All About Stock Screening

Earlier this summer, John Bogle, the founder of Vanguard, and perhaps the most outspoken proponent of passive investing, said that as indexing increases there will be an increased likelihood of exaggerated price swings in individual stocks and perhaps the whole market. We may not be near the critical level yet, but between mutual funds and exchange-traded funds, passive investing is approaching the 50% mark.

The major benefit from passive investing is reduced cost. Although active investing may have advantages, the additional cost of active managers is rarely justified by the improvement in returns they provide. Even so, it's increasingly believed that active investing may have an edge when markets are on the rebound, but are likely to lag during corrections. This may or may not have to do with the fact that active managers tend to favor stocks with above average betas (i.e., have increased market sensitivity).

Today, most trading still comes from active investors looking to exploit inefficiencies in stock pricing. How to identify inefficiencies? Let's look at stock screening.

The Basics of Screening

In the simplest terms, stock screening is the process by which analysts sort through the universe of stocks (typically thousands) to find those that meet specified criteria. The criteria often include such measures as price-earnings ratio, debt-to-capital ratio, past and projected earnings growth rates, and relative stock price strength.

The earliest efforts at screening were performed by institutional investors using mainframe computers that were sifting through data from providers such as FactSet and CompuStat. In the early 1980s, Value Line (my alma mater) introduced screening systems for personal computers available to individuals. In the years since, many other screeners have been introduced, some at little or no cost. My current favorite is FinViz.com, which has a highly flexible screener that's available at no cost.

Screening for Growth Stocks

To screen for reasonably priced growth stocks, you might want to begin with the following criteria: projected five-year earnings growth rate greater than 10%, price-earnings multiple less than 20.0 times, and market capitalization greater than $250 million (to eliminate really tiny companies). In addition, it would probably a good idea to add eps growth this year greater than 10% and debt/equity ratio less than 0.3 (to stick with healthier companies). To avoid the possibility of a misread of the fundamental data, it would be worthwhile to include an RSI (Relative Strength Index) greater than 50. Although I find little value in technical analysis, something may well be amiss if the fundamentals appear strong while the stock's price is heading into the tank.

Screening for Dividend Income

Similarly, for those seeking worthwhile dividend income, the factors would probably include market cap greater than $1 billion (usually these are mature companies), dividend yield greater than 2.5%, debt/equity ratio less than 0.3, eps growth this year greater than 5.0%, and projected five-year earnings growth rate greater than 5.0%.

These are just a few samples of how the process works. But as these filters are applied the universe of companies that meet these tests shrinks dramatically. Once that happens, the next step is to examine each company individually to either confirm the result of the screening or determine that there are intrinsic flaws that negate any further action.

Stock screening is a powerful tool that can greatly improve one's probability of successful investing. Make sure to add it to your investment toolbox.