WILEY Trading

FINDING #1 STOCKS

SCREENING, BACKTESTING, AND TIME-PROVEN STRATEGIES

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ZACKS INVESTMENT RESEARCH

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John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Matras, Kevin.
Finding #1 Stocks: Screening, Backtesting, and Time-Proven Strategies / Kevin Matras.
p. cm.—(The Zacks Series; 1)
Includes index.
ISBN 978–0–470–90340–7 (hardback); ISBN 978–1–118–05797–1 (ebk);
ISBN 978–1–118–05798–8 (ebk); ISBN 978–1–118–05799–5 (ebk)
1. Stocks. 2. Investments. 3. Investment analysis. I. Zacks Investment Research (Firm). II. Title.
HG4661.M369 2011
332.63'2042—dc22

2010050388

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To every trader and investor
who wants to be better.

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Acknowledgments

I'd like to thank Len Zacks, CEO of Zacks Investment Research, who made writing this book possible through his breakthrough research in creating the Zacks Rank; Steve Reitmeister, Executive Vice President at Zacks, for giving me the opportunity to do so and for sharing his insights with me throughout the years; Meg Freeborn of John Wiley & Sons for all of her help and editorial expertise; and a very special thank you and acknowledgment to my wife Mary for all of her support while I was writing this book and every day.

Thank you.

Kevin Matras
Zacks Investment Research

Introduction

Let me congratulate you. Why? Because whether this is the first investment book you've ever read or the hundredth, the more you read, the more you learn, and the more you do, the better you'll become at something, whatever that something happens to be.

Finding #1 Stocks is about becoming a better trader and investor. My goal is to show you how to do this with the proven, profitable trading techniques used by Zacks, a leading investment research firm focusing on earnings estimates and stock analysis for the individual investor. In addition, you'll see plenty of my personal favorite trading strategies. And I'm also going to show you how you can create your own stock picking screens and trading strategies and how to test them to make sure they work.

Throughout this book, I will share with you real life, practical, and actionable information and strategies that you can start using immediately in your own trading, like how to identify stocks with the highest probability of success, when to sell to maximize your returns, and how to minimize your risk while doing so.

By developing the skills taught in this book, you can live the kind of life you want to live and have the kinds of freedoms and choices that greater financial success can give you. Best of all, you'll see that it's a lot easier than you think and you won't have to stay glued to your computer screen to do it.

While all of the screening ideas and trading strategies explained in this book were created and tested with Zacks' own stock picking and backtesting program called the Research Wizard, you can recreate many of these with your own screening program. Some screeners are more capable than others, but the information presented in this book can be applied to anybody's trading without any special tools or set-ups. (If you don't have a screening program, not to worry; go to page 287 in the back of the book for a free trial of the Research Wizard and follow along.)

So read on for some great stock picking screens and trading strategies.

Your investments are one of the largest, most important chunks of money you will ever be responsible for in your entire life. (And if it isn't now, it likely will be one day.)

In the pages that follow, we'll show you how to better take care of it.

Let's get started!

Chapter 1

The Importance of Screening and Backtesting

One of the reasons why so many people are not seeing the kinds of returns they hope to see in their stock investments is because they don't know which stocks to buy and sell. They find themselves invested in mediocre stocks because they don't know of anything better to get into. For some, their knowledge or "universe" of familiar stocks is relatively small, and this limits their opportunity to invest in better ones.

Worse, when they finally do pick a new stock (likely an all too familiar one) and that doesn't work out as planned either, it discourages them even more from going out and finding others.

But it doesn't have to be that way.

Why Should I Use a Stock Screener?

With over 10,000 stocks out there to pick and choose from, we all need a way to find the good ones.

Aside from buying stocks that are talked about on TV, written about in the newspaper, or touted on the Internet (not to mention tips from a friend)—how else are you going to find stocks that meet certain characteristics?

Even if you don't use a screener now, most people still do their own screening in one way or another. You may hear that a stock has a certain growth rate or a certain P/E ratio or sales surprise or whatever. You then find yourself listening for or reading about or surfing the Internet for stocks that meet this criteria. Well, if you want to find stocks that meet certain criteria, certain characteristics, you can find them quickly and easily with a stock screener.

