THE WINNING EDGE ON WALL STREET

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The Winning Edge On Wall Street

A Blueprint Of
The "Real" Stock Market
Dedicated To
The Individual Investor

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The Winning Edge On Wall Street

ONE

The Winning Edge On Wall Street

Several studies point out the superior profit possibilities of stocks of smaller companies. In a paper entitled “Superior Profit Possibilities of Smaller Stocks,” Dr. Rolf W. Banz of Northwestern University supported the notion that stocks of smaller companies can outperform the market. Dr. Banz called their superior performance the “size effect.”

Dr. Banz discovered that over a 50-year period the stocks of the smallest 20% of the NYSE firms have, on average, outperformed stocks of the largest 20% of the NYSE firms by a significant margin. In fact, the small stocks performed almost four times better than the market. These smaller companies are riskier investments, but Banz found that even after adjusting for the difference in risk, small stocks outperformed larger stocks. On an annual basis, the 50 smallest stocks had a risk-adjusted return that was almost 24% higher than that of the 50 largest stocks.

Furthermore, while Banz used NYSE companies for this study, he concluded that there is evidence that similar, if not better, results could have been obtained by investing in small AMEX or in over-the-counter stocks.

Banz is not the only academician to publish such findings. Dr. Marc Reinganum of the University of Southern California has also done empirical studies on the rate of return from investing in smaller firms. Using a database containing up to 1200 companies, Reinganum ranked all firms on the basis of their aggregate stock market values (number of shares times stock price). He then combined the ranked securities into ten equally weighted portfolios. Reinganum found that the portfolio containing the smallest firms realized an average rate of return more than 20% higher than the portfolio containing the largest firms. His conclusion is in agreement with the Banz’s findings and with the “hunches” of many investors.

These academic studies underline the superior profit potential of small companies but come up a bit short in terms of explaining why. Banz thought that takeovers aided smaller companies, but the "size effect" was not fully explained. According to Banz, the size effect demonstrates the inverse relationship between size and effectiveness. Larger companies, with more staff, better finances, and an established track record, *should* perform better than the small upstarts. But they don't.

We feel one reason larger companies do not perform better is the inverse relationship between size and innovation. Larger companies tend to be bureaucratic; red tape prevails; timing becomes stretched out. Instead of looking for something new and different, there are only slight changes in existing products. One consultant aptly termed this phenomenon the "MBA syndrome," in which, under the guise of strategic planning, management becomes cautious and is not willing to gamble on anything short of a sure thing. Management finds it safer to relegate the problem to another study than to take action.

The size of a company also affects the motivation that comes from the "hands-on" effect. Decisions that have to be filtered down through many layers of planners and executives to where the actual product is produced tend to temper motivation on the part of producers. Perhaps more important is the effect this filtering process has on the motivation of top management. Removed from day-to-day business operations, many top executives develop a bias against action and toward maintaining the status quo. The professional managers in many of America's largest corporations often become caretakers, and the mediocre performance of American industry over the past 30 years is one result.

The smaller companies, while having risks of their own, do not work within the same bureaucratic structure. Often there is more direct contact between top management and the people working throughout the entire organization. More important, perhaps, is the more direct contact between top management and customers.

Smaller companies have much less bureaucratic red tape, and the ability of one person to see his or her idea put into action has an important motivating effect. Instead of coming up with a 400-page business plan, there is a tendency to try out more new ideas to see which ones fly. Bureaucratic analyses are replaced by a tendency to "let the market prove it." If an idea/product does not work, it is discarded and another is implemented. This attitude has an important effect on motivation, which quickly translates into the high profitability and rising stock prices of the smaller companies.

We've reviewed some important evidence that small companies outperform large companies by a significant margin. We've also offered some common sense reasons why the smaller companies afford superior capital-gains potential to investors. The remaining duty is to identify these smaller companies and determine which ones to buy and, then, when to buy them. How well an investor does his homework will determine whether he will come out with "the winning edge on Wall Street."

TWO

What To Look For In Emerging Growth Stocks

Thousands of securities are traded on the exchanges and over the counter. Just how do investors ascertain which of these securities have above-average potential? After successfully identifying companies with strong prospects for over 50 years, we have determined seven key points to consider in separating the wheat from the chaff.

1. *Liquidity* – A strong level of liquidity is perhaps the most important requirement. A company with moderate long-term debt, plus cash assets, has several advantages in a climate of relatively expensive credit.

First, the company has a margin of safety if it does not have high interest expenses. Due to the above-average risks associated with small companies, financial surprises can and do occur. Sales may slow or even decline. With a low level of debt, a company is better equipped to hold its own.

Second, if a company sees a genuine market opportunity, it can obtain bank financing for expansion. A company that has already used its lender of last resort has played all its cards.

Third, any company, no matter how mediocre, can still attract attention if it is well-financed, and shareholders can obtain a nice sum if a takeover materializes.

Remember, more small companies develop problems by growing too fast than by growing too slowly. Rapid growth not only outstrips management's abilities but all too often involves assumption of excessive debt for financing expansion. Thus, investors should look only for companies that are misers when it comes to debt. The "optimal" debt/equity ratio theories are best left in the classroom.

2. *Earnings Explosion Potential* – By earnings explosion potential we mean the probability of this company reporting major increases in earnings, not of 10% or 12%, but 50% or more. There are two situa-

tions in which this potential is likely to develop.

First, an otherwise attractive company that is temporarily reporting an earnings decline may have the potential for an earnings explosion. For example, if a well-financed company had earned \$0.50 per share, \$0.75 per share, and \$1.00 per share in three consecutive years, then dipped to \$0.50 due to an acquisition, an investor might project that this company could rebound to \$1.00 or \$1.25 per share after digesting the acquisition. When small, growing companies experience a temporary earnings setback, the stage may be set for a dynamic rebound in both the earnings and the stock price. Wise investors will be on the alert for these opportunities.

