Screening: The First Step for Finding Winning Stocks

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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
- Take home a feeling for some of the elements that help to build successful portfolios
Stock Selection Strategies

- **Screening Process**
  - Approach should match your investment philosophy
  - Establishing criteria to narrow a large stock universe to 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
  - Provide framework for buy/hold/sell process

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

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

Growth

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

Data as of 5/31/2013

Graph showing recent performance by style with data from 1998 to 2012, comparing S&P 500 (TR), S&P 500 Growth (TR), and S&P 500 Value (TR).
Strong Performing Growth & Value Screens

Data as of 5/31/2013
Value Screen: John Neff

- While serving as portfolio manager of the Vanguard Windsor Fund from 1964 until his retirement in 1995, Neff employed a value investing approach using a stringent contrarian's viewpoint.
- Approach presented in his book "John Neff on Investing"
Screening Process

- Construct and refine primary criteria
  - Quantitative filters that identify the type of investments that match your investment objective
    - Value example: low price relative to earnings
    - Growth example: high growth in earnings relative to competitors
  - Construct secondary criteria to determine if companies passed the screen for the right reasons
    - Value example: strong financial strength
    - Growth example: expanding profit margins
Article on Screening Process
http://www.aaii.com/stock-screens/constructingwinningstockscreen

Constructing Winning Stock Screens

Over the years, we have studied the works of many famous and successful investors.

Our goal has been to learn from the winning strategies and techniques of investment legends, modern day investment professionals with a proven record of long-term success and even prominent academic research on investing. We have found that it is easy to come up with a list of meaningful screening criteria, but building and applying a cohesive set of criteria can be challenging.

Screening is the application of quantitative criteria to a broad universe of stocks in order to narrow the list down to a few companies. It allows you to focus your attention on a smaller but more promising group of stocks. It also forces you to use a consistent framework to decide which stocks to add or remove from your portfolio. Discipline is a common trait shared with the successful investors that we have studied. It is too easy to let our emotions such as greed, fear and even pride take over the decision-making process and ignore the rational side of investing.
Primary Neff Value Filter: Price-Earnings Ratio

- Price divided by earnings per share
- Ratio embodies the market’s expectations of future company performance
  - Stocks with high growth prospects trade with high P/E ratios, while those with low ratios are expected to have low growth or high risk
- Seek out stocks with low price-earnings ratios with the belief that the market may be over-discounting the negative news or oblivious to company’s potential
Price-Earnings Ratio: Drawbacks

- Low P/E stocks without additional qualifiers may only highlight risky or troubled firms
  - Weak or risky firms, SEC investigations, verge of bankruptcy or lawsuits
- Quality of earnings: earnings influenced by management assumptions trickling through the account statements
  - Asset life assumptions/expense capitalization
  - Booking of sales
- Negative earnings & temporary developments—such as costs of new product rollouts or general cyclical slowdowns—can distort P/E
Price-Earnings Ratio: Screening Strategies

- Low absolute price-earnings screens
- Relative price-earnings screens
  - Below market P/E ratios
  - Below industry norms
  - Below company historical average
- P/E to growth ratio (PEG ratio) screens
  - P/E divided by EPS growth
    - Future vs. historical earnings growth
    - Adding dividend yield to growth rate
  - Look for low ratios
  - Identify stocks with earnings growth prospects that are not fully recognized by the market as measured through the price-earnings ratio
P/E Ratio = 10, EPS Growth = 5%
- PEG = P/E ÷ Growth = 10 ÷ 5 = 2.0

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

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

For further info see AAII stock screen “A Combination Approach: Value on the Move”
www.aaii.com/stock-screens/screendata/ValueEstGrowth
A Combination Approach: Value on the Move

Data as of 5/31/2013
The ratio of the price-earnings ratio to the sum of the estimated growth in earnings and dividend yield (div-adjusted PEG ratio) is less than or equal to half the median value for the entire database.

