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Evaluating Stocks: Styles and Approaches

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Introduction

With the wide variety of stocks in the market, figuring out which ones you want to invest in can be a daunting task. Many investors find it useful to have a system that helps them find stocks that are worth investing in, decide what price to pay, and realize when a stock should be sold. Bull markets--a period in which prices as a group tend to rise--and bear markets--a period of declining prices--can lead investors to make irrational decisions. Some sort of system can help you avoid emotional decision-making. Good investors understand why they're investing in a particular stock and how it fits into their overall portfolio strategy. Understanding how to evaluate stocks based on data rather than stock tips, intuition, or guesswork can help you know when your reasons for investing in a particular stock are no longer valid.

Even if you don't want to select stocks yourself--and many people have absolutely no interest in doing that kind of research--it can be helpful to understand the concepts that professionals use in their stock-picking process.

Growth investing vs. value investing

There are generally two schools of thought about how to choose stocks that are worth investing in. Though they represent very different approaches to evaluating stocks, many investors find that combining aspects of each can be useful.

One camp focuses on buying stocks that are bargains relative to the company's intrinsic worth. Value investors want to discover stocks whose share price doesn't reflect the company's true worth and that are effectively trading at a discount. Stocks can have low valuations for many reasons. The company may be struggling with business challenges such as legal problems, management difficulties, or tough competition. It may be in an industry that is currently out of favor with investors. It may be struggling to expand, have fallen on hard times, or simply been overlooked by other investors. A value investor believes that eventually the share price will rise to reflect what he or she perceives as the stock's fair value. Value investing certainly takes into account a company's prospects, but is equally focused on whether the stock is a good buy. A stock's price/earnings ratio is of particular interest to a value investor, or, if earnings are not yet significant, the price-sales ratio.

A contrarian investor is perhaps the ultimate example of a value investor. Contrarians believe that the best way to invest is to buy when no one else wants to, or to buy stocks or industries that are temporarily out of favor with the market. The challenge for a value investor, of course, is figuring out how to tell the difference between a company that is undervalued and one whose value is low for good reason. Value investors comb the company's financial reports, looking for clues about the company's management, operations, products, and services.

Some questions a value investor would ask about a company include:

- What would the company be worth if all its assets were sold?
- Does the company have hidden assets the market is ignoring?
- What would the company be worth if it were acquired by another company?
- Does the company have intangible assets, such as strong brand-name recognition, strong new management, or dominance in its industry?
- Is the company on the verge of a turnaround?

A growth-oriented investor, on the other hand, tends to seek out companies that are growing and pays less attention to how expensive the stock might be. Stocks of newer companies in emerging industries are often especially attractive to growth investors because of their higher potential for expansion and price appreciation despite the higher risks involved. A growth investor would give more weight to figures showing increases in a stock's trading volume and earnings per share (or sales growth if profits are not yet significant) than to its P/E ratio. However, some growth investors also pay attention to a stock's valuation, looking for what's called Growth at a Reasonable Price (GARP). The challenge for a growth investor is to avoid paying too much for expected earnings that are lower than anticipated.

A momentum investor looks not just for growth but for accelerating growth that is generating lots of investor interest, or momentum, in the stock. Momentum investors believe that you should buy a stock only when the price is rising, and often buy even when a stock is richly valued, on the assumption that the stock's price will go even higher. If a stock falls, momentum theory suggests that you sell it quickly to prevent further losses and buy more of what's working. The most extreme momentum investors are day traders, who may hold a stock for only a few minutes or hours then sell before the market closes that day. Momentum investing obviously requires more frequent monitoring of the fluctuations in each of your stock holdings, however. Unless you're prepared to not only do the initial research on a stock but keep up with its performance regularly, you should think twice before attempting a momentum strategy.

A growth investor might ask some of these questions about a stock:

- Has the stock’s price been rising recently?
- Is the stock reaching new highs?
- Are earnings per share accelerating from quarter to quarter and year to year?
- Is the volume of trading in the stock growing or diminishing?
- Is there a recent or impending announcement from or about the company that might generate investor interest?
- Is the market as a whole going up?

Growth stocks and value stocks often alternate in terms of their popularity with investors. One style may be favored for a while but then give way to the other. Some investors like to have a portfolio that includes both types.

Two ways to research stocks: fundamental vs. technical analysis

Whether the growth or value approach appeals to you--and it may be some combination of the two--you'll need to have some criteria to use in implementing it and selecting individual stocks. There's no shortage of data for investors; the challenge is figuring out which data seems most meaningful.