The second situation in which one is likely to find major earnings gain potential is the company with a vast market potential. Often these stocks have the highest P/E ratios (stock price divided by 12-month earnings per share), and market timing is, therefore, particularly important. Over the next few years electronics, data processing, health care, telecommunications, and certain business services stand to have above-average growth. We expect many companies in these industries to report sales and earnings at least doubling in five years, and then again in another five years. Earnings in a high-growth company will sometimes receive a setback (which is more often than not the only time an investor should buy the stock), but the sales curve will consistently edge higher.

3. *Capitalization* – There are two reasons investors who are interested in growth should consider companies with no more than 20 million shares outstanding. First, the stocks of companies with hundreds of millions of shares outstanding are harder to move than those of companies with fewer shares outstanding. More investors have to share the same opinion to have an effect on the price.

Second, the takeover potential is greater in companies with fewer shares outstanding. There have been some well-publicized, major takeovers, but the greater number of takeovers still occur in companies with fewer shares outstanding. When it comes to capitalization, small is indeed beautiful.

4. *Management's Equity Interest* – Investors should look for a company in which top management's interests are closely related to

investors'. In companies where top management does not own stock, or owns only moderate amounts, management may employ accounting methods or make tactical decisions to ensure that their bonuses, salaries, and other benefits are given priority over other expenditures, such as important research and development ventures.

When top management does not own stock, labor costs also get out of hand. One reason some companies have excessive labor costs and benefits is that management will receive more or less the same benefits for which they supposedly bargained "hard" at the negotiating table. Management and the union are often really in the same bed. An owner-manager, however, tends to keep costs a little more in line.

The bottom line is that when top management makes a bad decision, shareholders want them to feel it in a substantial decrease in their own net worth.

5. *Unique Operating Niche* – Many times it is assumed that a company has a sure lock on future profits because of a patent that will keep its product unique. Indeed, in some industries, such as drugs, this is the major reason so many companies are profitable. But other features of a company can make it unique and give an edge over competitors. Low-cost production is the forte of Emerson Electric Co. Despite the cyclical nature of its markets, the company, a manufacturer of electrical equipment and electronics, has maintained impressive results on the strength of its focus on keeping costs down. New product innovations can be the niche. Apple, for example, has been extremely successful in introducing new products.

6. *An Improving or High Return on Equity* – Return on equity has often been offered as a measure of management's abilities. Return on equity measures how well any particular company is able to turn investors' dollars into earnings. Obviously, shareholders in a company with a low return on equity would be better off liquidating the company or paying 90% of earnings out in dividends since investors may be able to earn a higher return from another investment.

A high return on equity takes on additional importance when the economy is in a relatively illiquid state. An above-average return of equity, accompanied by no debt or a modest level of debt, indicates that a corporation's growth should be easier to sustain. A high return on equity usually means that the company has an above-average financial operating ratio and can often fund projects internally. A high return on equity is also a must for the growing company to attract additional equity capital. Wall Street justifiably pays a premium for a higher return on equity, for it reflects on the company's future growth capabilities.

7. *Management's Ability and Integrity* – Most guides to security selection list management's abilities and integrity as important factors to consider. But how can an investor really evaluate these criteria? By looking at diplomas on the wall? Of limited help. By quizzing executives on their management strategies? Maybe. By talking to competitors? Perhaps. By talking to suppliers? Again, perhaps.

This is the most important factor, but also the most difficult on which to get a handle. More analysts have been misled by looking over the corporate grounds and receiving an exclusive interview than have gained valuable insight.

But if an investor can detect an attitude present among the employees, from the top down, which reflects a sense of urgency and above-average drive, the investor ought to investigate further. Ask the CEO only one question – what opportunity means to him/her. Then listen. The world stands aside for the person who knows where he/she is going, and the investor who latches on early to a corporation run by this type of person will excel in the market nearly every time.

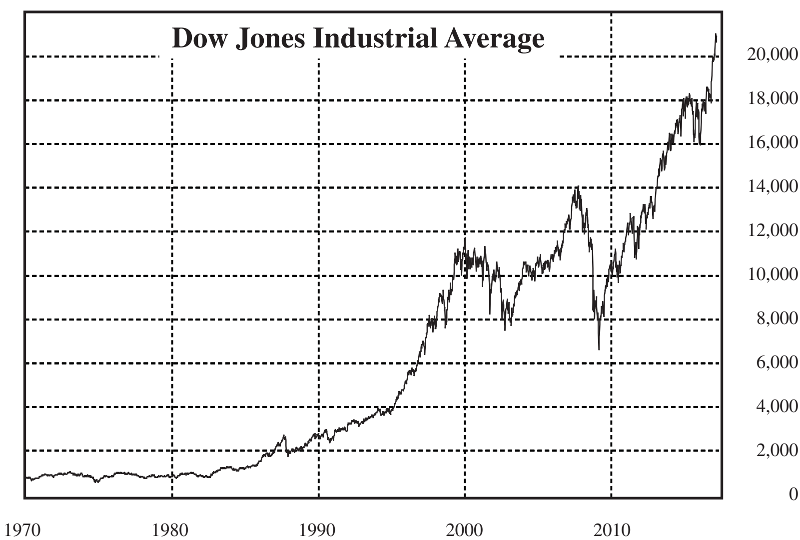
These seven factors are certainly not the only pertinent ones. However, they are definitely useful in determining which are the most promising of the smaller stocks.

In the profiles of successful emerging growth companies, these same factors emerge time and time again.

THREE

The Importance Of Timing

Timing is of the essence on Wall Street, yet remains an elusive achievement to most. During the ’70s, market timing could certainly not be ignored. The net gains in the stock market until the market pushed higher in 1982 had been zero for years. The distance between peaks and troughs, however, added up to several thousand points. But, even in the stock market environment of the past couple of years, where a buy and hold policy might have had the best opportunity to shine, the majority of the professional investment managers failed to keep pace with the overall market gains.



