Chapter One

Let's Start at the End

At the End of the Day, It's Earnings That Matter.

IN THE CLASSIC MUSICAL, *The Sound of Music*, the character of Sister Maria (played by Julie Andrews) tells us that we should start at the beginning because "that is a very fine place to start." In our search for profits investing in growth stocks, however, we shall do the opposite of the Sister's advice and start our search at the end. The plain fact is that at the end of the day what makes for a great growth stock, one that can grow to 5, 10, or even 20 times your original investment over time, is the *fundamentals* of the company. Can the company continually sell more of its products and services at higher and higher profits? Can it continue to innovate and adapt to marketplace changes and maintain a leadership position? In the end, what makes for a great growth stock is the ability of the company to continually sell more of its goods or services at high levels of profitability.

One definitive factor I have found over the years is that change is a fact of life on Wall Street. All too often I hear a pundit or guru telling us of one *magic-bullet* variable that is most important in picking winning stocks—such as price-to-earnings ratios or price-to-cash flow. Of course, these magic-bullet fundamentals can fall out of favor quickly. The one certain thing I can tell you from all my years of investing research is that many fundamental variables have a life span, perhaps two to three years at most, before they stop working and the edge is gone. It's kind of like the great football coach Bill Walsh and his dynasty football team of the 1980s, the San Francisco 49ers. Walsh had a clear edge with his newly invented West Coast offense that befuddled teams around the league and made the Niners all but unbeatable. However, over time, teams adapted to this innovation and the edge was dulled, leading the way for new teams to develop new game plans that led to Super Bowls. The 49ers had a great run, but just like on Wall Street, once the edge is gone, the run is over. There will be periods of time that the market favors stocks with earnings momentum, and periods where operating cash flow or earnings before interest, taxes, and depreciation (EBITDA) are the darlings of the day. As soon as the dance cards are full and everyone can be found chasing after the same thing, the band will stop and the party will be over.

Because of this tendency for the game to change, I have found that it is necessary to rank stocks on more than one fundamental variable, and from time to time I may even tweak the weighting of each variable. When my team and I were building our stock selection program, we looked at hundreds of fundamental factors to determine which ones ultimately had the most influence on the performance of a company's stock price. We also examined which factors are in favor on Wall Street and driving stock prices up or down at any given time. We use this powerful model to sort through the thousands of stocks traded to find those most likely to become high-powered growth stock winners.

I have found that there are eight tried-and-true key fundamental factors that drive stellar stock price performance and have stood the test of time:

1. *Positive earnings revisions:* when Wall Street analysts indicate that business is even better than anticipated

2. *Positive earnings surprises:* announced corporate earnings that are higher than analysts expected
3. *Increasing sales growth:* continuous rapid sales growth of a company's products
4. *Expanding operating margins:* corporate profit margins that are expanding
5. *Strong cash flow:* a company's ability to generate free cash flow after expenses
6. *Earnings growth:* sustained earnings growth quarter to quarter
7. *Positive earnings momentum:* earnings that are accelerating year over year
8. *High return on equity:* high overall corporate profitability

These indicators measure the financial health of a company, how well their products are selling, and whether they are able to maintain and even increase a very high level of profitability. A company that scores very high across all eight of our *fundamental* model variables is highly likely to have all the characteristics of a potential 10-bagger growth stock that we want to add to our portfolio right away.

The first of our eight key variables is **earnings revisions**. We search for stocks whose earnings estimates are revised upward by the Wall Street analysts who cover and research these companies. After all the fallout from Tyco, WorldCom, and Enron, along with the crusade by Eliot Spitzer, this factor is becoming more important. Analysts are so cautious that they have to be really impressed to keep raising their estimate of corporate profits. Apple is a great example. In a 90-day period in 2006, analysts who follow the stock raised their estimates multiple times.

The second fundamental variable is **earnings surprises**. This measures how far above or below the overall consensus estimates of Wall Street analysts the actual reported earnings are. Here we are looking for stocks that exceed what Wall Street believes they can achieve. Oil and energy stocks, for example, have continuously earned far more than the analysts thought they could. Since the corporate scandals and Wall Street prosecutions and investigations made by Elliot Spitzer, most analysts tend to be conservative in their estimates. Several years ago, they estimated that oil would sell for around $40 a barrel. As oil prices went to $60 and beyond, the earnings were far in excess of what was predicted and many energy stock prices skyrocketed!

Third is **sales growth**. All we do here is compare the current quarter's sales increase against the rate of increase from the same quarter for the prior year. Companies that show increasing sales at a very high rate are among the best candidates to become big winners over time. If a company can continually increase sales over long periods of time, then it would seem to indicate that they have a product or service that is very much in demand. We look for companies that show year-over-year sales increases of 20 percent or more. Most recently, sales growth led us to a company named Hansen Natural. This maker of the very popular Monster energy drink has seen sales rise from 100 million in 2003 to over 500 million in 2006, a revenue increase of over 65 percent annually.

The fourth of our eight fundamental variables is **operating margin growth**. A company's operating margin is simply the profits left after direct costs such as salary and overhead are subtracted. We then look at whether this percentage margin is contracting or growing year over year. A company's operating margin will increase when its product is in such high demand that the company can continue to raise prices for the product or service without an offsetting increase in costs. A great example of this type of margin expansion is a company named Bolt Technology. As demand for their seismic equipment used to explore for oil increased along with oil prices, profit margins went from 8 percent in 2004 to over 40 percent in 2006. This type of profitability increase was among the leading factors that (adjusted for splits) led the stock from $8 a share to over $40.

