Don't Get Burned By Hot Stocks (and How To Find Good Ones)

Earlier this summer, I got a call from a fellow whose portfolio had lost almost one third in less than two months while the market was moving steadily higher. When I asked how this happened, he said he was "investing" in hot tips he got online.

I came across an even more troubling situation last year when speaking with the sales assistant of a stockbroker whom I had known for a long time. The broker was an amiable gentleman who built a sizable practice based on a carefully cultivated image. He was a tall man, with a neatly trimmed gray beard, and always wore gold-framed granny glasses. His semicircular desk held a half dozen large monitors, each of which had a colorful chart or table prominently displayed.

There was little beyond the image. Although his background in investing was one step above nonexistent, his "marketing efforts" succeeded in rounding up hundreds of accounts. Sad to say, he got an unfortunate diagnosis a couple of years ago and the practice ended up in the hands of a staff whose prime responsibilities had been answering phones, scheduling appointments, and keeping files up to date.

When I heard the news from his assistant, I asked how the accounts were being managed. Her reply: "We get stock recommendations online." My reaction: shock.

Here's the problem. There's an enormous amount of information available online, more than enough to provide the foundation for productive analysis of stocks. The bigger issue, however, is what you do with the information. If you do nothing more than regularly loading up on this week's list of "10 Stocks To Buy Now", best of luck to you. You'll need it.

If, on the other hand, you look more deeply in an effort to uncover issues with worthwhile potential, the probabilities begin to shift in your favor. The basics of coming up with worthwhile additions to your portfolio include an analysis of ongoing profit trends, current valuation, and balance sheet health.

When appraising profit trends, take a look at earnings per share for the latest year, estimates for the current year and next year, and growth projections for the next five years. The earnings path should be consistently higher and future prospects should call for continuing gains of 10% or better to the end of the decade and beyond.

For a stock to be of interest, the valuation needs to be reasonable. How to figure that? Calculate the price-earnings multiple: current price divided by current estimated earnings per share. So if, for example, the projected growth rate is 12% a year and the multiple is 30 times, that's a price-to-earnings growth ratio (PEG) of 2.5. That's a rich number, which may hold up if there are no problematic corporate developments, but should there be bad news, shouts of "Timber!" may be heard.

Far better to limit holdings to those with PEG ratios of 2.0 or less. Above that, the stocks may be considered to be priced for perfection. Perfection is rare, which means the risks are high.

Next, review the balance sheet. That's relatively straightforward. Look for a current ratio (current assets divided by current liabilities) of at least 2 to 1. And look for outstanding debt to be less than one-third of total capital.

At this point, your list of candidates has probably been narrowed considerably. Now you need to find out whether the companies are consistently generating free cash flow. This is the net income available each year after outlays for capital expenditures, debt repayments, and dividends. Companies that can meet all of their obligations and still have funds left over are moving in the right direction.

After having covered these key fundamentals, it's essential to check out the relative strength of the companies' shares. As long as they're at least moving sideways, there's no problem. Even so, if the price is plunging while the fundamentals look good, there's often something wrong with the appraisal of the fundamentals. Although I think technical analysis of stock prices is akin to voodoo, a stock that's going south when the earnings numbers are going north is something to worry about . . . and avoid.

One more thing: Don't forget to look a close look at the industry or sector in which the companies are operating. Usually, you will find that the companies are in industries with bright futures, but there will be exceptions that must be weeded out. And, of course, there are cyclical companies in the midst of an upcycle that appear to be interest even though they really are not.