Five Factors To Consider When Picking Stocks

Although it must be clear that what happens to prices of stocks over short periods of time is largely a reflection of changes in investor psychology, there is more than enough information readily available to assist in the process of identifying issues that have a better than average chance of outperforming the market. Understanding the importance of this information is the difference between the astute investor and one who is awash in incomprehensible data.

In my early training as an analyst at the prestigious Value Line organization, I was part of a group of dozens of researchers who assembled and published a comprehensive range of data on well over 1,000 of the most actively traded companies. Each single-page report contained numerous data points as well as concise commentary about the companies covered. Yet the reality was that there were only a handful of key factors that told the tale of where things stood. Things have not changed in today's world of information overload.

However you go about this process, it's essential to be aware that stock selection must lead to portfolio selection. By analogy, the task is that of picking a team with a dozen or more well-chosen players. It is most certainly not an effort aimed at coming up with only one or two superstars.

The Price-Earnings Growth Ratio

The Price-Earnings Growth Ratio (PEG) is a good starting point. Just because a company is growing quickly doesn't mean it's a great investment. Yes, more rapid growth generally leads to high valuations (price-earnings ratios) and there are ranges of past valuation that can be helpful in evaluating the richness of the current valuation. Even so, there are guidelines that are worth paying attention to. That's where the PEG comes in

The PEG is calculated by dividing the price-earnings ratio (P/E) by the prospective rate of growth. So if the P/E is 20 and the growth rate is 10%, the PEG would be 2.0. Although there's no strict rule of thumb, the typical range for a PEG would be between 1.0 and 2.0, so in this example, the PEG would be considered to be stretched.

At a time when overall market valuations are rich, as they are now, there will be fewer stocks with low PEG ratios, but most of the time there will be an adequate supply to choose from.

Relative Strength Index

The Relative Strength Index (RSI) is a measure of a stock's price performance compared to that of the market generally. For most stocks, this index will range between 30 and 70, the latter being the strongest performers at a point in time. The majority will be somewhere in the middle, between 40 and 60.

The RSI is more of a check than a positive indicator. If all of the fundamental criteria are pointing toward a favorable finding, it's important to confirm that the RSI is not pointing strongly in an opposite direction. That may well be the case if the RSI number is toward 30 or lower. When that happens, there is an increased likelihood that some part of the fundamental evaluation is flawed.

Consistent Earnings Growth

There's nothing like consistency of earnings growth to help expand stock valuations. If over time earnings have grown steadily and without interruption, there will be good reason for investors to be confident that more of the same lies ahead. Always check at least the latest three years.

The flipside is that if prospects for the period ahead are for a pullback, it's likely that the price action of the stock will suffer. The market looks ahead and needs to like what it's seeing.

Coefficient Variance

The Coefficient Variance (CV) is a scary-sounding term, but it's really quite simple. It's a measure of the consistency of analysts' earnings estimates. The CV generally ranges from 0 to about 15. A low CV would be up to 4.0, suggesting that there's a reasonable consensus among analysts. As the CV climbs above 4.0, there is increasing reason to believe that the analysts really have little confidence in their estimates.

The upshot of a high CV is that there's a good chance of a significant earnings surprise. If the surprise is on the upside, that will probably help the stock. If it's a disappointment, it could be timber-r-r.

Where to find the CV? www.marketwatch.com

Free Cash Flow

Free Cash Flow (FCF) is another variable that can have a disproportionate effect on the price of a stock. FCF is the cash that's left over after taxes, capital expenditures, and debt repayments. When there's free cash flow, there's capital available for further company expansion.

A growing company with consistent free cash flow is worth watching, especially because available funds are often constrained during the early years. Excess funds being generated on a regular basis is one of the more powerful factors in fueling a good future stock performance.

When these five factors come together, it's often a good indication of a stock worth considering for addition to one's portfolio. Still, a qualitative assessment should follow before pulling the trigger.