The reason so few people can make money in the market is that human nature dictates that everybody loves a winner and hates a loser. However, to invest successfully in stocks, the reverse is often the key. When everybody knows that stocks are a good buy, when the New Highs list is expanding, when neighbors are talking about making a killing on this or that, or when the level of anxiety about stocks is low, that is the time to think about leaving the party. At the opposite end of the scale, when stocks have dropped so far that one even hates to look at the stock market quote page, the objective investor will sense that a buying opportunity is at hand.

The Dow Theory Stands The Test Of Time

The first step in developing good timing is to be in step with the primary trend — it is far easier to profit by investing with the trend than against it. The Dow Theory is by far the most time-tested tool for interpreting the direction of the primary trend. The Dow Theory often helps to keep investors out of "bull traps" in a down market. By the same token, when stocks are headed higher, the Dow Theory often aids investors in getting in on time.

The concepts of the Dow Theory are relatively easy to list, but experience is necessary for their most profitable application.

Dow Theory Tenets

The Averages Discount Everything (except acts of God) — This apparently simple statement is actually quite profound. The securities market represents the greed, fears, and aspirations of millions of investors. Economic pundits can project one way or another and run their econometric models, but only the Averages reliably project coming events. Traditionally, the Averages are six months ahead of economists in predicting economic conditions.

Dow's Trends — The Averages have three simultaneously occurring trends. The primary trend is the most important of the movements for longer-term investors and usually lasts two years or more. The secondary trend runs counter to the primary trend, lasting three weeks to as many months, and corrects one-third to two-thirds of the previous primary trend. The third trend, the minor movement, consists of daily fluctuations.

Both The Industrial And Transportation Averages Must Confirm — This is one of the most important Dow Theory tenets. The movement of one Average must be confirmed by the other before inferences should be drawn. In an up market, inability of one Average to verify the other in higher prices may mean a change in direction is at hand. By the same token, in a down market, the inability of one Average to verify the other in lower prices may mean that prices are about to turn to the upside.

Volume — Volume tends to be tricky to interpret, but generally a market which is overextended becomes dull on rallies and develops activity on the downside. Likewise, when the market is oversold, volume becomes dull on declines and expands on rallies. The common expression is, "Volume goes with the trend."

Lines — A line is a sideways movement that lasts three weeks or longer, during which time the price will fluctuate in a range of approximately 5%. A line indicates either accumulation or distribution. Breakouts have substantial forecasting implications.

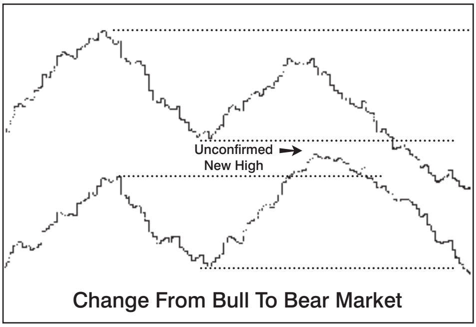
Bull Markets — Bull markets are long upward trends usually lasting two years or longer. There are usually three stages to a bull market. The first stage is represented by reviving confidence in the economy and declining interest rates, and the second stage experiences a known improvement in corporate earnings. In the third stage, speculation is rampant.

Bear Markets — Bear markets are long downward moves, interrupted by important rallies, usually lasting approximately 16 months.

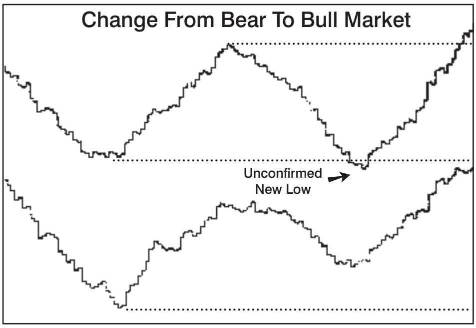
Bear markets begin before negative economic issues are being reported in the media. However, the first stage is quickly set by the abandonment of the hopes upon which stocks were purchased at inflated prices. The second stage reflects selling due to decreased earnings reports. The third stage is outright distress selling.

Determining The Trend — Determining the turning points in primary markets is very important. Trends are assumed to continue until a reversal has definitely been signaled. In a bull market a reversal occurs in three stages. First, a secondary reaction is identified (a correction that has run counter to the preceding primary upswing, has lasted at least three weeks, and has corrected at least one-third of the primary upswing). The market then rallies to recover one-third to two-thirds of the secondary downswing, and then drops again to penetrate the established secondary low. Again, the movement of one Average must be confirmed by the other.

Keep in mind that there are usually three phases in a primary market. The first secondary reaction may be severe, but it is too early for a bear market to start. The same is true for the second reaction. However, if the bull market has lasted for two years or more, and the second reaction in the market goes below the low point of the first reaction, a change from bull market to bear market is confirmed.



A change from a bear market to a bull market is just the opposite. A rally in the bear market first corrects one-third to two-thirds of the preceding bear market pri- mary down- swing. (At this point, it may be a bear mar- ket rally, or the first leg in a new bull market.) The mar- ket then tests the previous bear market lows and falls short of setting new lows. Following the failure to set new bear market lows, the market rallies to new highs, confirming the change in trend from bear to bull. (For a more complete explanation of the Dow Theory, send $6.00 for a copy of our 28-page booklet, The Dow Theory.)



Stock Prices Precede Economics

It might be helpful at this stage to review the typical economic climate that accompanies important stock market turning points since the turning points usually occur far in advance of the movements of the economic tide.

A bull market generally turns to a bear market when confidence in the economy is high — when analysts are in the process of marking up earnings estimates and the financial news, in general, is quite good. In the market, however, solid stocks have been bid up to a relatively high level, and now money starts to flow into more speculative stocks. The new issues market is probably active, with many corporations that do not even have a sales record floating stock. Just as there is speculation in stocks, there is speculation in business. The most viable investments have been made, and now businesses are financing more questionable investments. Accompanying this speculative climate is an increasingly high level of interest rates, making it costly to speculate on margin and making the cost of capital in business too high. More costly capital, combined with the drying up of values, is typical of bull market tops.

