RULE

1

Think like a Fundamentalist

"If you are going to own a stock . . . it should be a good one!"

Upward Trending Technicals + Strong Demand Fundamentals = Investment Success

Rule 1 is about stock selection. It could be titled the "What to Buy" rule. Buying fundamentally strong companies will lower your risk and improve your chances of generating significant and consistent profits. In this rule, you will learn why *thinking* like a fundamentalist is good, but *trading* like a fundamentalist is bad. In this rule, you will learn how to know *what* to buy, not *when* to buy. You will learn when to buy in Rule 3.

You will learn the importance of stock selection based on some, but not all, fundamentals. You may know a lot about fundamental analysis, or you may have no idea what the term means. Regardless, this is a must-read rule. Don't rush through it, and certainly do not skip it. This is a critically important rule.

When you learn the concept of thinking like a fundamentalist, you will be surprised at how easy and straightforward it is to use that thinking to vastly improve your ability to know just the right stocks to "consider" buying. The key is to own *only* fundamentally strong stocks, but you want to own them *only at the right time.*

You may already use fundamentals in your analysis of a company before buying the stock. If you do, that is good. If you don't, you soon will. Remember, half of your decision making about what to buy is based on fundamentals. The other half is based on technicals, which we will get into in later rules.

Keep this concept in your mind throughout this book: You want to develop a set of rules that will give you a distinct advantage in the stock market. This doesn't mean you have to become a master of everything there is to know about fundamental analysis or technical analysis. In fact, you are better off not becoming too consumed with too much analysis. You could spend dozens (even hundreds) of hours studying a company's fundamentals before you buy stock in that company. But, unless you are a Warren Buffett, where you are buying millions of shares, you really do not have to spend all that much time in your fundamental analysis.

This may seem somewhat counterintuitive. After all, if an investment methodology is good enough for Warren Buffett, why wouldn't it be good enough for any investor? It all comes down to the law of diminishing returns.

Law of Diminishing Returns

This "law" has as its premise that there is a point at which the cost of obtaining additional knowledge becomes significantly higher than the value of knowledge itself. In other words, the effort you would have to expend to find enough additional knowledge about a company will cost you much more than the investment you are making in the company. For a stockholder who is only buying a small fraction of a company's total outstanding shares, the cost of significant additional fundamental research becomes far more expensive than the shareholder will ever hope to make in net total return. Warren Buffett, however, can spend significant effort and cost to analyze every aspect of a company's fundamentals and have very little negative impact on his potential net total return.

As an engineer, I am always looking for the most efficient use of my time. I want to spend the least amount of time possible to extract the minimum level of information required to make an appropriately informed decision about the quality of the fundamentals of a stock.

If you spend too little effort, you will not have the sufficient information to make an intelligently informed decision. This means that you would be putting too much faith in your hunches or what you hear on TV every evening or what your broker told you or what your golfing buddy said. You must do your own fundamental research, and you must do enough to make an intelligent and informed opinion, but don't overdo this research.

Don't spend too much effort, either. Too much research on a company can lead you to buy the company's stock because you have invested so much of your time researching it. You will begin to justify the purchase of stock because, either consciously or subconsciously, you have already invested so much of your valuable time that you will want to justify that effort by owning shares in the company. That is overkill on research. Remember, when you buy shares of stock, you are *not* buying the company, you are buying *only* a tiny fraction of the outstanding publicly traded shares. Don't spend more time researching the fundamentals than it is worth. A little later in this rule, I will give you a list of fundamentals that are easy to research and give you just the right amount of business knowledge of the company to justify making a stock selection decision.

Your Rights as a Shareholder

I often find that investors think that they are actually buying a piece of a company when they buy the stock of that company. Some even think that when they pay their broker for those shares, somehow the company is selling the shares and that the money they paid for the shares actually flows directly back to the company. Both of these assumptions are completely false.

