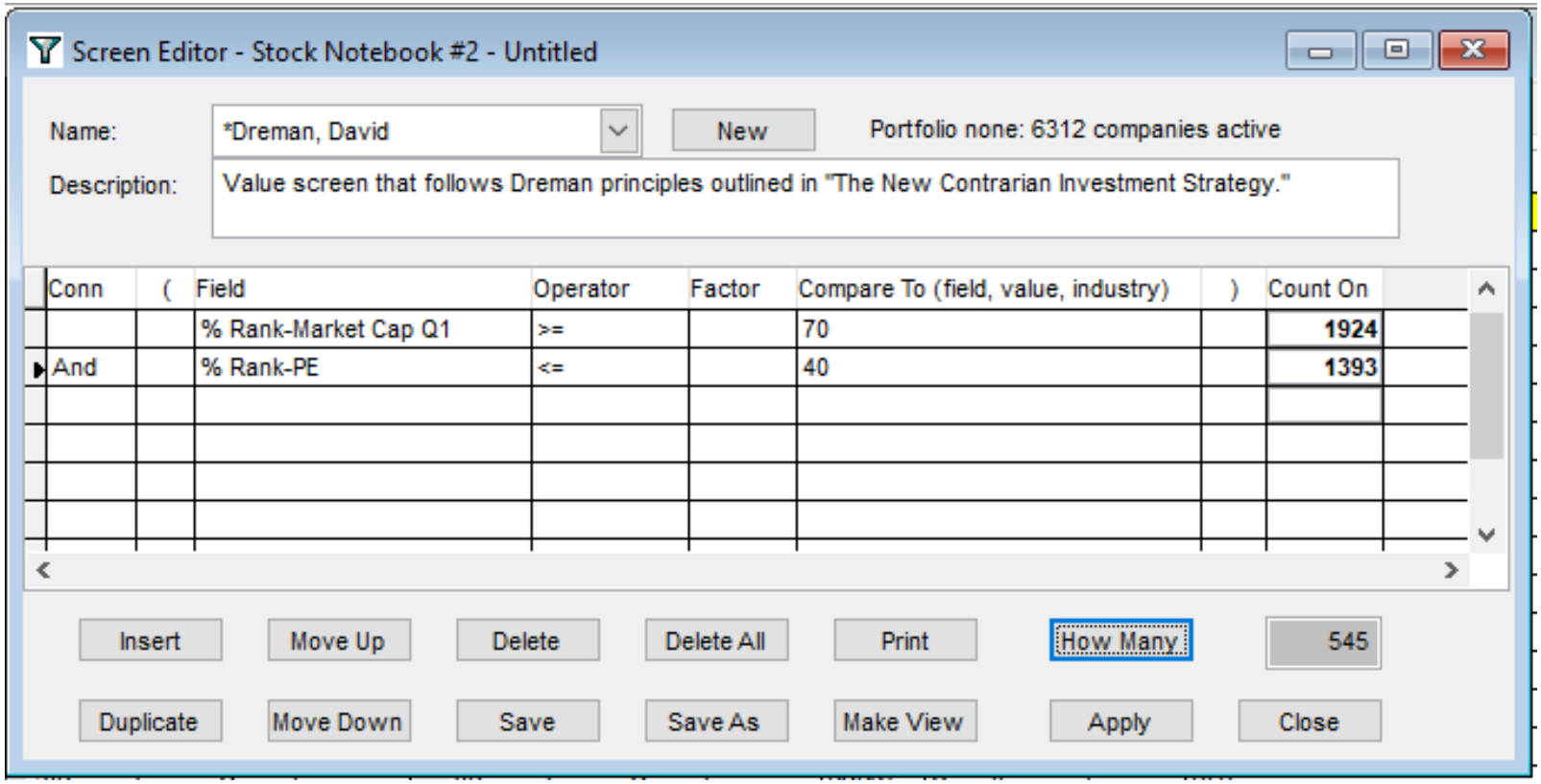
Mid to large-cap companies are subject to less “account gimmickry” because they are more “in the spotlight”



Median market cap: $434 million
Average market cap: $7.1 billion

P/E ratio in the lower 40% of the entire database

P/E is a function of expectations – higher P/E for greater expectations. Low P/E group is out of favor with the market, but they aren't always deserving a lower multiple.



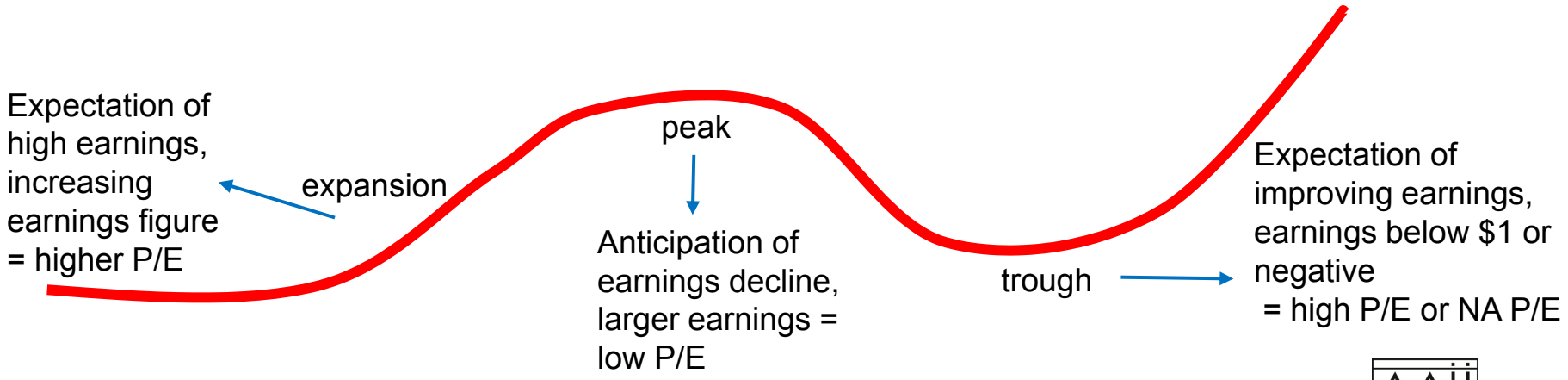
Median P/E: 20.9
Average P/E: 36.8
545 pass cumulatively, 1393 independently

Price-Earnings Ratio: Drawbacks

It's important to understand the possible drawbacks of the metrics you use.