But just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

Just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

But how will you know?

Backtesting!

Once you've created a screen, you can then backtest it to see how good or bad your screening strategy has performed in the past.

In other words, does your screening strategy generally find stocks that go up once they've been identified? Or does your screen generally find stocks that get buried once they've been identified?

This is good stuff to know. With backtesting, you can see how successful your stock picking strategy has performed in the past so you'll have a better idea as to what your probability of success will be now and in the future.

Of course, past performance is no guarantee of future results, but what else do you have to go by? Think about it. If you saw that a stock picking strategy did nothing but lose money year after year, trade after trade, stock after stock, over and over again, there's no way you'd want to trade that strategy or use that screen to pick stocks.

Why?

Because it's proven that it picks bad stocks. Sure, it may turn around and start picking winners all of a sudden, but it may also continue to pick losing stocks the way it always has. On the other hand, what if you saw that a strategy did great year after year, period after period, over and over again? You would, of course, want to trade that strategy.

Why?

Because it's proven to be a profitable stock picking strategy. And while it may start picking losers all of a sudden (now that you're using it—right?), it may also continue to pick winning stocks just like it had been doing over and over before.

Now, keep in mind that a screening and backtesting program isn't a box of magic, but it's a great way to see what works and what doesn't before you put your money at risk.

Backtesting is a great way to see what works and what doesn't before you put your money at risk.

Unfortunately, too many people have no idea how to pick the right stocks. And this often leads people into staying in the wrong stocks too long or never getting into new stocks altogether.

I remember I had a conversation with a friend several years ago who was stuck in a losing stock:

Me: Why are you still in that stock if it keeps going down, losing you money?

Friend: I don't think it'll go much lower from here.

Me: Did you think it would go this low when you first bought it?

Friend: No.

Me: Do you think it will go up from here?

Friend: Probably not right away. It may still go down some more.

Me: You know, there are plenty of stocks going straight up. Why don't you get out of that one that keeps going down and losing you money and get into a better one?

Friend: I don't know of any better stocks to get into.

Me: What if you did know of a better stock to get into, would you do it?

Friend: Yeah! (Pause) But I'm not sure *how* to find better stocks.

And that last comment said it all. He was in losing stocks because he didn't know how to pick better ones. But if he had a proven profitable stock picking strategy, he could.

Don't get me wrong. Just because you have a great strategy for picking winning stocks, it isn't going to preclude you from ever having another losing trade. On the contrary, even some of the best strategies "only" have win ratios of 65% or 70% or 80%—not 100%.

But if your stock picking strategy picks winners far more often than it picks losers, you can quickly cut your losses once you find yourself in a losing trade and feel confident that your next pick will have a high probability of succeeding.

If your strategy picks winners far more often than losers, you can feel confident that your next pick will have a high probability of success.

And that's why someone should use a screener and a backtester to pick stocks.

Chapter 2

Identifying What Kind of Trader You Are

Now that we know the importance of screening and backtesting, the next step is to identify what kind of trader you are (or want to be). This will make sure that you're getting into the right kinds of strategies and stocks *for you.*

The first step in identifying what kind of trader you are is to ask yourself some questions. What's interesting is that, often when I ask someone what kind of trader they are, they'll immediately say they're a growth trader or a value investor, and so forth. But when they stop and review the answers they've given themselves, it turns out they're completely different than the kind of trader they thought they were.

Here are three great questions to ask yourself to help you identify what kind of trader you are.

Question 1: What Kinds of Stocks Do You Want to Invest In?

This first question is intentionally broad, but it's a great place to start. Once you've indentified the kinds of stocks you'd like to trade, you can then learn about what style of trade these types of stocks fall into. And knowing what types of stocks you're looking for will make the process of finding them that much easier. So first things first.

Are you looking for:

- High flyers and fast movers?
- Stocks with big earnings momentum or aggressive growth?
- Maybe solid companies with dependable growth?
- Perhaps mature companies with income producing dividends?
- Or deeply discounted or undervalued stocks?

There are a lot of different types of stocks to choose from. I've listed just a few. But do your best at answering this first main question. Once you're done, then it's time to dig a little deeper.

Question 2: What Characteristics Do You Want Your Stocks to Have?