It is true that shareholders are typically granted special privileges, including the right to vote on matters such as elections to the board of directors and the right to share in distributions of the company's income, assuming the company, of its own volition, actually distributes income. However, shareholders' rights to a company's assets are subordinate to the rights of the company's creditors. What this really means is that you, as a shareholder, do not actually own a piece of the company's assets. Do you doubt this? Okay, the next time a company is getting ready for bankruptcy, buy one share and see what you get on the other side of the bankruptcy event. The *only* time you are likely to get anything is when the company goes out of business and liquidates its assets and owes its creditors less than its liquidated value. That almost never happens. What happens, most of the time, is that the company reorganizes under the bankruptcy laws and then issues new stock to new shareholders. The previous shareholders are left with absolutely nothing—no shares, no assets, no refunds, no shares in the new company, nothing. So, don't kid yourself; if you own shares of stock in a company, all you really own are pieces of paper that are bought and sold on stock exchanges based on simple supply-and-demand market forces. But you don't actually own the company.

Why, you ask, is this important to know? It is important because I don't want you to get emotionally tied to a company via its stock. Keep in mind that a share of stock is really nothing more than a derivative of the company.

Derivative

In very general terms, a derivative is just something (in this case, a share of stock) whose value changes in response to the changes in underlying variables (in this case, the company that issued the stock).

There is a misconception that when you buy a share of stock, the money that you pay somehow filters its way back to the company that issued the stock. It does not. This happens *only* when you are a part of the original or subsequent public offering. Once the shares start trading after the public offering event, you are participating in a market where the public is buying and selling shares strictly between the owner and the seller. If the price of a company's stock quadruples in price, the company does not get one dime of that increase unless it issues new shares. Of course, the people who work for the company, including the corporate management, will own shares of the company and they will, just like any other shareholder, enjoy the increase in value of their shares. But the company itself does not get *any* additional cash from the shares that are being traded (bought and sold) on the open market.

This is often confusing when you hear the financial talking heads discuss "market cap." If the market price of a stock drops by 20 percent, for example, you will hear the financial analysts talking about how the company's market cap was suddenly cut by 20 percent, resulting in the fact that the company is now worth so many billion dollars less than it was the day before, or words to that effect. In reality, nothing changed as far as the company is concerned. The actual business operations, the book value, the revenue, the total sales, the products in the pipeline, and the like did not change one iota just because the share price dropped by 20 percent. That 20 percent change was the change in the total worth of all the publicly traded shares of the company. And who owns those shares? Investors do, not the company. So it is the collective group of investors that lost their market cap, not the company. There is an exception to this. When a company uses the stock it owns of its own company as collateral for loans, and then the share price drops, its collateral also drops in value. This can cause a company to experience significant financial distress if that company had its stock highly leveraged (i.e., collateralized).

Market Cap

A measurement of corporate or economic size that is equal to the current market share price times the number of shares outstanding.

Remember, you are just buying and selling pieces of paper that have value only because someone else (another investor) is willing to pay you a certain amount of money for those shares.

The objective of this rule is to teach you how to incorporate a fundamental analysis into your investment strategy and save a lot of time by concentrating on only a small subset of fundamentals that are the most important to consider when you are looking for just the right stock.

Objective

There are several thousand stocks that trade every day in markets all over the world, with over 14,000 at this writing, that trade just on U.S. exchanges alone. When you get ready to add a stock to your portfolio, your objective is to pick the right stock out of this vast sea of publicly traded companies.

But the selection process of trying to pick just the right stock from such a large universe of stocks can be a daunting task. It can seem like you are trying to find a needle in a haystack. Actually, this analogy is true. But in this rule, you will learn that finding that needle (or perfect stock, in our case) is far simpler than you might think.

The first step is to understand that fundamentals really do matter when it comes to finding that perfect stock. But an exhaustive study of a company's fundamentals can be overwhelming and very time consuming. Fortunately, there are very few fundamentals that really matter when you are trying to find just the right stock to consider buying.

Fundamentals Matter—Just Not All of Them

To start this process, I want you to *think like a fundamentalist.* Perhaps you are unfamiliar with the term as it is used in stock analysis and don't know what it means to be a fundamentalist, let alone think like one. But, before I explain what it means to think in this way, I would like to share a story with you:

> At a recent World Money Show, a lady came strolling by the booth, with her eyes cast upward toward the 20-foot banner that spread across the top of our booth. Across the right side it said "Think like a Fundamentalist," and on the left side, it said, "Trade like a Technician." She stopped and pointed up at the sign and asked my wife in a rather indignant tone, "Just what are you trying to say with that statement up there?" My wife turned to look at the sign and asked her which statement she wanted clarified. The lady said, "It's that 'think like a fundamentalist.' Are you telling me I have to be a Christian to invest in the stock market? You need to rethink the way you do your marketing!" Before my wife could respond, the lady walked off.