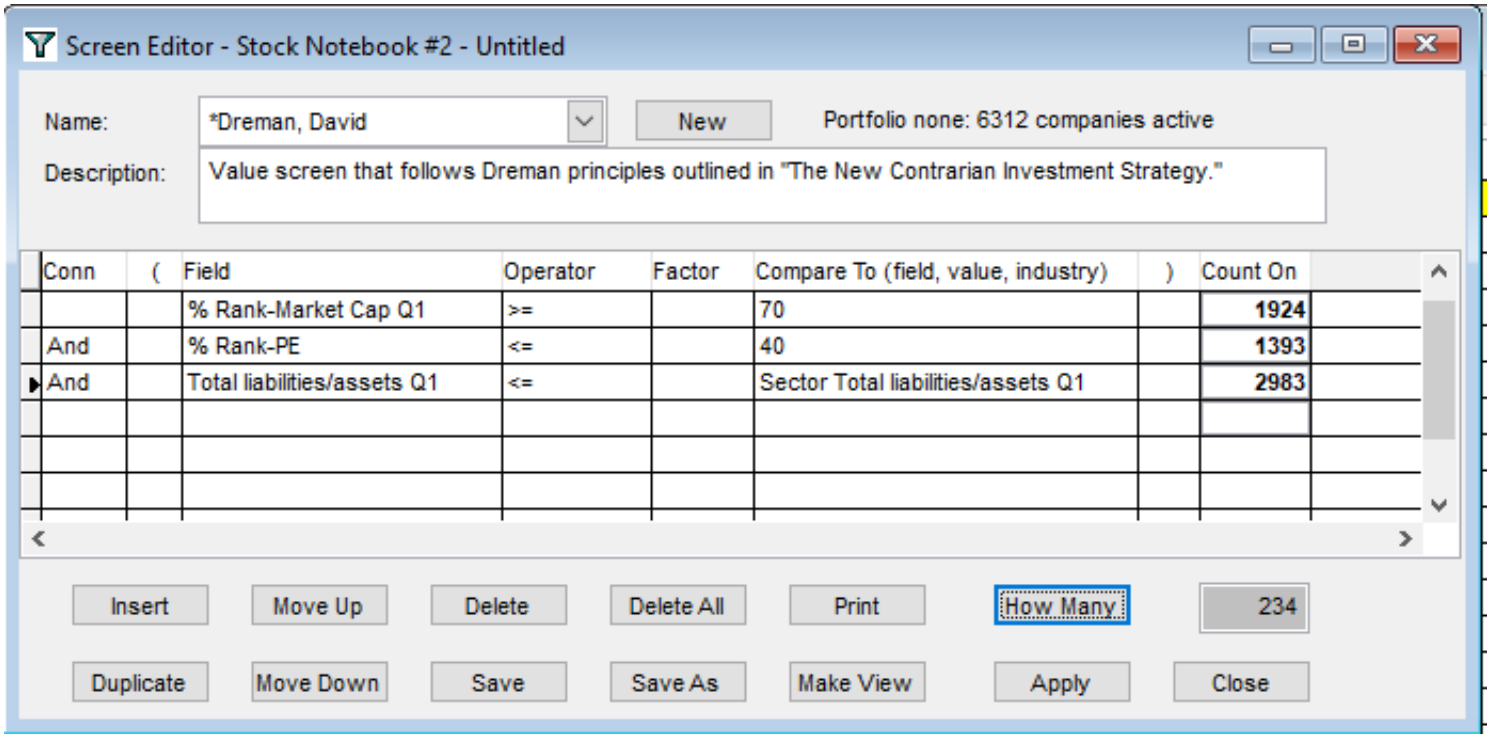
- Low P/E stocks without additional qualifiers may only highlight risky or troubled firms
- Quality of earnings: earnings influenced by management assumptions trickling through the account statements
- Negative earnings & temporary developments—such as costs of new product rollouts or general cyclical slowdowns—can distort P/E

*** Be cautious of cyclical and financial firms when it comes to P/E



Total liabilities to total assets ratio is below sector median

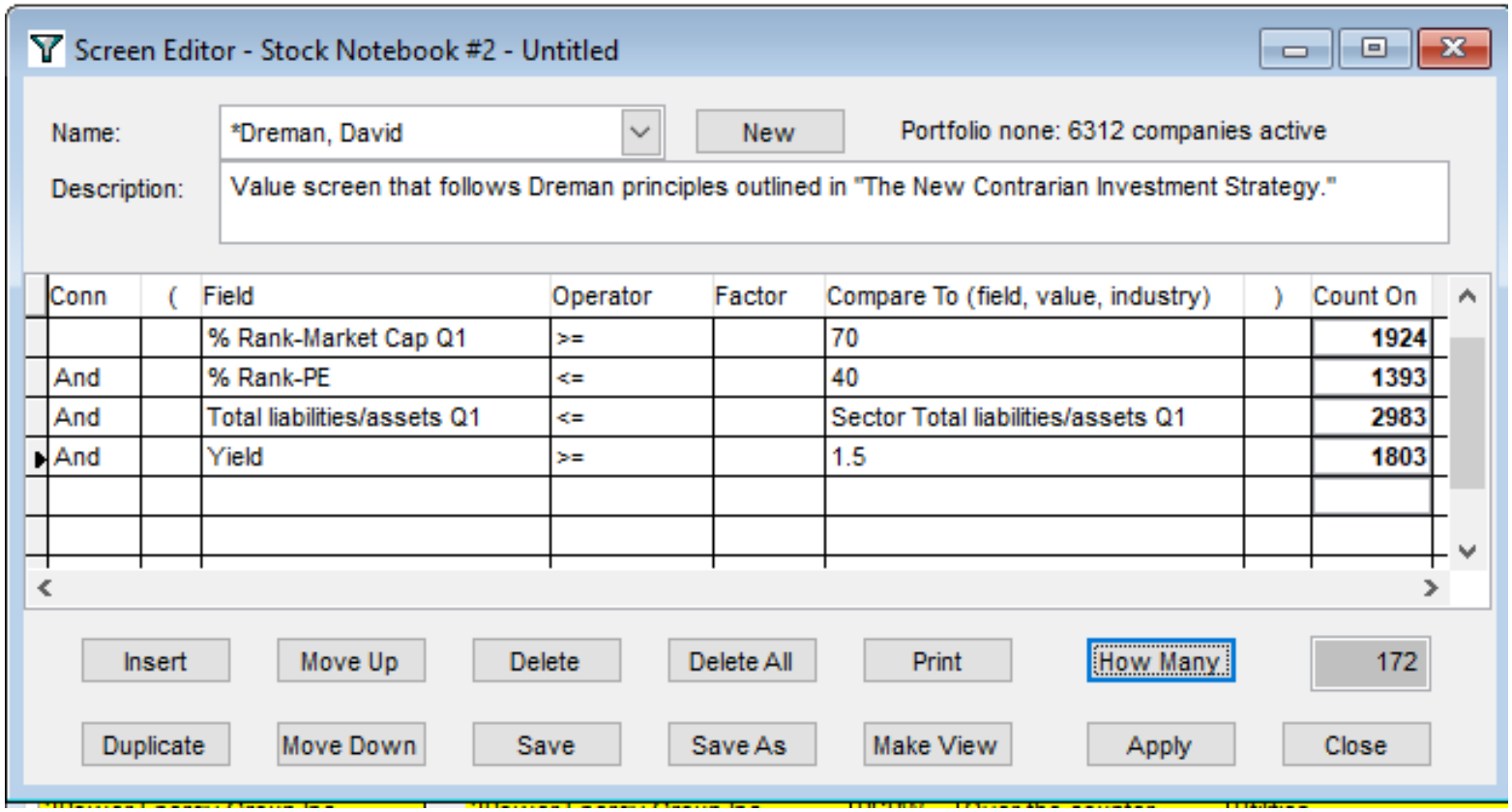
Dreman feels that a contrarian stock should have a strong financial position. This will enable a company to weather periods of operating difficulty, which low price-earnings stocks sometimes experience. A strong financial position also helps to ensure the safety of a company's dividend payment.