This is an extension of Question 1, but now we're getting into some of the details. And it's these details that help distinguish one type of stock from another. Go through the list below and expand on the characteristics as much as you'd like. This is actually a fun step and can be quite interesting because oftentimes some of the details people identify with are quite different than the types of stocks they identified as wanting to trade.

Ask yourself which characteristics are most important to you:

- Low valuations (e.g., low P/E ratios, or price to sales ratios, etc.)?
- Great management (as reflected by a strong ROE)?
- Stocks making new highs?
- Maybe big earnings growth or earnings surprises?
- Companies with a particular ranking (like the Zacks Rank)?

The number of possible characteristics is virtually endless. But there's no need to list them all. The characteristics you've probably already thought of are enough to better understand what kinds of stocks are right for you. Although, you might want to go back to the first question to see how closely aligned your answers to both 1 and 2 are to each other. Whether your answers are in perfect synch (good for you) or all over the map (don't worry about it for now), this is all part of the identification phase. And so is the next question.

Question 3: What Do You Want Your Stocks to Do for You?

Of course you want your stocks to make money. But how? How do you expect them to perform? Over what time period? And by how much? Answer this question and the ones that go along with it to better identify what type of trader you are.

- Are you looking to make fast money by getting in and getting out quickly?
- Or are you interested in finding long-term core holdings?
- Are you looking for stocks to generate income?
- Or would you prefer a medium-term trading strategy to actively pick stocks and grow a portfolio?

These are great questions to ask yourself. And there are other great questions as well. What are your investing goals? Have you ever achieved any of them? (If not, could it be that you've been focusing on the wrong stocks to achieve those goals?) What is your time horizon? What are you even trying to make this money for? Is this for fun? For your retirement? For your kid's education? In other words, what are you investing for?

You may be thinking that figuring out what kind of trader you are is no big deal. But it is. And it's absolutely imperative that you do. Why? Because if you find yourself trading a strategy or getting into stocks that are not in alignment with who you are and what you want, you're going to drop that strategy (no matter how good it's proven to work); you're going to drop that strategy the very moment it hits a rough patch.

Identifying the type of trader you are and what kinds of stocks you want to get into is a critical step to trading success.

You may also want to reflect on your current holdings and ask yourself if your answers are consistent with what's in your portfolio. Are your stocks consistent with who you are as a trader? Are they consistent with the kinds of stocks you want to be in? If they are not, you need to make a change.

Chapter 3

Defining the Basic Trading Styles

Once you've taken stock of yourself (no pun intended) and have a better understanding of what kinds of stocks you want to be in, the next step is to identify what trading style fits you the best. Each trading style has a unique set of characteristics that sets it apart from the others.

To make it easier to identify what kind of trader you are, let's define the four main fundamental trading styles: Momentum, Aggressive Growth, Value, and Growth and Income. And there's no need to worry if you don't fit perfectly into just one style. Many people have parts of each style in them, including myself. But it's still important to accurately identify what the different trading styles are and what stocks are best suited for each one.

Momentum Style

Momentum traders and investors look to take advantage of upward trends or downward trends in a stock's price or earnings. We've all heard the old adage, "the trend is your friend." And who doesn't like riding a trend?

Momentum style traders believe that these stocks will continue to head in the same direction because of the momentum that is already behind them. Momentum traders often fall into two categories, those who focus on price momentum screens and those who focus on earnings momentum screens.

Price Momentum

If you're looking at a *price momentum* screen, you're going to be looking at stocks that have been continuously going up, day after day, week after week, and maybe even several months in a row.

These are the kinds of stocks a momentum trader is after. And this, of course, also includes stocks making new 52-week highs. I point this out specifically because some people hate getting into stocks making new highs. We'll talk later about why I think that is. But it's important to know that there's a lot of evidence that shows stocks making new highs have a tendency of making even higher highs.

If you're uncomfortable buying stocks making new highs, that's okay. But the Momentum style of trade is probably not for you.

I should also mention that this style of trade will likely carry with it a higher degree of volatility, which is the rate at which a stock moves up or down. Although, the Momentum trader expects the gains made because of this to make it all worthwhile.