Fundamental analysis looks at data about an individual company and its operations. Because stock prices reflect what investors are willing to pay for a share of the company's earnings, fundamental analysis sifts through facts and figures to try to determine just what those shares are worth. They try to assess the company's prospects for the future based on its past and current performance. The investing community tends to "price in" things it expects to happen in the future, not only with an individual company but with the economy as a whole. Fundamental analysis is a good way to compare companies in the same industry; it is somewhat less useful in comparing stocks in very different industries.

Technical analysis looks not at a company as a business but at the company's stock price. It attempts to identify trading patterns by relying heavily on charts that show price history and the volume of trading in a particular stock. Investors who use technical analysis believe examining those patterns can help them identify when a stock is under- or over-valued. Technical analysis also is used to examine trends in the stock market as a whole.

Many investors try to use some combination of the two styles of analysis. Buy-and-hold investors tend to focus on fundamental data, though fundamentals can be used by both growth and value investors.

Theories of stock investing

Over the years, investors have used some combination of the above approaches to develop specific theories about what certain pieces of data reveal about what's happening or will happen in the markets. Some theories, though no longer followed today, can serve as an introduction to more modern trading practices. Others are criticized for having no real forecasting value, but can be used as a way to monitor trends. Keep in mind that none of these theories can guarantee the future performance of any investment. The following are the most widely known theories.

Dow theory

Dow theory is a technical method for analyzing the movements of the market as a whole to try to forecast its general direction. It assumes that three movements are operating simultaneously in security prices: the primary, the secondary, and the daily movement. The primary movement (also known as the major or primary trend) can last anywhere from 28 weeks to 33 months and depicts the long-term trend of the stock market (i.e., a major bull or bear market). The secondary movement (also known as the secondary reaction) can last anywhere from 3 weeks to 3 months and depicts a rally in a bear market or a correction in a bull market. The daily movement (also known as the day-to-day movement) depicts the day-to-day fluctuation of stock prices.

Dow theory examines stock prices with the assumption that over time security prices develop patterns, illustrated in turn by stock indexes. It uses two figures used to measure stock market prices--the Dow Jones Industrial Average and the Dow Jones Transportation Average--because they are believed to be good barometers of economic changes. These stock indexes often move together; a signal from one is considered valid only if it's confirmed by the other. According to the theory, if the primary trend for both is generally rising--if short-term highs and short-term lows both trend higher overall--their simultaneous movement signals a strong bull market. Such a primary upward trend is believed to have reversed course only if both averages drop and then subsequently meet resistance whenever they try to rally past those lows. In contrast, a decline in both averages would imply a strong bear market. A primary downward trend is said to have ended when both averages not only rise but find support at a certain price level whenever they try to drop again. When the two averages move in opposite directions, the market is uncertain and the market is said to be trading in a range, or range-bound.

Critics of Dow theory say its reliance on industrial and transportation stocks no longer reflects the modern economy, and identifies trends too late to be of any real value. Its proponents say Dow theory was never intended to forecast precise market bottoms and tops, and that overall market behavior has not changed dramatically since Dow theory was developed.

Elliott wave theory

This analyzes the ebb and flow of collective investor mood. Like Dow theory, Elliott wave theory argues that the market moves in cycles, or waves, based on investor sentiment. Its hypothesis is that a bull market is caused by the natural impulse to build a better future based on material values, and a bear market is caused by our need to take a rest and let the market correct. Each is a reaction against the other, and the waves they create, when charted, follow a predictable pattern.

Odd-lot theory

Odd-lot theory, another technical method for analyzing security prices, focuses on the buying and selling behavior of investors who buy in small quantities, or odd lots (fewer than 100 shares).

Tip: *Generally, there are two basic units of trading on the Nasdaq and New York Stock Exchange (NYSE): odd lots and round lots. Round lots are for orders of 100 shares or multiples thereof. Odd lots are orders for fewer than 100 shares. Odd-lot trading data is published in the financial press.*

The odd-lot theory is based on the belief that these odd-lot or small-time investors often misjudge the market, most frequently just prior to a change in market direction. It says that small investors will get caught up in the excitement of a bull market and increase their purchases while the market reaches its top. Conversely, those same small investors will tire of experiencing losses in a declining market and will sell as the market reaches its bottom. The crux of this theory is that small investors are incapable of making informed investment decisions. As a result, the odd-lot theory suggests that you determine what the market "losers" are doing and do the exact opposite. In other words, larger, more knowledgeable institutional investors should sell when small investors buy, and buy when small investors sell.