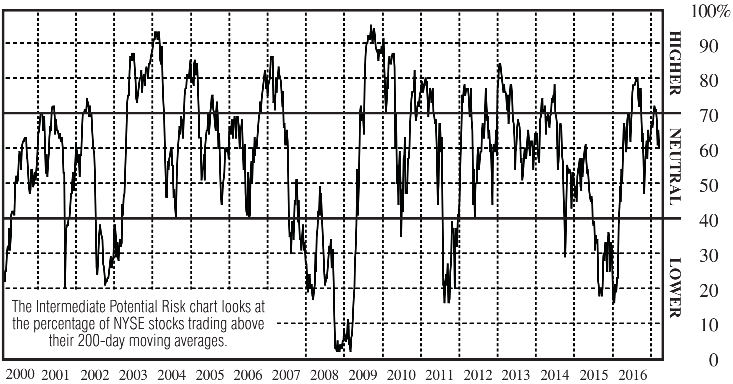
The bottoms of bear markets are accompanied by an economic climate that is as desolate as the previous bull market top was exuberant. The financial news is bleak and the board rooms are empty. Stocks cannot be given away. In all probability, there has been at least one panic. Here again, interest rates provide an important clue to the market's future behavior. Just as the previous level of high interest rates put a lid on prudent business expansion, declining interest rates now make business expansion affordable. There is little question why major stock market advances cannot get under way as long as the bond markets are in the doldrums. During the second stage of a bear market, stocks tend to fall sharply as lower earnings reports are released. In the final stage, however, stocks become more resistant despite the fact that these negative reports are still being released. When stocks start showing buoyancy and a bond market rally is under way in earnest, the bull market is probably right around the corner.

Intermediate-Term Timing

The market swings from excessive optimism to excessive pessimism. Strapping a polygraph to investors to test their current levels of greed or fear might be a foolproof way to tie up some stock market profits, but it is certainly impractical. Intermediate-term timing can be clarified by any number of technical indicators which measure emotional selling. These tools tend to correlate strongly with secondary reactions as they develop in bull markets.

One simple indicator of a buying opportunity is a climax sell-off following a 15% drop in the market, which certainly represents investors' discomfort. Usually the news media will have an eye on the public's emotions as well and will be fanning the flames of anxiety even more.

Another method would be to buy stocks when the number of stocks declining exceeds the number of stocks advancing 14 to one. At these market points, stocks are being dumped on a wholesale basis, and in general, investors' anxiety is high. But, if the market is classified as being a primary bull market under the Dow Theory, the laws of probability suggest that purchases will work out in almost all cases. These periods of excessive declines tend to occur every five to six months.



Still another technique is to measure the number of stocks selling above or below their 200-day moving averages. This indicator, like any other, cannot forecast what stocks are likely to do. But like the Dow Theory, it can inform the investor as to where he or she is at any point in time. Most investors do not even know where they are, much less where they are going.

Using the 200-day moving average indicator, an investor knows that if 80% of the stocks are trading above their 200-day moving averages, they are not cheap. If 80% of the stocks are trading below their 200-day moving averages, they are not dear. The 40% level is useful in identifying intermediate buying areas in bull markets. If investors can overcome their anxiety and keep their eyes on the chart, they might just profit.

Divergence A Useful Tool

A final method for making intermediate-term timing decisions is to look for divergence, which under the Dow Theory indicates a possible important turn in the trend. When one Average makes a new high (or low) unconfirmed by the other Average, importance of the new high (or low) must be discounted. More often than not, this divergence indicates a change in direction.

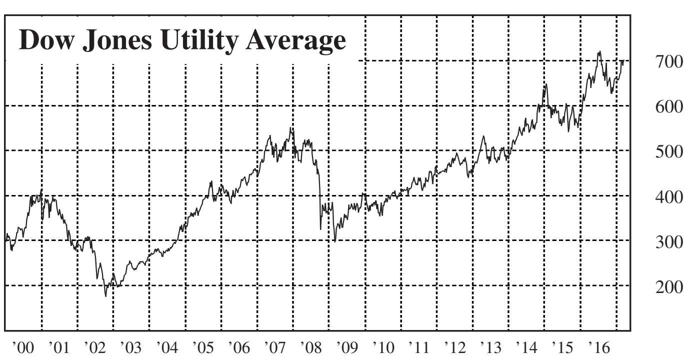
Throughout the history of the stock market, divergence has been important in picking turning points, especially when a selling climax occurred in the weeks, or one or two months, preceding.

Additional Indicators That Feature Divergence

Advance/Decline Line – Divergence is also indicated by the failure of the New York Stock Exchange Advance/Decline line to follow the Dow Jones Industrial Average either up or down. The Advance/Decline line appears to work better at tops than at bottoms, where it often lags the Dow.

New Highs/New Lows – The failure of the number of stocks on the New Highs list to expand when the DJIA is hitting a new high signals trouble ahead, while the failure of the number of stocks on the New Lows list to expand when the DJIA is hitting a new low indicates that the market is turning upward.

Dow Jones Utilities – A significant market rally cannot proceed under conditions of tight money. While there are a number of confusing methods to measure the money supply, the Dow Jones Utility Average remains a simple gauge of liquidity, as utilities are capital intensive and are more sensitive to interest rates. Capital expansion, and hence future earnings growth, cannot occur if credit conditions are becoming unfavorable. New weakness in the Utilities while the market is still advancing suggests that stocks will soon be turning down in anticipation of future earnings erosion. A move by the Utilities to the upside, however, suggests better credit conditions ahead.



FOUR

Fortunately For Investors, The "Stars" Will Identify Themselves

The colloquialism "the cream rises to the top" applies to nature, human behavior, and stock prices. Those who are aware of this truth and exploit it, profit. Those who don't will remain bridesmaids forever.