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

Current Market PEG
Avg: 2.84
Median: 1.50
Stocks: 1,957

230 firms passing from a total of 7,431 companies

(data as of 6/14/2013)
The estimated growth rate in earnings per share is greater than or equal to 7% and less than or equal to 20%

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

1,585 firms passing independently, 128 cumulatively

Note only 2,423 stocks with long-term growth estimates
The five-year growth rate in sales is greater than or equal to 7% and less than or equal to 20%

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

1,278 firms passing independently, 38 cumulatively
Free cash flow per share over the last 12 months and the last fiscal year (Y1) is positive

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

2,752 firms passing independently, 20 cumulatively
The operating margin over the last 12 months and last fiscal year is greater than or equal to the industry’s median operating margin

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

2,677 firms passing independently, 16 cumulatively
**Stock Investor Pro** - Screening data date: 6/14/2013

![Stock Notebook #1 - Untitled](image)

### Company name

<table>
<thead>
<tr>
<th>Ticker</th>
<th>PE to Div adj EPS Est growth</th>
<th>PE</th>
<th>EPS Growth Est</th>
<th>Sales-Growth 5yr</th>
<th>Operating margin 12m</th>
<th>Yield</th>
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<td>11.750</td>
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<td>12.000</td>
<td>10.0</td>
<td>39.7</td>
<td>8.2</td>
<td>N</td>
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</table>

16 stocks selected - ranked by PE to Div adj EPS Est growth, ascending
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.
Growth Screen: CAN SLIM

- William O’Neil developed his growth stock approach through study of company characteristics prior to their big stock price increase
C=Current Quarterly Earnings

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

787 firms passing from a total of 7,431 companies

(data as of 6/14/2013)
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

134 firms passing independently, 27 cumulatively
N=New Products, Management, Highs

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

Screen for stocks within 10% of their 52-week high

2,827 firms passing independently, 21 cumulatively (993 passed on 9/2011)
S = Supply and Demand

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

Screen for float of less than 20 million shares outstanding

2,824 firms passing independently, 7 cumulatively
L=Leader or Laggard

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

Screen for 52-week relative strength rank above 70%

2,194 firms passing independently, 2 cumulatively
I = Institutional Sponsorship

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

Screen for at least 5 institutional shareholders, consider cap

5,044 firms passing independently, 1 cumulatively
M=Market Direction

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

The Cup with Handle is a bullish continuation pattern that marks a consolidation period followed by a breakout. It was developed by William O'Neil and introduced in his 1988 book, *How to Make Money in Stocks*.

As its name implies, there are two parts to the pattern: the cup and the handle. The cup forms after an advance and looks like a bowl or rounding bottom. As the cup is completed, a trading range develops on the right hand side and the handle is formed. A subsequent breakout from the handle’s trading range signals a continuation of the prior advance.
### Stock Investor Pro - Screening data date: 6/14/2013

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>PE to Div adj EPS Est growth</th>
<th>PE</th>
<th>EPS Growth Est</th>
<th>EPS Cont-Growth 5yr</th>
<th>Yield</th>
<th>Market Cap Q1</th>
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<tbody>
<tr>
<td>Bancorp of New Jersey Inc</td>
<td>BKJ</td>
<td>NA</td>
<td>16.6</td>
<td>NA</td>
<td>36.6</td>
<td>1.7</td>
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<td>Lithia Motors Inc</td>
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<td>25.000</td>
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<td>Grand Canyon Education Inc</td>
<td>LOPE</td>
<td>1.2</td>
<td>19.0</td>
<td>16.196</td>
<td>92.1</td>
<td>0.0</td>
<td>1439.8</td>
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<td>Schweitzer-Mauduit Interna</td>
<td>SWM</td>
<td>0.9</td>
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<td>15.000</td>
<td>89.2</td>
<td>2.4</td>
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<td>Dorman Products Inc.</td>
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<td>NA</td>
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<td>0.0</td>
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<td>Investors Bancorp, Inc.</td>
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<td>Tenneco Inc</td>
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<td>Domino's Pizza, Inc.</td>
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<td>Cooper Companies, Inc., The</td>
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<td>Green Mountain Coffee Roasters</td>
<td>GMCR</td>
<td>1.4</td>
<td>29.9</td>
<td>21.500</td>
<td>81.1</td>
<td>0.0</td>
<td>11693.6</td>
</tr>
</tbody>
</table>