Median L/A: 60.7
Avg L/A: 77.9
234 pass cumulatively, 2983 independently

Dividend yield greater than or equal to 1.5%

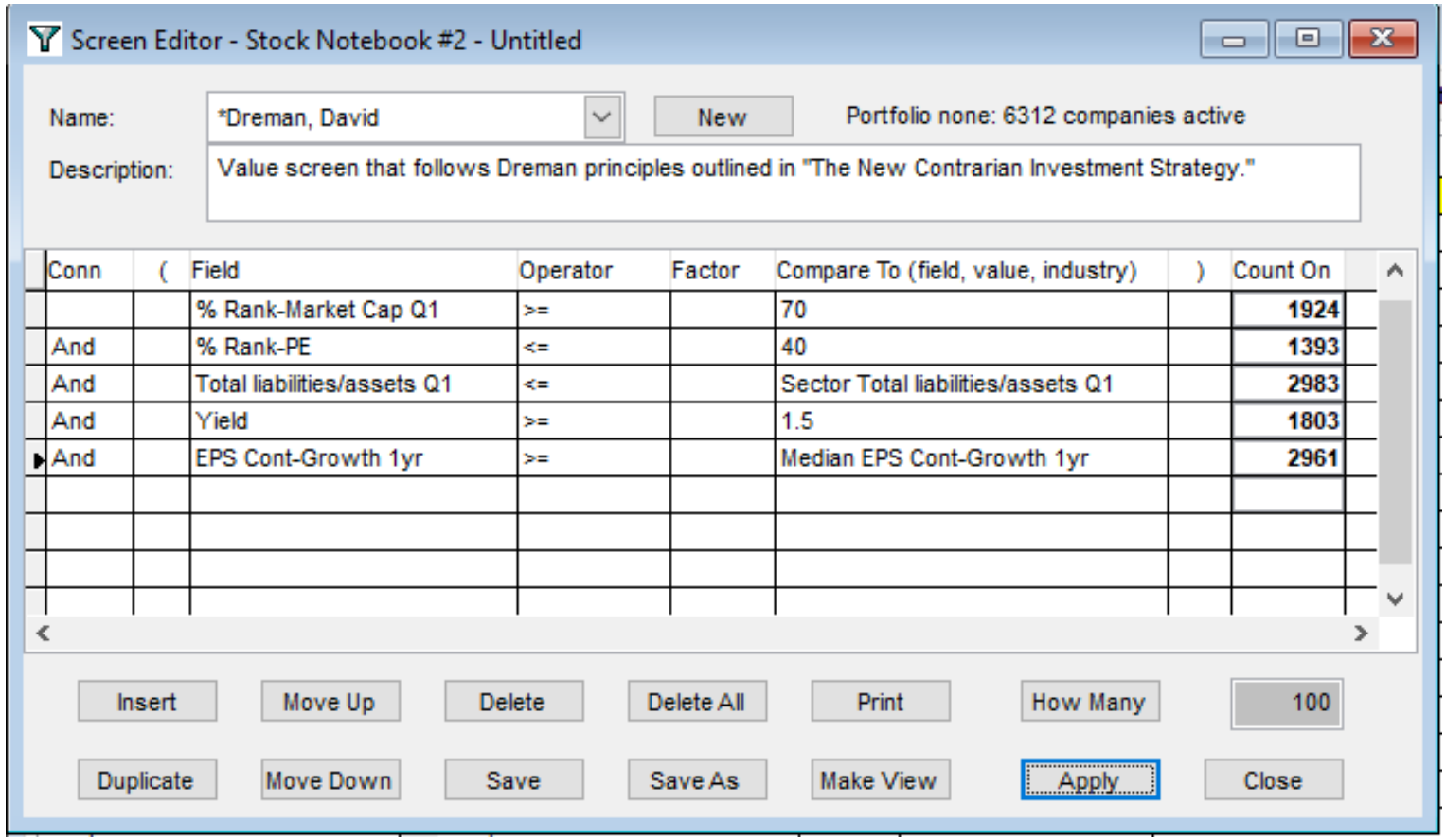
Dividend that can be sustained and possibly raised. Dividend will provide protection against price decline and contribute to total return.



Median dividend yield: 0.0%
Average dividend yield: 1.4%
172 pass cumulatively, 1803 independently

1-year continuing EPS growth above median for database

Looking for stocks that don't deserve their low valuation – need a reason to increase in price. Earnings drive stock price over long term.



Median Y1 continuing EPS growth: 10.7%
Average Y1 continuing EPS growth : 9.8%
100 pass cumulatively, 2961 independently

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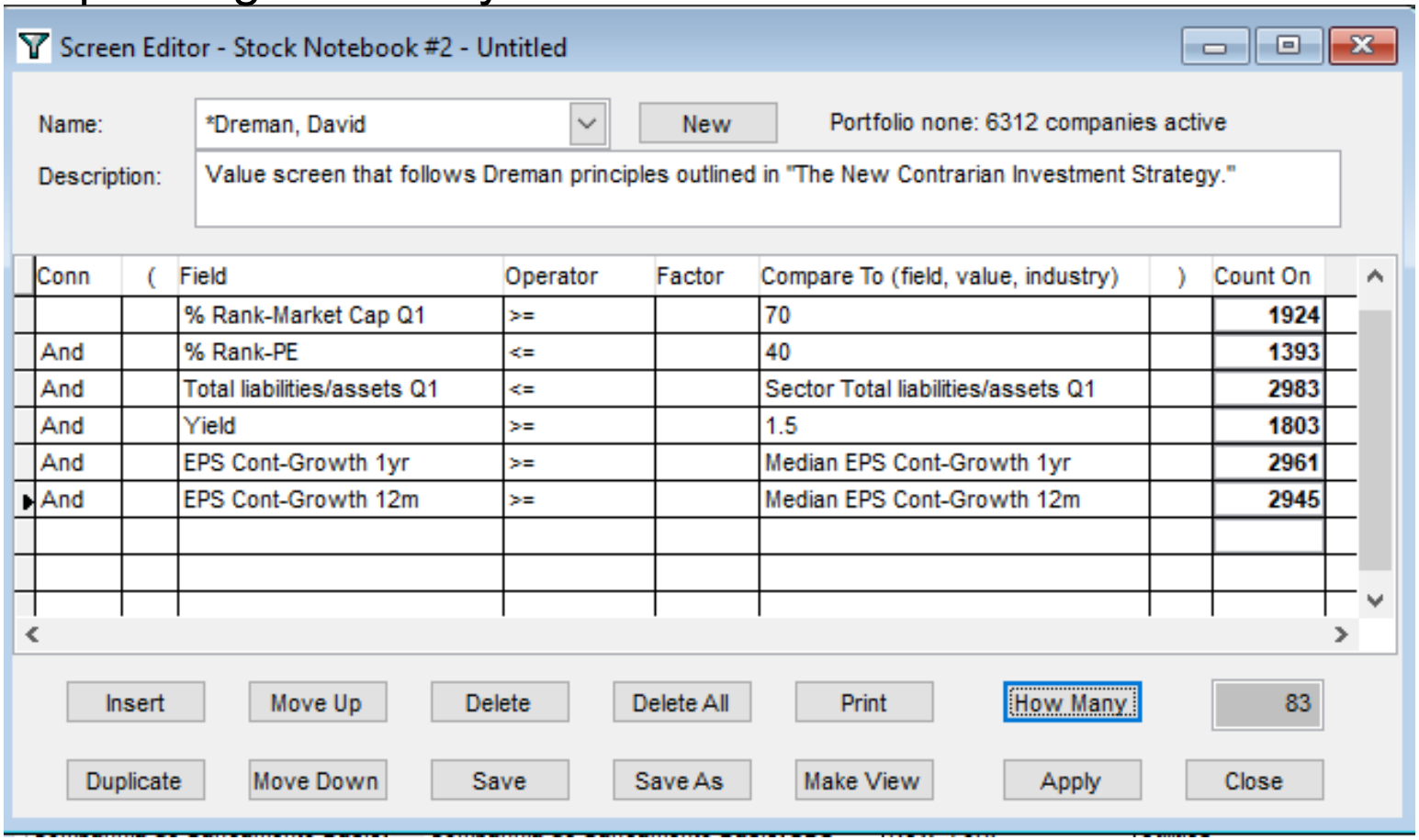
12-month continuing EPS growth above median for database

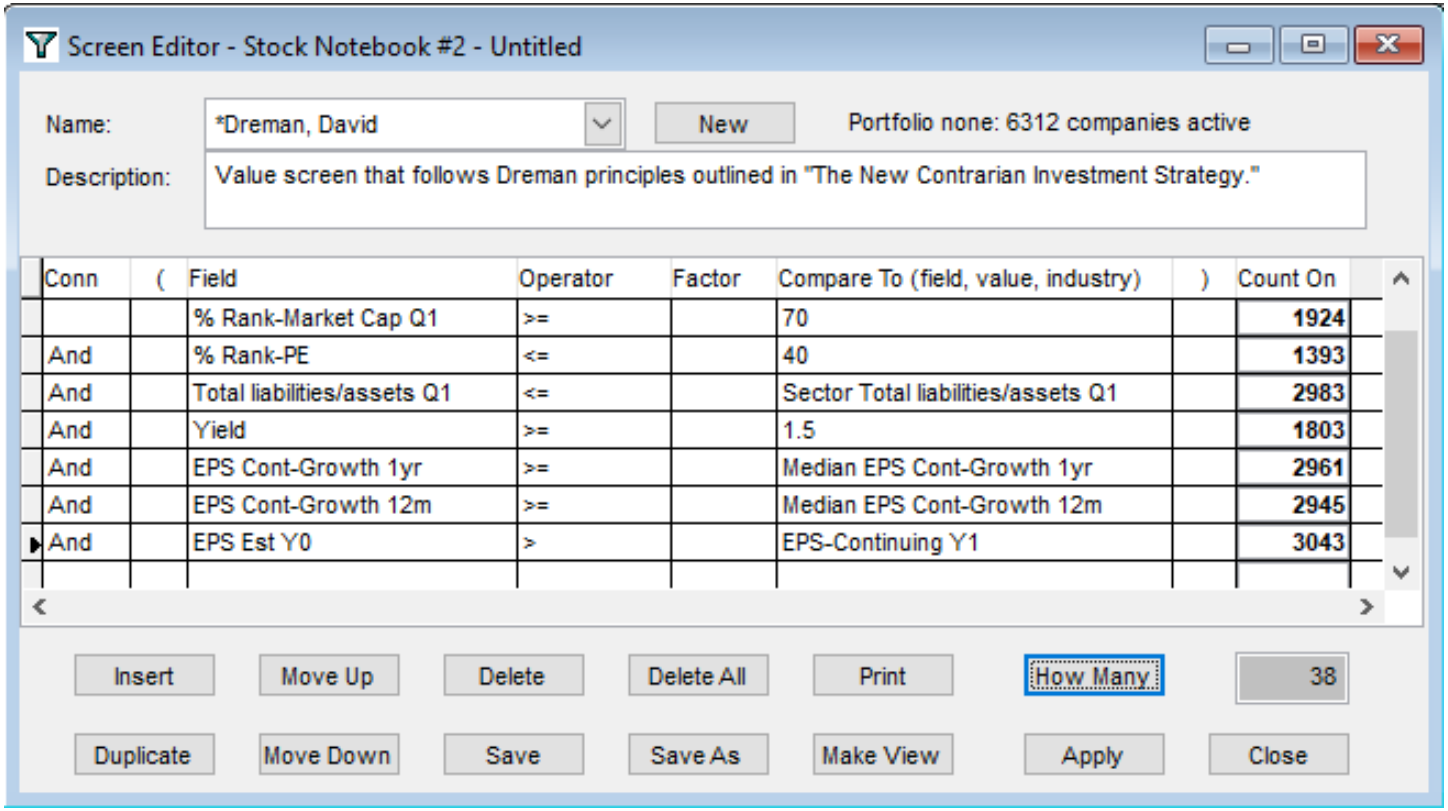
12 trailing months is more recent than 1-year. Y1 can be over a year old depending on fiscal year-end