One of the most important elements in the management structures of highly successful companies is that they create a climate that allows the key people to identify themselves. They allow their executives to take responsibility and make things happen. It is ironic that the larger the organization, the further away from this effective system the selection process moves. A larger company "over-analyzes" executive selection; the smaller company lets the top performers show themselves. The larger company tends to be risk averse, and the smaller one is more willing to let the chips fall where they may.

Fortunately for investors, just as key executives will identify themselves quickly in smaller companies, stocks that are emerging stars will also identify themselves.

Buy Name Stocks

It is important that investors look for stocks that already are making a name for themselves. For one, just the fact that the company is becoming better known may be some indication of an aggressive management team. But, investors should also be aware that stocks that have been capable of attracting bullish enthusiasm in the past will do so again. Today's wallflower may or may not. An investor who wants to do extensive homework can spend the time, energy, and money to ferret out the future "name" stocks, but why not let the other market participants do it for him or her? For maximum stock market results, it is important for the investor to know which stocks are capable of attracting attention.

Any investor who has been in the stock market through at least three bull markets knows that many of the current leaders were leaders in the previous bull markets. There are exceptions, as certain types of stocks, such as the inflation plays, are one-time events only. However, certain types of growth stocks will come back time and time again. Stocks which have attracted bullish enthusiasm in the past do so in the future.

Use Charts For Clues

Some of the most successful stock market investors have effectively identified stars on the basis of price and volume data committed to memory. They remember price quotes and volume numbers from *The Wall Street Journal* or *Barron's*, which allow them to track stocks. Most readers do not have the time nor patience to keep memory drawers full of this data, but fortunately charts are available for that purpose.

While we do not want to entertain the argument of just how precise certain chart patterns can be in forecasting future stock movements, we do think utilizing charts to monitor the demand (or lack of demand) for any stock is not only efficient, but it makes good sense. Stocks do not randomly make the List of New Highs or List of New Lows. Some stocks move more or less with the market, others against, and others ahead of the market. Since most investors are "long" buyers of stocks, it is obviously important to be with the stocks that are going to be ahead of the market.

Experience shows that some stocks make money for investors, others do not. Some stocks are in net demand, others are not. Some defy the laws of gravity, others do not. Study the charts of today's performers and you'll see plenty of relative strength clues in the previous price patterns.

Investors can utilize charts of different time frames for identifying relative strength. We have gleaned some winners from examining both ten years of monthly ranges and also 18 months of daily price patterns. What is important in these charts is that the stock is showing improved relative strength over the given time period. When the market is advancing, these stocks are the pacemakers. When the market is emerging from a secondary reaction, these stocks are among the first to advance.

The Buying Opportunity

For years we have kept "watch lists" of both listed and unlisted securities based on chart patterns. A favorable chart pattern tells us that there is demand for these stocks, but it does not tell us to purchase them at that moment in time. On the contrary, by the time a stock is attracting widespread investor attention, it can no longer be bought wholesale. Chances are, that particular stock is currently *too* active.

But, what the investor can do is put this stock on his or her watch list and wait for the inevitable correction. If there is any law in the stock market, it is that every stock will have buying corrections, and the greater the advance, the greater the correction. The more active the stock is at the time of purchase, the greater the chance of an imminent correction.

The correction, although expected, is apt to be occurring at a time when investors are discouraged about a particular company's prospects, especially if the company is reporting lower earnings per share. Perhaps investors are discouraged about the company's industry prospects. The energy stocks, for example, tend to go from boom to bust time and time again. Or the correction may be due to a general market sell-off when investors' anxiety is high. Whatever the reason the climate is depressing, the investor who has studied chart patterns welcomes it as a buying opportunity.

FIVE

Don't Buy New Issues, But If You Must . . .

Obviously all growth stocks were at one time new issues, and the new issues market is frothy at times because of the public's appetite for that "pot of gold." But a new issue is more often than not brought out at the best possible price for the issuer and the investment banker and the worst possible price for the investor. There are scores of better buys in companies that are already seasoned. In fact, the volume in new issues is a reliable indication that the market is topping out, and investors ought to be selling, not buying, new issues. But as some investors prefer to dabble in the more speculative sectors of the market, we offer some pointers that should help limit losses.

Myths About New Issues

Myth #1: New issues are a "sure thing."

Nothing in the market is a sure thing, least of all new issues. The quick profit in new issues depends on getting the stock at the offering price and selling it on the speculative upsurge which may accompany the offering. Small investors rarely get sought-after shares at the offering price and are frequently found buying the stock at the top from someone who got shares in the initial offer.

Myth # 2: New issues are underpriced.

It is in the best interest of the issuing company to see that the stock is sold to the public at the highest possible price. This pricing policy insures ample proceeds to the company and large commissions to the underwriter. However, reputable underwriters try to price new offerings fairly in order to sell the stock as easily as possible. Still, in comparison to the general market, new issues are richly priced.

The Slow But Steady Approach

It is not impossible for a small investor to make money in new issues. However, the small trader is more likely to be successful by trying to select a long-term winner than by trying to pick tomorrow's "hot" stock.

#1: Select only the very best.

Read the prospectus carefully and pay special attention to:

- *The company's operating status* – If the company has not begun operations or derives the bulk of revenues and earnings from sources other than its primary business, it is an outright gamble.
- *Reported earnings* – Only earnings from operations, excluding extraordinary items, should be considered. Even when the potential is great, a lack of earnings indicates a problem. In fact, it may be the company's inability to raise funds through other means that has driven management to seek outside investors via a public stock offering. If a company must go public to avoid bankruptcy, the stock should be passed by.
- *Growth rate* – Truly enormous growth rates can be turned in by companies preparing to go public. But no company can maintain an astronomical growth rate indefinitely. When growth slows, the stock's price will also decline.
- *Financial integrity* – Forget about the great new idea or the new product that will make everything else obsolete. If the company's finances are not sound, nothing else can make up for it.
    a. The firm's long-term debt should not exceed shareholders' equity.
    b. The current ratio (current assets divided by current liabilities) should be at least 2.0.
    c. The quick ratio can be found by summing cash, securities held, and accounts receivable and dividing the total by current liabilities. Coverage of 1.0 is acceptable.
- *Remuneration of corporate officers.*
- *The price which present shareholders paid for their shares.*

- *The number of shares which will be retained by present shareholders.*
- *Use of proceeds* – The use of offering proceeds to pay salaries, develop a new product, or repay debt frequently means the company cannot obtain financing through other channels. If banks and venture capitalists shun the firm, so should small investors.