11 stocks selected - ranked by Market Cap Q1, ascending
Growth Summary

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

- 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 Web site within “AAII Stock Screens” segment in the Portfolios section
Common Elements

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

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

- Unique Niche

- Strong Financials

- Price Momentum

- Earnings Revisions

- Disciplined Investment Approach
Potential Pitfalls of Stock Screening

- Dependent on the accuracy of the underlying data
  - No database is 100% “clean”
- 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
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
  - Provides framework for buy/hold/sell decision
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.

- To succeed with an 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 expect miracles

- Maintain reasonable expectations
- Market is reasonably efficient, but not in the academic sense that all information is instantaneously reflected in prices of all stocks. Nevertheless, information will eventually lead to stock price adjustments
  - Adjustments quicker for larger companies than smaller firms
- Micro-cap stocks tend to have consecutive periods of overperformance and then underperformance
- Important to maintain diversified portfolio and consider all asset classes and foreign markets as well as domestic markets
Sort order of table can be changed by clicking on tabs.

Data as of 12/31/2012

<table>
<thead>
<tr>
<th>Screen</th>
<th>YTD</th>
<th>3-Yr</th>
<th>5-Yr</th>
<th>10-Yr</th>
<th>Inception</th>
<th>Risk Index</th>
<th>Category</th>
<th>Alphabetical</th>
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</thead>
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<tr>
<td>Piotroski: High F-Score</td>
<td>91.7%</td>
<td>42.7%</td>
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<tr>
<td>Murphy Technology</td>
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<td></td>
<td></td>
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</tbody>
</table>
Guide to Stock Screening

These approaches run the full spectrum, from those that are value-based to those that focus primarily on growth. Some approaches are geared toward large-company stocks, while others uncover micro-sized firms. Most fall somewhere in the middle. There are even a number of specialty screens that attempt to gauge the stock selection impact of a single variable—such as earnings estimates revisions. Needless to say, the characteristics of these stock investment approaches vary widely.

Choosing A Screen

It is important to understand the investment characteristics of any approach you are using. By browsing through the passing companies tab of a stock screen, you can get a better idea of the kind of companies that a screen favors along with a sense for any industry concentrations that a screen may generate.

AAII tracks the results of the screens on this site. Every month we update each screen using Stock Investor Pro and post a new list of passing companies. The results are usually posted in the middle of each month using data from the previous month’s end.

The purpose of AAII's stock screening area is to provide you with access to a wide range of investment approaches.

The performance of the stocks passing each screen is tracked on a monthly basis. The month-to-month closing price is used to calculate the return, which assumes an equal investment in each.
Members can download spreadsheets with that detail performance by month or year.

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.
## Risk & Return

When selecting a stock screening strategy, there are a number of factors to consider, including your time horizon and how quickly you are able to monitor your stock portfolio. While historical performance is an important component of the selection process, periods of extreme fluctuation. As a result, it is also useful to see how various strategies perform over different market conditions. AAll stock screens is that you can compare the performance and risk of a variety of strategies against broad market indices.

The risk and return data provided here allows you to evaluate the riskiness of the AAll stock screens relative to the overall market performance, including on a risk-adjusted basis and over the latest bear and bull market periods.

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

### 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 measure 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:** \[(\text{Index Std Dev} \times \text{Portfolio Std Dev}) - (\text{Portfolio Return} \times \text{Margin Rate})\] + Margin Rate

### Average Annual Price Gain:
The compound average annual price gain is shown since inception and for the last 1, last five, 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

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Historical Annual Return (%)</th>
<th>Average Ann't Price Gain (%)</th>
<th>Price Gain (%)</th>
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Portfolio Characteristics

The Portfolio Characteristics table presents a snapshot of the characteristics of the stocks that made up each portfolio 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 hold.