Earnings Momentum

The same momentum concept is true with earnings. If you're an *earnings momentum* trader, you're looking for companies whose earnings growth rate continues to accelerate, quarter after quarter after quarter. These are the kinds of companies that are going to fall into this category.

Another thing to keep in mind is that it is quite common for price momentum companies and earnings momentum companies to trade at higher valuations—like a higher P/E ratio, for example. Why? Because investors witnessing this momentum are usually willing to pay up for these stocks for fear that they'll get even more "expensive" if they wait.

It should also come as no surprise that these two types of momentum (price and earnings) will often go hand in hand. Companies with earnings momentum attract buyers. And more buying equals more demand, which in turn increases stock prices.

Aggressive Growth Style

Aggressive Growth traders are primarily focused on stocks with aggressive earnings growth or revenue growth (or at least the potential for aggressive growth). And you can expect volatility in this style of trading as well.

You'll often find smaller-cap stocks in this category because smaller-cap stocks are typically newer companies that are in the early part of their growth cycle. Of course, they don't all have to be small-cap stocks. They could be mid-cap stocks or even large-caps, too. For example, if there's a company that has been in existence for a while and they have a new product or service and they're lighting sales on fire, you may see some spectacular growth rates allowing that company to work its way into an aggressive growth style screen.

However, a word of caution: It's not as easy as just simply looking for stocks that have the highest growth rates. So don't go out and start looking for stocks with a 500% or 1,000% growth rate. While there will definitely be companies out there like that who do well, my studies have shown that those kinds of companies will typically underperform. In fact, oftentimes you'll see the companies with the highest growth rates perform almost as poorly as those with the lowest growth rates.

Why is that? It's because those levels of growth are unsustainable. And the stocks are often priced for perfection.

For example, let's say company XYZ just reported earnings of 1 cent. Now analysts are projecting next quarter's earnings to be 6 cents, which is a 500% growth rate. Weeks go by, and for whatever reason the analysts now revise their earnings estimates down to 5 cents a share. So, while 5 cents is still a 400% projected growth rate, it's also 100 points less than what was first expected for a –16% earnings estimate revision.

And if you're the person who just got into that stock the day before, you'll likely be scratching your head wondering why on earth a stock with a 400% growth rate is getting pounded. That's why.

Aggressive growth stocks are some of the most exciting picks out there. And they can be extremely rewarding. Just be sure to use your head when looking for those kinds of companies. And pay attention to the earnings estimate revisions. One of the best ways to find aggressive growth stocks is to screen for companies with growth rates that are meaningfully above the median for their industry, but not necessarily crazy high above it.

Value Style

Value investors and traders favor good stocks at great prices over great stocks at good prices.

This does not mean they have to be cheap stocks in price, though. The key is the belief that they're undervalued. That they are, for some reason, trading under what their true value or potential really is, and the value investor hopes to get in before the market "discovers" this and moves higher.

There could be many reasons why these stocks are being discounted by the market. Maybe they had disappointed in previous quarters and everybody just kind of lost interest. Maybe they don't have the kinds of exciting growth rates that can attract investor interest like an aggressive growth stock can. Maybe they're just in a boring industry. Who knows?

But the value investor is trying to find these kinds of stocks that have been ignored by the market. And normally you'll see these kinds of stocks showing up in your screens by looking at their valuations.

Understand though, the value investor will typically need to have a longer time horizon because, if that stock has been undervalued (i.e., "ignored" for a while), it may take a bit of time before that stock gets noticed and makes a move. So don't think that just because it showed up on your screen that it's immediately going to skyrocket. You may need a longer holding period for the rest of the market to catch up and reprice that company higher.

But keep your eyes out for their earnings estimates. There usually needs to be a catalyst for these unloved, underappreciated, overlooked companies to move. And I can think of no better way than to look at a series of upward earnings estimate revisions to put these stocks on someone's radar screen and to have them sit up and take notice.

Growth and Income Style

Growth and Income investors are looking for good companies with solid revenue that pay a good dividend.

Oftentimes these are more mature, larger-cap companies that generate solid revenue. These companies then pass that revenue along to their shareholders in the form of a dividend.

These are companies that may not have the kinds of spectacular growth rates like some of the younger or smaller companies have (or like they themselves had when they were younger and earlier in their growth cycle).