#2: Buy below the offering price.

Once a promising new stock has been located, there is a temptation to buy it immediately. However, those who bought "runaway" new issues only to see them fall steadily back toward their original price know the pain of overpaying for new issues.

- *The stock that gets away is the exception* – When the stock has been carefully chosen for its long-term potential and financial integrity, an investor may buy on a price setback with confidence that quality will eventually win out.
- *Be patient* – Most new issues decline in price when the market falls. Investors patient enough to wait out the speculative fervor are usually able to purchase the shares at a lower price. Be sure the stock in question is sound and then wait.

#3: Follow the company's progress.

There is an old investment adage that urges investors to investigate before investing. Part of investigating a new issue is to keep an eye on activity once public trading has begun.

- *Less established concerns may run into difficulties* – The small computer outfit that plans to set bigger competitors on their ears usually finds the going quite rough. Keeping an eye out for such potential problems can prevent a costly mistake.
- *Secondary offerings can be a sign of trouble* – A secondary offering of a recent issue may be a sign of distribution of the stock by insiders.

#4: Buy when the stock is unpopular.

We follow this advice in the selection of all stocks, but it applies especially to new issues because of their inherent volatility. The upside move typically carries the stock far above any reasonable measure of its value, and similarly, the correction brings the stock to ridiculously low levels. That is the time to pick up the solid, but scorned, recent issue.

Risks Are High

One cannot overemphasize the risks involved in new issues. No one who cannot afford to lose funds should even consider these stocks. The strategy which we propose should limit the risks and prevent some costly mistakes. One can best protect one's investment by:

1. Seeking out quality in new issues.
2. Strictly limiting the amount of one's total investment in new issues.
3. Staying with new issues underwritten by reputable firms.
4. Keeping abreast of developments within the company.

Our approach is certainly not the road to "easy money," but we feel it is the safest, and perhaps the easiest, approach for the amateur investor to follow. Careful selection and patience should enable investors to come away from the new issues market with some excellent capital-gains candidates.

SIX

How To Pick A $5 Stock

The Appeal of a $5 Stock

In addition to the appeal of a "bargain," there are other good reasons for purchasing carefully chosen $5 stocks:

1. *The profit potential of small capitalizations* – Many of the best choices in the $5 category have a small number of shares outstanding. Professor Rolf W. Banz's paper, "The Superior Profit Possibilities of Smaller Stocks," shows small stocks outpacing larger stocks by a four-to-one margin over a 54-year period.

2. *Smaller stakes* – Low prices limit downside risk. While a loss is always distressing, no one can lose more than $5 on a $5 stock.

3. *Lack of institutional interest* – The absence of institutional interest provides the opportunity for substantial capital gains as the company grows and captures institutional attention.

How to Limit Risk

High risk is usually associated with stocks priced at $5 and under. The underlying companies may be more vulnerable to business failure, liquidity crises, and recessions than their larger brethren. However, it is also true that where there is risk, there are superior opportunities for capital gains.

In stalking these gains there are steps investors can take to limit risk:

1. *Diversify* – Diversification may be considered in two parts: (1) One should have a sound portfolio of good quality stocks, bonds, or other assets; (2) One should be well diversified in $5 stocks. A general guide is to keep a balance between cyclical and noncyclical industries.

2. *Buy for the value, not the price* – Even at $5 or less, a stock can be overpriced. Buy the stock based on the company's assets and its expected future earnings stream, considering ongoing business and probable future additions.

3. *Limit exposure* – Put a fixed limit on the amount available for investment in $5 stocks — 5% to 10% of the total portfolio may be used as a guideline. Another method is to use only dividends and interest received from more stable investments.

4. *Protect profits* – When a stock rises to 150% or more of the original cost, half the position can be sold, with the remainder retained to participate in any further advances.

5. *Monitor progress* – Keep abreast of changes in the company's direction or finances.

Selecting The Best $5 Stocks

In the $5 range there are three groups of stocks which are especially appealing: emerging growth companies, turnaround plays, and takeover candidates.

Identifying Emerging Growth Stocks:

1. *The importance of financial integrity* – The single most important factor in evaluating a growth company for long-term investment is its ability to operate profitably and generate capital internally. Long-term debt should be less than 40% of total capital, and the current ratio (current assets divided by current liabilities) should exceed 2.0.

2. *The expected future earnings stream* – In evaluating future earnings potential, one should be looking for annual gains on the order of 20% to 50%. Most of the following will be true of companies with good earnings prospects:

- ❑ over the last five years, earnings per share have grown at least 10%-15% annually;
- ❑ the company is active in a relatively new technology or product area;
- ❑ over the last five years, profit margins have been rising or steady;
- ❑ the company has a history of successfully introducing new products;
- ❑ the company targets a particular segment of its chosen market.

3. *Management* – It is difficult for a small investor to evaluate the quality of management, but some facts can usually be obtained. Investors should look for companies where:

- ❑ management is not near retirement age;
- ❑ management has gained experience at other companies in the same or similar industries;
- ❑ the company founder is still on hand;
- ❑ management owns stock in the company.

4. *Time Frame* – The emerging growth stock is a long-term investment. It takes time for such companies to grow and develop, and investors should exercise patience.

Stalking the Turnaround Play:

The opportunity for a turnaround exists wherever results have been poor and the management complacent or incompetent. While there are probably dozens of companies which fit that description, genuine turnarounds have more distinctive traits that mark them as ripe for change – 1) a change in management; 2) redeployment of assets; 3) insider buying. Finding potential turnarounds requires some sleuthing. A majority of the following are often true of potential turnarounds:

- ❑ within the past 1-2 years, there has been a major change in top management – a new chairman or chief executive officer, for example;
- ❑ unprofitable or marginally profitable operations have been discontinued;
- ❑ corporate officers or directors have been buying the company's stock.