Median 12m continuing EPS growth: 13.0%
Average 12m continuing EPS growth : 11.2%
83 pass cumulatively, 2,945 independently

Est EPS for current fiscal year (Y0) greater than reported EPS for the last fiscal year (Y1)

Look at the general direction of earnings – want companies that are expected to grow



Median 3-5 year EPS growth estimate: 11.7%
Average 3-5 year EPS growth estimate : 11.2%
38 pass cumulatively, 3,043 independently

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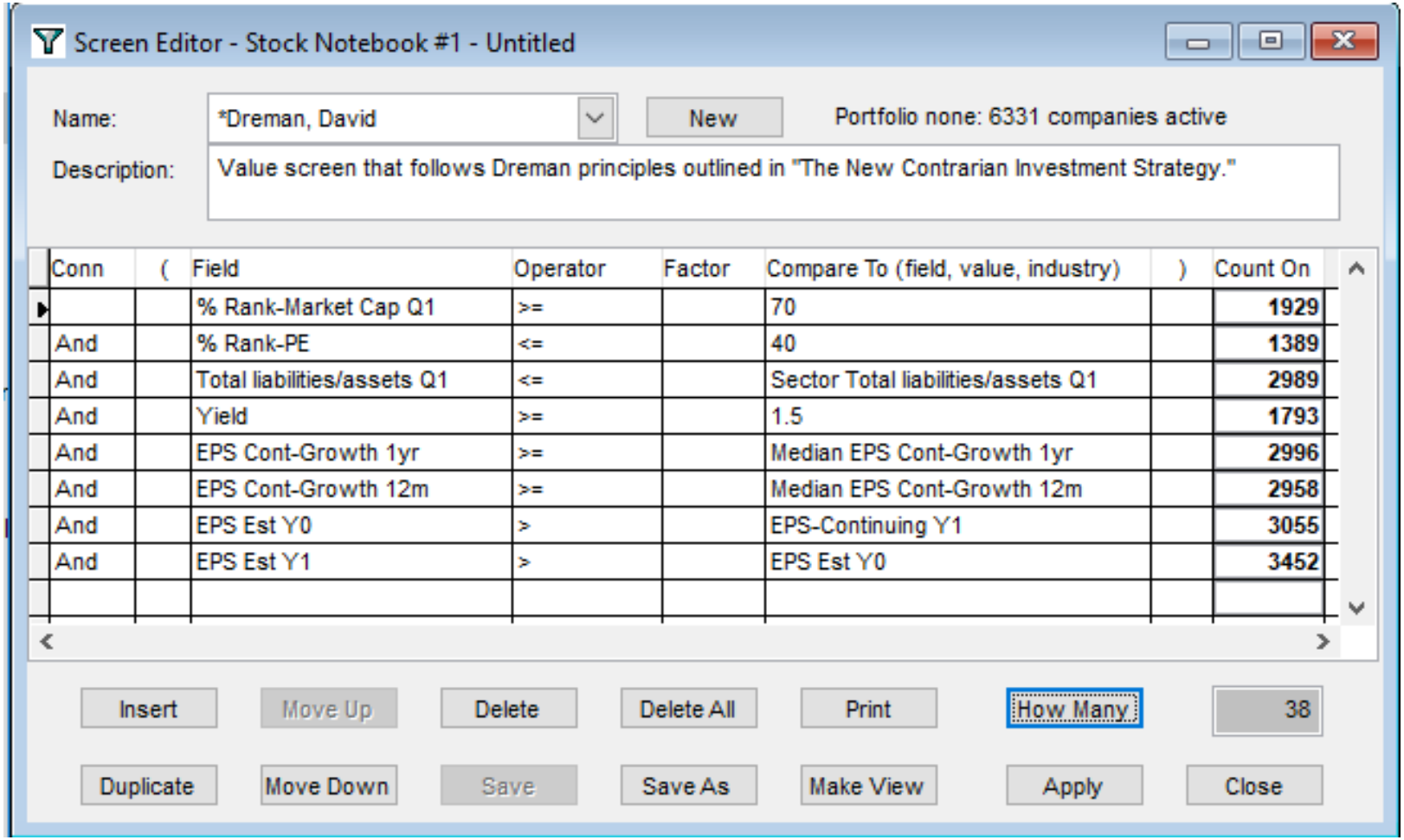
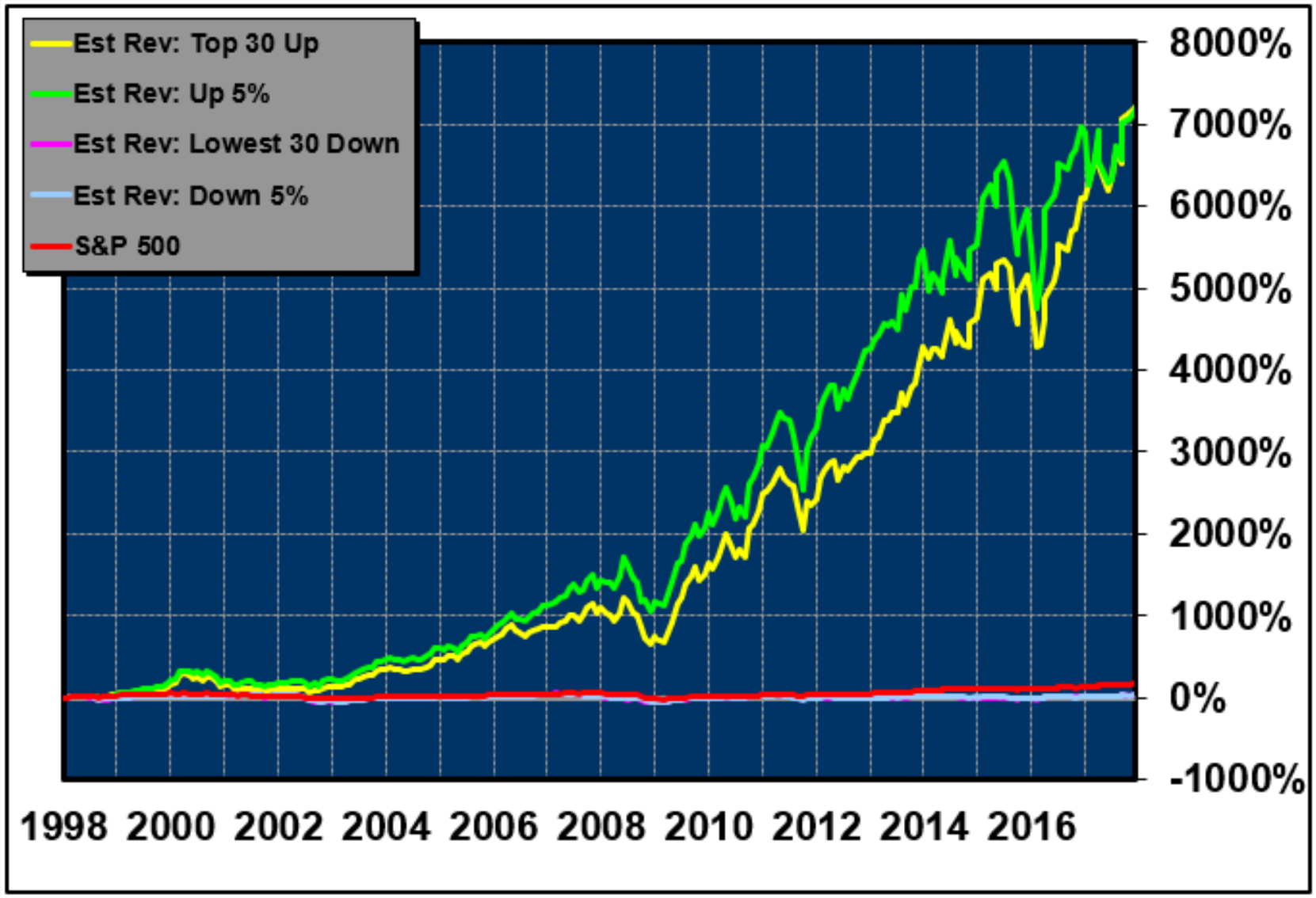
Analyzing the Dreman Screen