Data as of 12/31/2012

<table>
<thead>
<tr>
<th>Strategy</th>
<th>P/E Ratio (X)</th>
<th>Price to EPS Est. Growth (X)</th>
<th>Price-to-Book Value Ratio (X)</th>
<th>Price-to-Sales Ratio (X)</th>
<th>Dividend Yield (%)</th>
<th>Hist. EPS Growth (%)</th>
<th>Est. Long-Term EPS Growth (%)</th>
<th>Market Cap ($ Mil)</th>
<th>52-Week Relative Strength (%)</th>
<th>Avg #</th>
<th>Turnover %</th>
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<tr>
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<td>105.0</td>
<td>25</td>
<td>49.2</td>
</tr>
<tr>
<td>Kirkpatrick Growth</td>
<td>24.1</td>
<td>1.3</td>
<td>2.2</td>
<td>1.2</td>
<td>1.0</td>
<td>-15.7</td>
<td>19.8</td>
<td>2,109.5</td>
<td>59.3</td>
<td>12</td>
<td>61.8</td>
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<td>InvestWare Quality Growth</td>
<td>22.4</td>
<td>1.2</td>
<td>4.5</td>
<td>2.5</td>
<td>0.0</td>
<td>26.1</td>
<td>18.1</td>
<td>8,011.8</td>
<td>11.4</td>
<td>21</td>
<td>11.3</td>
</tr>
<tr>
<td>IBD Stable 70</td>
<td>22.2</td>
<td>1.2</td>
<td>4.5</td>
<td>3.2</td>
<td>0.0</td>
<td>29.6</td>
<td>18.1</td>
<td>8,250.9</td>
<td>1.9</td>
<td>41</td>
<td>11.6</td>
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<tr>
<td>Templeton</td>
<td>21.4</td>
<td>1.2</td>
<td>4.1</td>
<td>3.2</td>
<td>0.0</td>
<td>31.6</td>
<td>17.5</td>
<td>6,813.7</td>
<td>-0.2</td>
<td>23</td>
<td>27.3</td>
</tr>
<tr>
<td>Ruffett</td>
<td>20.4</td>
<td>1.4</td>
<td>4.9</td>
<td>2.2</td>
<td>1.0</td>
<td>19.9</td>
<td>16.0</td>
<td>5,896.7</td>
<td>-3.5</td>
<td>30</td>
<td>20.0</td>
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</table>

Sorted by P/E Ratio (X) ↓
O'Neil's CAN SLIM Screen

Investment approaches are often classified as either "value-based" or "growth-based" strategies that focus on fundamental company characteristics. But not all approaches fit easily into these definitions.

William J. O'Neil devised one interesting approach that combines both fundamental and technical factors.

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CAN SLIM: The Philosophy

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## Companies are ranked by Relative Strength 52wk (d)

<table>
<thead>
<tr>
<th>Company name</th>
<th>Ticker</th>
<th>Exchange</th>
<th>EPS Cont-Growth from Q5 to Q1</th>
<th>EPS Cont-Growth from Q6 to Q2</th>
<th>EPS Growth Est</th>
<th>EPS Cont-Growth 5yr</th>
<th>Float</th>
<th>Shares Average Q1</th>
<th>% Rank-Rel Strength 52 week</th>
<th>Price as % of 52 Week High</th>
<th>Institutional shareholders</th>
<th>Institutional Ownership %</th>
<th>Web address</th>
</tr>
</thead>
<tbody>
<tr>
<td>OmniAmerican Bancorp, Inc.</td>
<td>OABC</td>
<td>Nasdaq</td>
<td>120</td>
<td>27.3</td>
<td>5</td>
<td>46</td>
<td>9.481</td>
<td>10.3388</td>
<td>86</td>
<td>97</td>
<td>88</td>
<td>63.5</td>
<td><a href="https://www.omniamerican.com/">https://www.omniamerican.com/</a></td>
</tr>
</tbody>
</table>

Source: AAII's Stock Investor and Reuters Research, Inc. Data as of 12/31/2012
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