Like most methods for forecasting security prices, the odd-lot theory is not without controversy. Although research has shown that odd-lot purchases increase in rising markets and odd-lot sales increase in declining markets, detractors of the theory feel it has no real forecasting value.

If the odd-lot public is wrong at times, so are larger institutional investors. Both small and large investors have sold at the market bottom and bought at the top. Consequently, there is no reason to believe that the buying and selling habits of the odd-lot public form an accurate way to monitor the stock market. In addition, reliance on odd-lot trading to indicate the behavior of small-time investors is skewed by the movement of investors from the odd-lot to the options market, which allows investors to make small trades in options that represent round lots. As a result, many now feel the odd-lot theory is more properly utilized as a way to monitor trends, not as a crystal ball to predict market change.

Dogs of the Dow

A value-oriented approach, the Dogs of the Dow strategy focuses on buying large, dividend-paying stocks that are relatively cheap compared to their peers in the Dow Jones Industrial Average. Investors using this theory buy equal amounts of the 5 or 10 Dow stocks that have the highest dividend yields and hold them for exactly one year. They then sell those shares and invest that money in whichever 5 or 10 Dow stocks are the new dogs--i.e., they now have the highest yields. According to the theory, a high dividend yield--dividend divided by share price--means that the stocks of these mature, blue-chip companies have dropped temporarily and will rebound, making them good buys.

Proponents contend that this is an easy way to beat the performance of the market as a whole. However, critics argue that if a stock is a Dow dog year after year because its dividend yield is high, the stock price may be stagnant or dropping. (With any stock, the dividend yield goes up when the stock price goes down, assuming dividend payments stay the same). Also, they contend that the Dogs of the Dow succeeds only as a contrarian strategy. As more investors have become familiar with it and make their changes before the first of the year--the traditional time for changes to Dogs of the Dow portfolios--it has become less useful.

Random walk theory

This theory assumes that in an efficient market, all investors have access to all necessary information regarding a company and its securities. As a result, the theory argues, it's difficult to get an advantage over any other investor, and accurately forecasting a stock's price is impossible. A stock's performance, it says, is based on bits of information that investors learn about at random. That means that a stock's price history represents not a pattern, as technical analysis contends, but a random walk. Any patterns and trends in securities prices are merely coincidence.

Stock prices reflect all or most of the constant, ongoing stream of information about a company and its environment, and they change quickly as investors compete with one another in response to each piece of data. If an investor thinks that a stock is priced too high, he or she will either sell it or refuse to buy it; if an investor feels the stock is underpriced, he or she will most likely purchase it or hold it if he or she already owns it. In an efficient market, any overvaluing or undervaluing of a stock is temporary and random, and the price eventually reverts to its true value.

Supporters contend that the efficient market hypothesis supports a passive investing style that keeps trading costs to a minimum and attempts to match market performance rather than trying to beat the market. Critics of random walk theory argue that there are indeed patterns of market behavior that successful investors can recognize and use.

Stock research resources

There are any number of resources, both in print and online, that can help you find general information on investments. In addition, a number of resources are valuable specifically for stock research.

Start with your financial professional’s website. Brokerage and other financial services firms often include investment research capabilities, both proprietary and from third parties. You may need to be a customer to get access.

SEC's EDGAR database contains all SEC filings, including 10Ks (yearly) and 10Qs (quarterly).

Hoover's online database of companies includes both free and paid content. Value Line offers sample reports on all 30 companies in the Dow Jones Industrial Average, and its fundamental data on approximately 1,700 large companies is available by subscription or in most public libraries.

Stock price quotes, either delayed 15 to 20 minutes or real-time, are available online nearly everywhere. Traditional news outlets, such as television stations, have basic data, and many newspapers are reducing or eliminating daily stock tables and putting the information in their online editions. Also, many Web search engines or services such as Yahoo! or America Online have extensive links to a wealth of stock data in their finance or investing sections.

Company-specific discussions or message boards let you connect with others interested in a particular stock. However, take everything with a grain of salt. Posts are generally anonymous, and misleading or false information can be posted by people who are paid to promote a particular stock.

If you're interested in running some stock screens, an online search will yield a variety of screening tools that let you set criteria and parameters to narrow your list of candidates for investing or further research.

To schedule an appointment with Faye Sykes, click here .

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