Last metric is next fiscal year's estimated EPS to be higher than the current fiscal year.



Conn	(	Field	Operator	Factor	Compare To (field, value, industry)	)	Count On
		% Rank-Market Cap Q1	>=		70		1929
And		% Rank-PE	<=		40		1389
And		Total liabilities/assets Q1	<=		Sector Total liabilities/assets Q1		2989
And		Yield	>=		1.5		1793
And		EPS Cont-Growth 1yr	>=		Median EPS Cont-Growth 1yr		2996
And		EPS Cont-Growth 12m	>=		Median EPS Cont-Growth 12m		2958
And		EPS Est Y0	>		EPS-Continuing Y1		3055
And		EPS Est Y1	>		EPS Est Y0		3452

38 companies passing as of 2/27/2018



Data as of 1/31/2018

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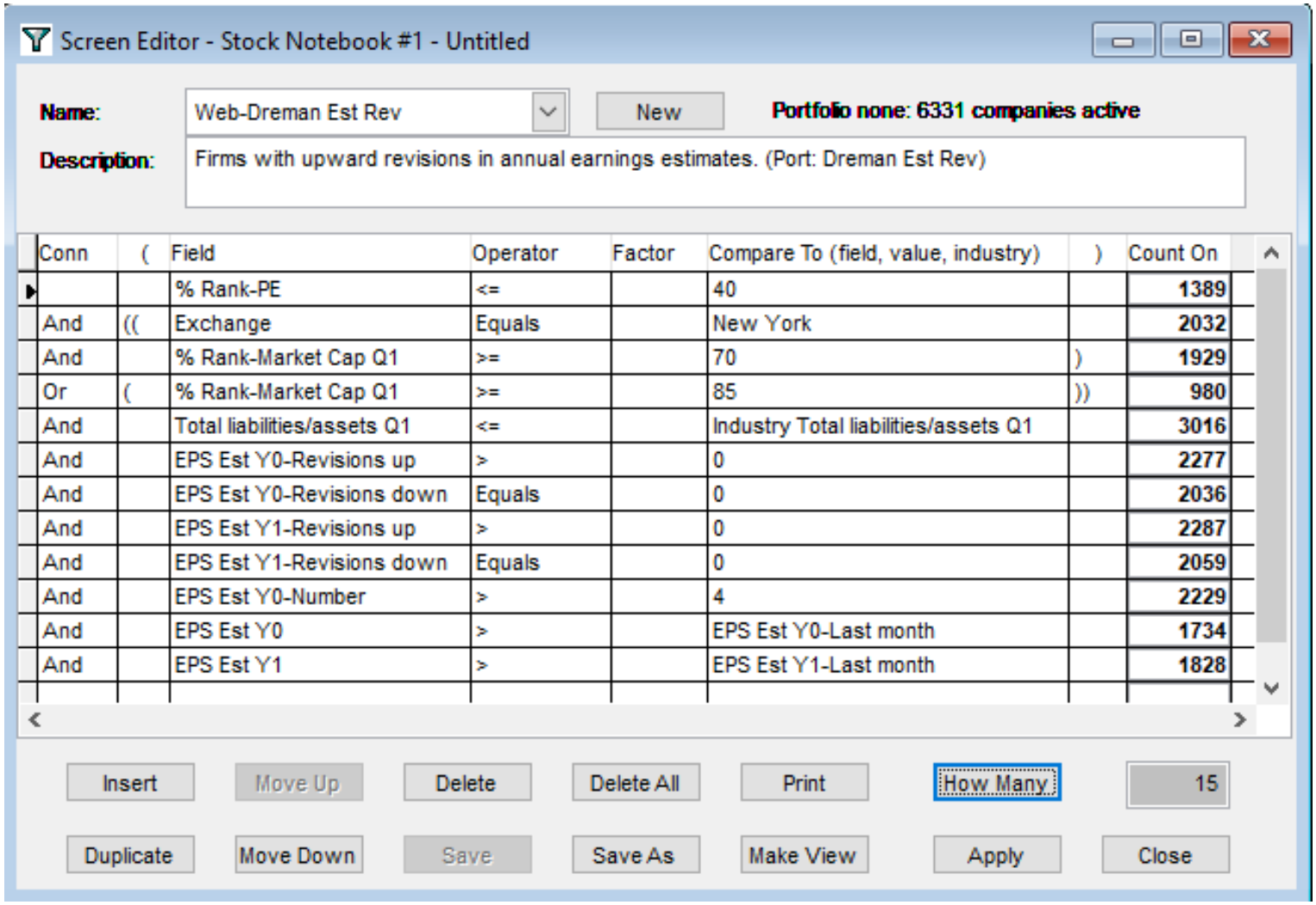
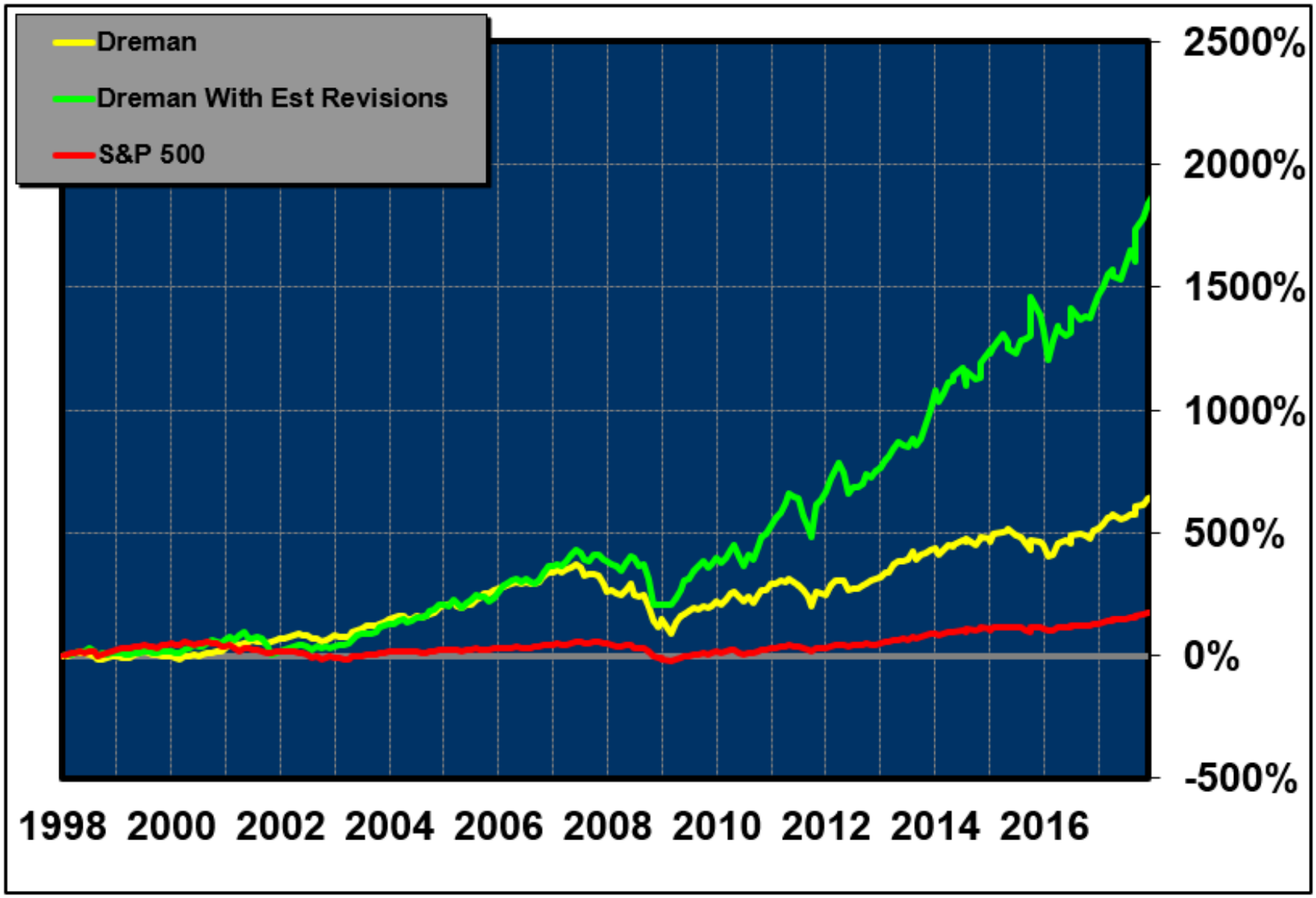
Analyzing the Dreman Est Rev Screen