Identifying a Takeover Candidate:

Perhaps few profit opportunities have received as much attention as corporate takeovers. Because of the uncertainties involved, it is important to choose a stock which is attractive apart from its takeover prospects. Companies ripe for takeovers often have some of the following traits:

- ❑ a small capitalization;
- ❑ a market price less than book value;

- ❑ a “weak” management team;
- ❑ ownership of undervalued assets or important patents.

The following may be true of a potential takeover:

- ❑ the company has fewer than 50 million shares outstanding;
- ❑ management is dominated by persons near retirement age;
- ❑ management’s record on innovations and improving returns has been poor;
- ❑ the company owns assets whose market values are potentially higher than those shown on the balance sheet;
- ❑ outside investors have been steadily buying the stock.

SEVEN

The Six Myths Of Mutual-Fund Investing

It's no secret that mutual funds have become the investment of choice for millions of individual investors, often at the expense of ownership of individual stocks.

But mutual funds, despite their popularity, are not the "perfect" investments that they are often portrayed to be in the financial media and mutual fund advertising. To be sure, mutual funds provide a number of advantages for investors, such as diversification and convenience. But investors who invest solely in mutual funds while ignoring individual stocks, especially small-capitalization stocks, may be relegating their portfolio to mediocre performance at best. This chapter takes a look at some common myths of mutual fund investing and examines each of these drawbacks relative to common stocks.

Myth #1: Mutual funds are safe investments.

Contrary to what many investors believe, mutual funds, including money-market funds, are not federally insured investments. Even funds sold by banks are not federally insured. And if you use the word "safe" to mean that mutual funds are immune to sharp downturns, you're wrong as well. Remember that funds are only as safe as the securities in which they invest.

Are mutual funds safer than stocks? Certainly, diversification does matter when limiting risk, and diversification is easier to achieve with mutual funds than stocks. Still, investors who choose no-load mutual funds over a portfolio of growth stocks may be surprised to see just how "safe" these funds aren't during declining stock markets.

Myth #2 : I can expect above-average performance from my mutual fund.

You can expect above-average performance, but you probably won't get it from your fund. In any given year, it's not unusual for two-thirds of all mutual funds to underperfrom the market as measured by the S&P 500.

Several factors account for the lackluster performance of most funds. First, many academics argue that the market is so efficient — in other words, that stock prices reflect all that is known about a stock and discount information so quickly as to make finding mispriced stocks very difficult — that it is extremely difficult to outperform the market on a consistent basis. Many practitioners in the investment field hold that markets are not as efficient as academics believe. Still, you probably won't find too many fund managers who won't acknowledge the difficulty in beating the market.

But even if you believe that it's possible to beat the market regularly, how many mutual fund managers are out there who have the skill to do so? Very few. And the few mutual fund managers who truly add value pales in comparison to the ever-increasing number of mutual funds. Are all of these funds being managed by fund managers who add value? Of course not. Furthermore, performance may be even weaker over the next decade if the equity market turns more difficult. After all, it wasn't too hard to show double-digit gains during the last decade when stocks in general were rising at such a rapid rate. However, in an environment where market returns are more in line with historical averages of roughly 9% per year for stocks, the disparities between the few effective fund managers and the huge number of mediocre ones will be even more evident.

Also affecting mutual fund performance is that, in some instances, a mutual fund may have little incentive to go for above-average performance. For example, a fund that accumulates, say, $5 billion in assets may have much more of an incentive to maintain the status quo by carrying high cash amounts or focusing on conservative investments. That's because, at $5 billion in assets, fees to the mutual fund family could be anywhere from $30 million to $60 million every year, even if the mutual fund doesn't make a dime for its shareholders. Thus, preservation of capital rather than asset appreciation may be the primary objective of the fund manager.

A portfolio of good growth stocks may not always outperform all mutual funds over time. However, investors who ignore stocks for mutual funds may be overlooking some attractive long-term capital-gains performers while relegating their investment dollars to subpar performance.

Myth #3: Investing in no-load mutual funds is "no-cost" investing.

Much of the popularity of no-load funds is the fact that they can be bought without a sales fee. However, to say that investing in no-load funds is "no-cost" investing is simply not true. In many cases, the costs of investing in no-load funds are greater than the costs of investing in individual stocks. The problem is that most investors don't realize it since mutual funds deduct expenses from your holdings, which means you never actually write a check to pay the fees.

The sales fee, or "load" fee, is only the tip of the fee iceberg in terms of the costs of investing in mutual funds. Funds have a variety of fees at their disposable to pluck money from your pockets:

- *Annual management and administrative fees* — These are the fees that all no-load funds charge to manage and administer the assets. Rates differ from fund group and across types of funds. However, it is not uncommon for equity funds, especially those investing in foreign securities, to have annual management fees of well over 1% and more than 2% in some instances. Administrative fees may include such things as account setup fees, annual account maintenance fees, telephone redemption fees, wire redemption fees, IRA annual maintenance fees, account closeout fees, and check redemption processing fees.
- *12b-1 fees* — A number of no-load mutual funds charge 12b-1 fees to help defray marketing expenses. These fees have become more regulated in recent years, although 12b-1 fees can still consume a healthy chunk of your assets.
- *Back-end loads* — Since mutual funds realize that investors don't like up-front load fees, they have become adept at building less-conspicuous fees into the system. One such fee is a "back-end" or redemption fee. Most back-end load fees kick in if a fund holder sells shares within five years. The fees decline the longer the fund shares are held and usually disappear if the fund holder holds the shares for longer than five or six years.