Batting fifth on our growth stock selection team is **cash flow**. Cash flow is simply the amount of cash actually earned and kept by a company after paying all expenses and is often the single best measure of corporate financial health. Companies that regularly pay out more than they bring in are likely to experience severe hardship at some point. A company can show earnings, then spend all of it and then some on necessary capital expenditures—which are included in expenses on the income statement—and actually end the year with less money than they started with. We measure how much free cash flow a company has each quarter and then compare it to the total market capitalization of the company to see what investors are willing to pay for shares at any point in time.

The next variable is **earnings growth**. This measurement finds those companies who earn more money year after year. It is usually measured in terms of earnings per share. Earnings per share (EPS) is just the company's earnings divided by the number of shares they have outstanding. Companies that are continually growing earnings year over year get a higher score than those that aren't. That's why we call it *growth investing*. Most of the stocks we buy show strong, continual year-over-year growth. For instance, DirecTV Group went from a loss of 21 cents a share in 2004 to earning well over a dollar a share in 2006. In real numbers, they went from losing $375 million to making over $1 billion. That's growth!

The seventh fundamental feature we are looking for is **earnings momentum**. This simply measures the percentage increase of earnings year over year. Companies that are accelerating and growing earnings faster year over year are stronger candidates for our portfolio than those where earnings are slowing. A great example of what we are looking for is seen in a company like Steve Madden (SHOO), where from 2004 to 2005 they grew earnings by over 61 percent. That's a great number, right? They then turned around and earned over 117 percent more the following year! This type of powerful performance drove the stock from around $10 a share to over $40 in two years.

Last but not least on our list is **return on equity**. Return on equity (ROE) is a measure of corporate profitability. It is calculated by dividing the earnings per share by the equity (book value) per share. The higher this number, the more profitable a company is and the higher return management is providing to shareholders. Companies that are dominant in their industry tend to earn very large returns on the equity invested. The search for high ROE stocks has helped us find such profit machines as International Game Technology, AES Corporation, Loews, and First Marblehead.

To give you some idea of how powerful these eight indicators are, my research staff and I went back and reviewed how stocks showing the strongest rating in each of the eight categories have performed over the past several years. We found that the highest-rated stocks in each category outperformed the universe of stocks we follow. The table below lists all eight of our variables and shows how much better in price performance they have done than all other stocks combined:

Variable	Outperformance of Universe Over Three Years
Earnings revisions	10%
Earnings surprises	13%
Sales growth	7%
Operating margin growth	61%
Free cash flow	59%
Earnings growth	30%
Earnings momentum	60%
Return on equity	30%

As you can see, some clearly have done better than others, although, because this measures outperformance, clearly all have done better than the market as a whole. But why not just use the variables that score the highest? For the same reason that the 49ers aren't in the playoffs: Just as everyone learned to run and defend the West Coast offense and it became a less powerful weapon, as soon as we relied on just a few measures, the game would change and we would miss great stocks. Instead we plug all eight variables into our model and come up with a basic overall fundamental weightings. The amount each variable counts may be changed or tweaked over time, but all eight variables are considered when searching for the big winning stocks. It is the combination of variables that has allowed us to discover such great stocks as America Movil (up 400 percent in three years), Apple (up over 300 percent in two years), and Hansen Natural (up over 1,000 percent in three years.) It also helps us to avoid stocks that are likely to become disappointing investments and to sell those that have been great winners but are starting to show signs of deteriorating fundamentals. By concentrating on the numbers, and *just* the numbers, we try to take the guesswork out of picking winning stocks. I may not be able to tell which MP3 player manufacturer, tennis shoe company, or nanotechnology venture will pan out to be a huge winner, but relying on the numbers has identified the winning stocks.

In this book I am going to show how these variables, combined with risk and portfolio management, can indeed make you rich over time. I will explain each variable in depth so you can understand just how powerful they are and how they influence stock prices. These fundamental variables are the result of a lot of research and effort by myself and my staff and have enabled me to outperform the stock market year after year in good times as well as in bad. I will also show how to use *reward/risk measurements* to determine when these fundamentally superior companies are experiencing intense buying pressure that will make the price of their stock climb steadily higher. Of course, it is not enough to know what and when to buy, so I will also show you how to determine that a stock has become too risky and that buying pressure is abating and it needs to be sold.

I will also show you how to use *portfolio management techniques* to take a lot of the day-to-day risks of investing in stocks out of the growth stock equation. I will even talk about ways to manage the biggest risk to successful growth stock investing—human emotions such as fear and greed that all too often lead us to do the wrong thing at exactly the wrong time. It is difficult to be buying amid panic, and selling when everyone else is excited about the stock market, but I am going to teach you how to use my system to do exactly that.

Speaking of my system, I will also give you a powerful tool to help you select market-beating stocks and manage your portfolio. I maintain an enormous database at my offices in Reno, Nevada. This database has all the fundamental data and daily price records for nearly 5,000 stocks. I will give you access to the database through a web site that has been set up specifically for readers of this book. There you will find a tool that rates individual companies based on each of the eight variables we'll discuss here, as well as on how much buying pressure their shares are currently experiencing in the marketplace. Once you understand from this book how powerful this system for picking growth stocks can be, you will find it an incredibly useful tool for finding the top-performing stocks on Wall Street and blending them into a successful wealth-building portfolio.

Let's get started, shall we?