Conn	(	Field	Operator	Factor	Compare To (field, value, industry)	)	Count On
		% Rank-PE	<=		40		1389
And	((	Exchange	Equals		New York		2032
And		% Rank-Market Cap Q1	>=		70	)	1929
Or	(	% Rank-Market Cap Q1	>=		85	))	980
And		Total liabilities/assets Q1	<=		Industry Total liabilities/assets Q1		3016
And		EPS Est Y0-Revisions up	>		0		2277
And		EPS Est Y0-Revisions down	Equals		0		2036
And		EPS Est Y1-Revisions up	>		0		2287
And		EPS Est Y1-Revisions down	Equals		0		2059
And		EPS Est Y0-Number	>		4		2229
And		EPS Est Y0	>		EPS Est Y0-Last month		1734
And		EPS Est Y1	>		EPS Est Y1-Last month		1828

15 companies passing as of 2/27/2018

Dreman with Estimate Revisions



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Value Summary

- Produces consistent, **long-term** success, but can fall behind other approaches on occasion, particularly in the strongest portion of a bull market or during economic transitions
- Value strategy has worked at all market-cap levels—micro cap to large cap

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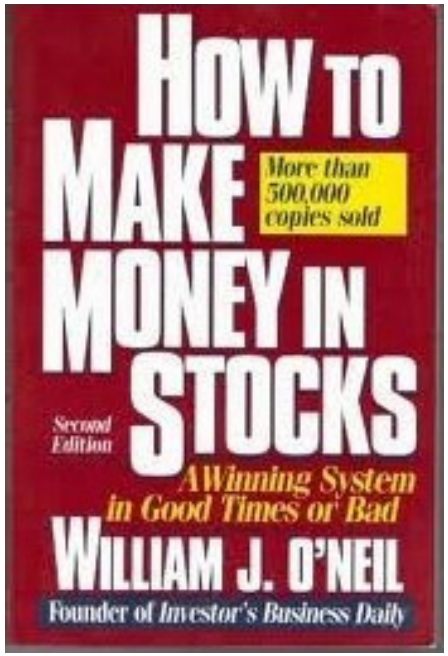
Growth Screen: CAN SLIM

William O'Neil developed his growth stock approach through study of company characteristics prior to their big stock price increase

Approach presented in second edition of "How to Make Money in Stocks: A Winning System in Good Times or Bad"



With all the options you have as an investor, why settle for stocks with little to no growth in earnings per share?

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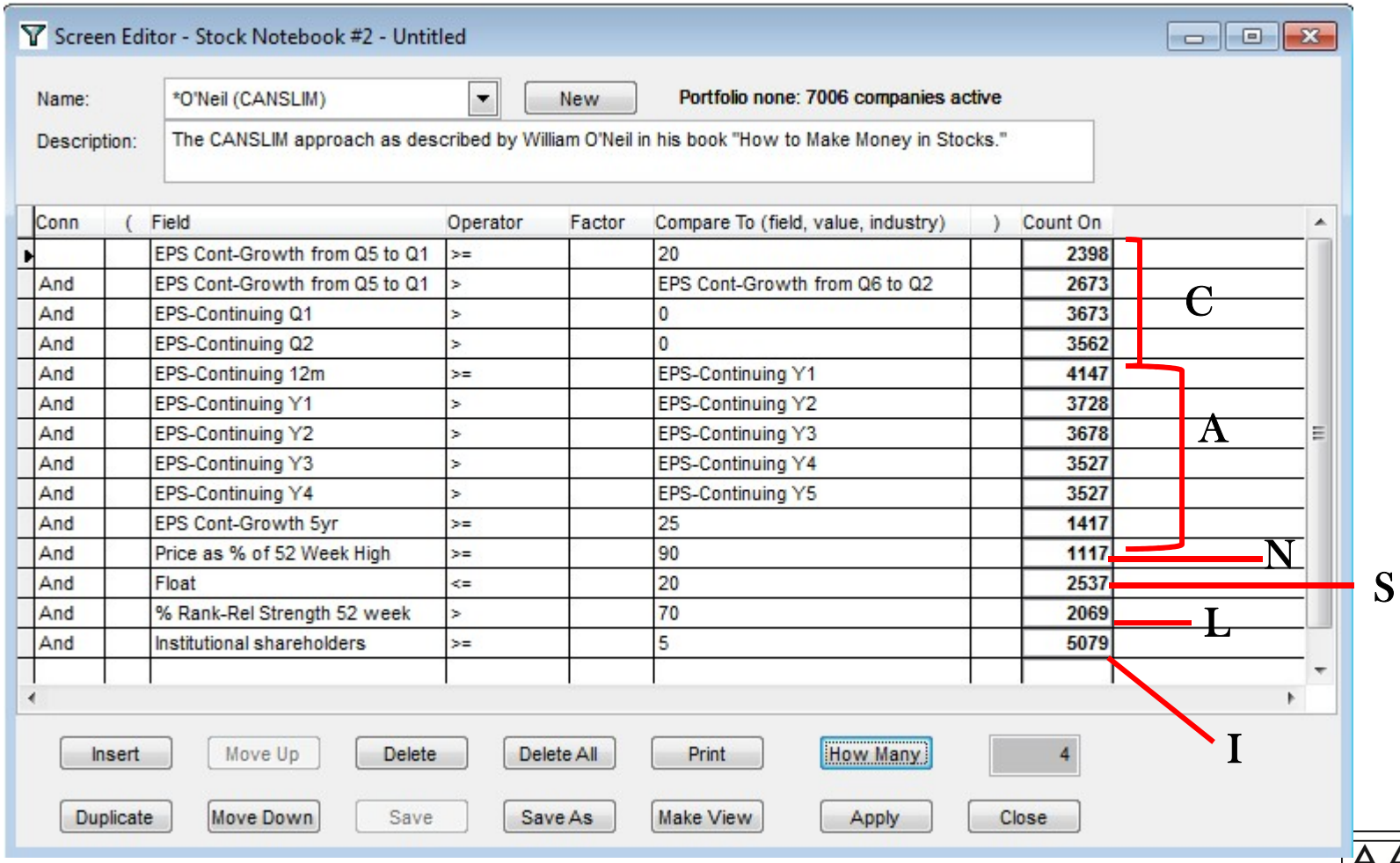
CANSLIM in Stock Investor Pro