When you add all of these fees together, it's quite possible that a mutual fund may be charging you 2%-3% per year in fees. That translates to annual fees of $200-$300 on holdings of $10,000. That's $200-$300 that will never earn a dime in the future. How much money do these fees cost over a 20-year period? Assuming your fund fees average $250 per year for 20 years, and assuming you could have earned an average of 8% annually, the fees would cost you about $12,355.

By using a discount broker and holding down trading activity, the annual costs of managing a portfolio of individual stocks is much lower than the costs investors pay even when investing in no-load mutual funds. Investors should keep in mind that the cost advantage of stocks versus funds means that a typical mutual fund must outperform a portfolio of stocks by at least 1%-2% every year in order to generate the same "after-fee" returns. That gives stocks a big edge in terms of long-term potential performance.

Myth #4: Picking no-load mutual funds is easier than picking stocks.

One of the major selling points of mutual funds is that it's a lot easier to pick a winning fund than a winning stock. All you need to do is look at track records and stick with the top funds. Sounds easy, right?

The reality is that picking mutual funds has become a lot like picking stocks. First, the sheer number of funds presents problems. Sorting through the thousands of mutual funds to find winners is no different than sifting through thousands of stocks to find winners. In fact, it may be more difficult. At least with stocks, you can examine balance sheets and income statements, assess growth prospects of the industry, analyze new products, etc. With funds, the emphasis is on historical performance.

Muddying the waters are the aggressive promotional campaigns being waged by mutual fund companies. These ads all focus on performance. However, a fund that may be advertising its impressive 10-year performance may be a fund that has turned in horrible results in the immediate three-year period. Furthermore, the fund's excellent 10-year track record may have been compiled by a fund manager who is no longer in charge of the fund.

Picking top-performing stocks, like no-load mutual funds, is certainly no picnic. However, investors who do their homework have much more information at their disposal to evaluate a stock versus the limited quantitative tools available to analyze mutual funds.

Myth #5: Investing in mutual funds has no special tax consequences.

Perhaps the biggest downside to investing in mutual funds is that, in many cases, buying a mutual fund means buying a tax liability.

Investors in funds, especially funds with high portfolio turnover, are likely to incur a tax liability at some point in the year. This occurs when the fund manager sells issues that have appreciated, thus turning an "unrealized" gain into a "realized" gain. Since funds with high turnover do a lot of selling, these funds generate a lot of realized gains each year, and these realized gains are distributed to fund holders. When this occurs, current shareholders of the fund incur a tax liability. The bad part is that *all* fund holders must pay the tax on realized gains that are distributed each year. That means that even if you bought the fund in the last month of the year and weren't holding the fund when the big gains were posted, you still must pay a capital-gains tax on the realized gains if you received them. In fact, even if the value of the fund has dropped since your investment — in other words, you're holding a paper loss in the fund — you still have to pay taxes on realized gains distributed to you.

Even funds with low portfolio turnover cannot escape the tax issue. Mutual funds with low turnover have large unrealized capital gains. While a fund that has huge unrealized gains is an indication of a fund that has been successful in picking winners, it also poses potential bombshells for new investors in the fund. Indeed, at some point, the fund will sell these stocks and distribute the "realized" gains to current fund holders. Thus, buying a fund with low turnover may mean that you are also buying a fund with potentially huge "hidden" tax liabilities.

Keep in mind this tax burden is aside from the usual taxes you have to pay on dividend distributions the fund makes during the year as well as taxes you must pay when selling fund shares at a profit.

The tax issue concerning mutual funds is especially significant at this time given that the markets have been strong in recent years and a plethora of funds may have large unrealized gains. Should fund managers sour on the market and begin selling stock, the size of the distributions of realized gains — and therefore the size of your tax headache — could grow.

Fund investors are at the mercy of fund managers when it comes to incurring an unwanted tax liability. The fund managers decide when and how much realized gains to distribute. Fund managers also determine what types of stocks to purchase — high dividend-paying stocks, which create additional tax liabilities for fund holders, or low dividend-paying stocks. The fact is that fund managers don't manage the fund based on tax considerations. That's because mutual funds don't pay taxes — you do. However, with stocks, you control your tax destiny. You decide when to realize capital gains. You decide if you want to invest in high dividend-paying stocks — and incur the tax liability for dividend income — or low-dividend paying stocks or stocks paying no dividend. You decide when to offset capital gains by taking losses. In short, stock investors control when and how much to pay in taxes on their investments. This control, which is not available in mutual funds, can have huge implications in terms of investment returns over time.

Conclusion

This chapter is an attempt to discuss what are common misconceptions about mutual funds versus individual stocks. Do mutual funds have a place in a portfolio? Certainly. Mutual funds provide excellent ways to gain representation in foreign markets, for example. Funds are also good choices for diversifying investments in fixed-income investments, such as bonds as well as government securities. However, to assume that mutual funds are the only game in town is to overlook the many positive benefits of individual stock ownership, especially ownership in emerging growth stocks.

EIGHT

Conclusion

The following remarks were originally written for the first edition of *"The Winning Edge On Wall Street"* back in 1981. Please read with that in mind.

> At the time of this writing there is a downturn in the activity of smaller companies in the country. A continued policy of tight money is slowing the economy, and even the most dynamic of the smaller companies are beginning to feel the pinch. Stock prices have fallen, and the new issues market has dried up. Indeed, the failures of Ray Dirk's John Muir & Co. and W. S. Wein put a damper on the attractiveness of new issues and, indirectly, smaller company stocks.
>
> We feel, however that this is just a temporary condition. Too many important social and economic trends are sowing the seeds for a tremendous advance in the economy and the stock market.

Now, with the benefit of 20/20 hindsight we are very pleased with our observations and forecasts.

But where do we go from here? In our view, a long period of prosperity may lie ahead with accompanying dramatic strength in well-selected common stocks. There will be periodic setbacks along the way, of course, and maybe even a bear market or two. But we are of the opinion that common stocks will afford many investors tremendous profit opportunities during the years ahead.

For timely individual stock recommendations, consult any of the newsletters published by Horizon Publishing Company:

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