C=Current Quarterly Earnings

Strong and improving quarterly EPS performance

—at least 18% to 20%

- Important to compare quarter over quarter
- Earnings from continuing operations

A=Annual Earnings Increases

Significant and steady increase in annual earnings

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

N=New Products, Management, Highs

Catalyst to start a strong price advance

- New product or service, management team, technology
- Stocks reaching new high after consolidation period

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S=Supply and Demand

Firms with a smaller number of shares outstanding should increase more quickly

- O'Neil recommends looking at "float"

(Shares outstanding less shares held by insiders)

L=Leader or Laggard

Look for market leaders in rapidly expanding industries

- Buy among the best two or three stocks in a group
- Use relative strength to identify market leaders

I=Institutional Sponsorship

A few institutional sponsors are needed for above-market performance, but not too many

- Look at record of institutions

M=Market Direction

The trend of the overall market will have a tremendous impact on the performance of your portfolio

- O'Neil tends to focus on technical measures when determining the market's overall direction

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Average Number of Holdings and Turnover

Screen	Avg. Number of Holdings	Average Turnover (%)	Monthly Variability Largest Gain	Monthly Variability Largest Loss
CAN SLIM	6	56	69.6%	-23.1%
CAN SLIM Rev	7	63	52.7%	-26.7%
CAN SLIM No Float	15	48	23.5%	-35.5%
Dreman	22	31	23.9%	-22.2%
Dreman Est Rev	12	84	21.4%	-26.2%

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Growth Summary

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

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Things to Consider When Screening

- If not many stocks pass, you may be able to change some of the parameters. (problem: no way to know the effect without backtesting)
- Does your screen apply to financials/REITs/ADRs? Chinese stocks? OTC stocks? Some of these need to be screened out
- Verify the source of data for the screening program you're using
- Does your screen produce enough results for you to invest in after you winnow down the results with your analysis?
- "Sell" criteria is not always the opposite of the "buy" criteria
- Look at your favorite mutual funds and ETFs – what do they look for?

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Things to Consider When Screening

- Be aware of where you are in the business cycle and how that may affect ratios (change parameters based on market conditions)
- Different screening tools will produce different results
- Beware of negatives (growth rates)
- When in doubt it's good to compare to industry/sector
- Use quarter-over-quarter or year-over-year to eliminate seasonality
- Double-check figures (50% growth rate going from $0.02 to $0.03 EPS)
- Screening can also apply to ETFs, mutual funds
- Percentile ranking: "What Works on Wall Street"

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Benefits of Stock Screening

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

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Potential Pitfalls of Stock Screening

- Dependent on the accuracy of the underlying data
- Limited mainly to quantitative factors
  - Factors such as quality of management, brand strength, competitive position, etc., must be evaluated separately
- May still be missing good companies that meet most but not all criteria
- Introduces you to companies you are not familiar with and that require further analysis
  - Screening is only the first step!
  - Stock screening only isolates companies with similar characteristics
  - You need to decide whether the stocks belong in your portfolio

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Keys to Long-Term Success

- Many approaches to investing can be successful, but failure to identify an approach and follow it will eventually lead to disaster
- Pick sell rules and stick to them!
- To succeed with a individual stock approach:
  - Need enough time to manage a stock portfolio
  - Need to manage diversification of portfolio
  - Need an interest in managing a portfolio—in good times and bad
  - Need discipline to follow the program once you have committed to it

Don't forget transaction costs!!

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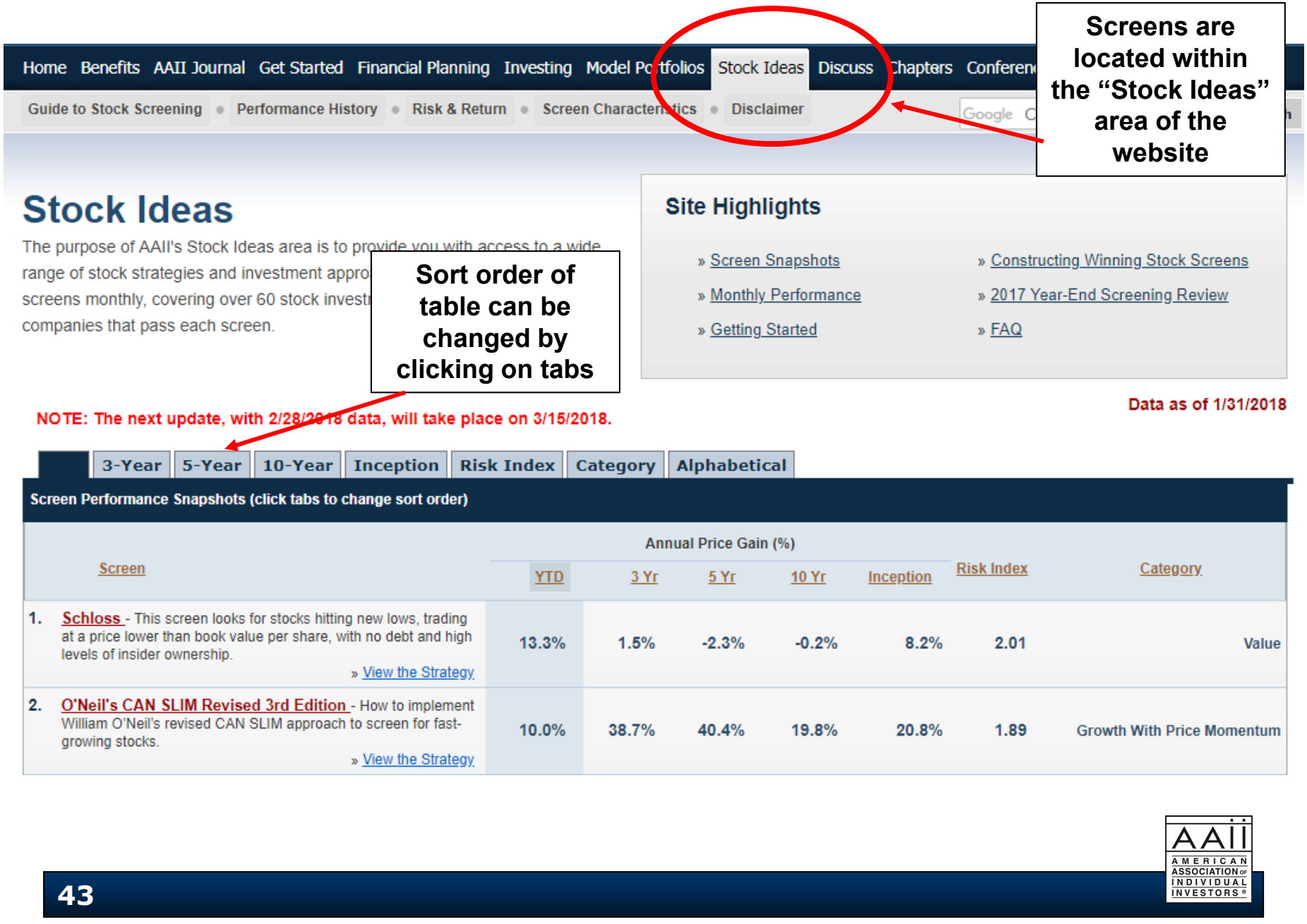
Popular Approaches

- *AAII Journal* and *Computerized Investing* have examined the characteristics of successful investors
- Tracking performance of our interpretation of these approaches in *Stock Investor Pro*
- Companies passing screens and chart of results available on AAII website within "AAII Stock Ideas" area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Guide to Stock Screening • Performance History • Risk & Return • Screen Characteristics • Disclaimer
Screens are located within the "Stock Ideas" area of the website
Stock Ideas
The purpose of AAII's Stock Ideas area is to provide you with access to a wide range of stock strategies and investment appro screens monthly, covering over 60 stock invest companies that pass each screen.
Site Highlights
» Screen Snapshots
» Monthly Performance
» Getting Started
» Constructing Winning Stock Screens
» 2017 Year-End Screening Review
» FAQ
Sort order of table can be changed by clicking on tabs
NOTE: The next update, with 2/28/2018 data, will take place on 3/15/2018.
Data as of 1/31/2018
3-Year 5-Year 10-Year Inception Risk Index Category Alphabetical
Screen Performance Snapshots (click tabs to change sort order)
Screen
Annual Price Gain (%)
YTD 3 Yr 5 Yr 10 Yr Inception
Risk Index
Category
1. Schloss - This screen looks for stocks hitting new lows, trading at a price lower than book value per share, with no debt and high levels of insider ownership. » View the Strategy
13.3% 1.5% -2.3% -0.2% 8.2% 2.01 Value
2. O'Neil's CAN SLIM Revised 3rd Edition - How to implement William O'Neil's revised CAN SLIM approach to screen for fast-growing stocks. » View the Strategy
10.0% 38.7% 40.4% 19.8% 20.8% 1.89 Growth With Price Momentum

Members can download spreadsheets that detail performance by month or year

Home | Benefits | AAII Journal | Get Started | Financial Planning | Investing | Model Portfolios | Stock Ideas | Discuss | Cha

Guide to Stock Screening | Performance History | Risk & Return | Screen Characteristics | Disclaimer

Performance History

Before following any AAII stock screen, we recommend that you look at the long-term returns as well as recent performance. Understand that the screen portfolios that we present are merely computer-generated lists, based on our own interpretation of popular investment approaches.

That being said, our screen tracking results are quite impressive. Complete performance statistics are presented in the table below.

Note: *Click on the column headers to sort by specific year. Definitions of Price Change and Monthly Variability are available by clicking on the question mark icons.*

Downloadable Excel Files

Monthly Cumulative Performance

Annual Performance

Other links

FAQs | Disclaimer | Performance Charts

Data as of 1/31/2018

Performance of All Stock Screens

Value | What is a Value Screen?

Strategy	Price Gain (%) YTD	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	Annualized Total*
Cash Rich Firms	2.2	12.3	17.1	-7.8	2.5	36.6	10.5	-32.8	14.4	56.9	-38.0	7.7	17.2	-2.5	18.6	64.0	**10.1**
Dogs of the Dow	2.0	3.5	22.9	-1.4	6.8	27.9	9.6	10.7	19.4	8.1	-45.4	-1.8	26.8	-9.8	-1.3	20.4	**3.9**
Dogs of the Dow: Low Priced 5	1.9	-1.7	13.0	11.7	3.0	34.5	15.7	13.1	17.3	-7.7	-58.7	-2.7	34.9	-11.8	6.1	17.6	**3.2**

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Risk & Return

When selecting a stock screening strategy, there are a number of factors to consider, including your time horizon monitor your stock portfolio. While historical performance is an important component of the selection process, the result, it is also useful to see how various strategies perform over different market conditions. One of the values o performance and risk of a variety of strategies against broad market indexes and other strategies.

The risk and return data provided here allows you to evaluate the riskiness of the AAII stock screens relative to th risk-adjusted basis and over the latest bear and bull market periods.

Note: Click on the column headers to sort by specific year.

Risk & Return Spreadsheet

Risk Index:

The risk index is the average standard deviation of return for the stock screen divided by the average standard deviation of return for the S&P 500 large-cap index. Standard deviation is a measure of return volatility and is computed using monthly returns since the beginning of 1998. A risk index of 1.00 denotes risk equivalent to that of the S&P 500 index. Values above 1.00 are riskier than the index and values below 1.00 are of less risk than the index.

Risk-Adjusted Return:

One way to produce an easily understood marriage of risk and return for portfolios is to adjust the return for risk so that the return reported for all portfolios assumes risk equal to that of a market benchmark. Portfolios with volatility above the market benchmark will have their returns proportionally lowered, while funds and portfolios that are less risky (have lower volatility than their benchmark) will have their returns adjusted proportionally upward.

The risk-adjusted return uses the annual rate of return and the annual standard deviation of price return since the beginning of 1998 to measure volatility. Standard deviation is a measure of return volatility and is computed using monthly returns since the beginning of 1998. The market benchmark used for return and risk is the S&P 500 large-cap index. The margin rate is being used as the risk-free rate of borrowing to leverage the portfolio to match the risk of the market portfolio.

Risk-Adjusted Return: [(Index Std Dev ÷ Portfolio Std Dev) × (Portfolio Return - Margin Rate)] + Margin Rate

Average Annual Price Gain:

The compound average annual price gain is shown since inception and for the last year, last five years, and last 10 years. Returns are calculated through the previous month-end. These figures only consider price change and do not include dividends. The performance reflects buying and selling each month at the month-end closing price. The impact of

Value | What is a Value Screen?

Strategy	Historical Annual Risk & Return		Avg Ann'l Price Gain (%)					Price Gain (%)									
	Risk Index (X)	Risk Adj Return (%)	Since Inception	1 Yr	3 Yr	5 Yr	10 Yr	Bull Mkt	Bear Mkt	Monthly Variability Best	Monthly Variability Worst	YTD	2017	2016	2015	2014	2013
Cash Rich Firms	1.39	9.4	10.1	17.7	8.4	10.4	4.6	156.2	-45.6	17.6	-20.7	2.2	12.3	17.1	-7.8	2.5	36.6
Dogs of the Dow	1.21	3.1	3.9	5.8	9.8	10.5	4.0	334.6	-69.0	17.1	-23.4	2.0	3.5	22.9	-1.4	6.8	27.9
Dogs of the Dow: Low Priced 5	1.54	0.8	3.2	3.4	8.4	10.3	-0.2	405.8	-82.9	27.6	-34.8	1.9	-1.7	13.0	11.7	3.0	34.5

Screen Characteristics

The Screen Characteristics table presents a snapshot of the characteristics of the stocks passing each screen at a specific point in time. This table is updated quarterly and provides an indication of the types of stocks that each strategy tends to identify.

Data as of 12/29/2017

Default View

Downloadable Excel Files

Portfolio Characteristics

Other links
FAQs | Disclaimer | Performance Charts

Strategy	P/E Ratio (X)	Price to EPS Est. Growth (X)	Price-to-Book Value Ratio (X)	Price-to-Sales Ratio (X)	Dividend Yield (%)	Hist. EPS Growth (%)	Est. Long-Term EPS Growth (%)	Market Cap ($ Mil)	52-Week Relative Strength (%)	Monthly Holdings	
										Avg #	Turnover %
Value											
Cash Rich Firms	21.3	1.6	1.5	1.4	0.2	3.5	7.0	513.9	-6.6	28	23.6
Dogs of the Dow	27.3	3.0	4.0	1.8	3.7	-4.2	4.8	216,790.9	-17.3	10	7.9
Dogs of the Dow: Low Priced 5	22.2	2.4	3.6	4.1	3.8	3.3	5.9	216,790.9	-6.4	5	16.1

Dreman Screen

» Printer-friendly

The Philosophy

David Dreman has long studied the psychological underpinnings of the overall stock market and its impact upon valuation levels. Unlike the rational market assumed by traditional academic studies, Dreman sees stocks and markets driven by emotions that often push prices from their intrinsic value. Dreman feels the best approach to beating the market is to follow the principles of contrarian investing.

Performance | Passing Companies | Screening Criteria | Chart

	Dreman	S&P 500
YTD Return:	5%	5.6%
Five Year Return:	12.1%	13.5%
Ten Year Return:	7.9%	7.4%
Inception:	10.8%	5.5%

Data as of 1/31/2018

Dreman represents AAII's interpretation of the investment approach and is not determined by the original strategist. The list of **passing companies** represents a hypothetical portfolio, which is used to track the screen's performance on a chart.

Contrarian investing is a disciplined investment approach using value measures that helps to avoid the emotional traps of the market. The contrarian strategy seeks to profit from other investors' misjudgments by seeking stocks that are out-of-favor with the market and avoiding the high-flying fashionable stocks that have been swept up by market euphoria. Eventually the market rediscovers out-of-favor stocks and lets the high-fliers fall back to earth.

David Dreman is one of those most associated with contrarian investing through his books and long-running Forbes column. He began writing about stock market psychology in the early 1970s through his first book, "Psychology and the Stock Market." Dreman followed up this work in 1979 with "Contrarian Investment Strategy-The Psychology of Stock Market Success" (revised in 1982 under the title "The New Contrarian Investment Strategy"), which examined the range of possible contrarian investment strategies in greater detail. These books served as the primary source for this article.

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Selecting a Screener

- Data source?
- How many metrics in the database?
- How often is the data updated?
- Learning curve/ease of use
- Customer service options if you have questions
- Any videos/training?

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