Fundamentalist

With regard to the stock market, a fundamentalist is someone who uses a company's financials and operations to make trading decisions.

There are a number of great responses I would have loved to give her, but alas, I wasn't there at the time.

Suffice it to say, in the context of this book, the term *Fundamentalist* is someone who examines a company's financials and operations—such as sales, earnings, growth potential, assets, debt, management, products, and competition—for the sole purpose of determining if the company's fundamentals meet the fundamentalist's requirements.

A fundamentalist, then, is anyone who makes a stock investment decision based on the results of analysis of the company's financial condition. This analysis is called *fundamental analysis.* Investors who rely heavily on a fundamental analysis to determine what and when they trade in the stock market are considered *fundamental investors.*

Table 1.1 shows a reasonably exhaustive list of fundamentals.

As you can see, this list of fundamentals can be overwhelming. You could spend many hours researching a company based on these fundamentals before making your decision to buy. Then each time new information comes out on the company, you would have to reanalyze the company again, using all of these fundamental parameters. This would consume many more hours. But you will find that you need to study only very few of these fundamentals to learn all you need to make a stock selection decision. I call this small subset of fundamentals my "Demand Fundamentals." I'll explain more about this smaller subset a little later in the rule.

Nevertheless, think about how much time you would need to spend working on all these fundamentals if you just have 10 stocks in your portfolio. But, what if you have 20 or 30 or more? This could rapidly become way more than a full-time job. You might even have to consider hiring a few MBA graduates to help you!

Faced with this task, far too many investors either ignore fundamentals altogether or they spend way too much time analyzing too many fundamentals. I would never buy a stock without analyzing the company's fundamentals, but I am interested in only a very discrete few fundamentals. If your goal is to buy only stocks that will move up in price, you will want to analyze those parameters that have the biggest impact on driving stock prices higher or lower.

Remember, you are using a fundamental analysis to find those stocks that you will *consider* buying. You should never buy a stock solely based on a fundamental analysis. There are just too many other factors that come into play when picking a stock to buy. My 10 rules in this book will teach you how, what, and when to buy and how, what, and when to sell. Using fundamental analysis as the only criterion to buy a stock means you are leaving way too much to luck that your stock selections will make you money. I don't buy

Table 1.1 General Fundamentals

Total cash	Insider shares sold
Profit margin	Shares held by institutions
Operating margin	Number of institutions holding shares
Debt to equity	Price-to-sales (PS) ratio
Last split ratio	Revenue per share
Trailing price-to-earnings (PE) ratio	Revenue per employee
Forward PE ratio	Net income per employee
Last year's PE ratio	Year-over-year revenue
Trailing PS ratio	Quarter-over-quarter revenue
Last year's PS ratio	Year-over-year earnings
Market cap	Dividend rate
Annual dividend	5-year average dividend
Current dividend	5-year revenue growth rate
Payout ratio	3-year revenue growth rate
Yield	5-year annual income growth rate
Current earnings per share (EPS)	3-year annual income growth rate
Forecast earnings per share	5-year dividend growth rate
Earnings before interest, taxes, depreciation and amortization (EBITDA)	3-year dividend growth rate
Total revenue	Gross margin
Total outstanding shares	Price-to-book ratio
Total shares short	Book value per share
Insider percentage	Last 3 quarters' EPS growth rate
Current inventory	Annual EPS growth rate
Previous year's inventory	5-year average EPS
Institution percentage	5-year EPS growth rate
Return on equity	Price strength
Previous year's net profit	Industry ranking
Total employees	Sector ranking
Short interest ratio	Product pipeline
Short interest percent of float	Competitive advantage
Insider shares bought	

stocks and hope I am going to be lucky. I make money in the stock market because of the 10 rules in this book, not because of luck. I would rather you become a disciplined, thoughtful, smart investor. Plus, you will find that the more you follow a well-thought-out investment strategy based on a solid set of rules, the "luckier" you will become at making money—serious money—in the stock market.

At the beginning of the previous paragraph, I used the word *consider*. It is critically important that you realize Rule 1 is used only to find those stocks that you should "consider" buying when the time is right. Rule 1 will help you determine *what to buy*, not *when to buy*. You will learn *when to buy* in Rule 3. When you learn the concept of thinking like a fundamentalist, you will be surprised at how easy and straightforward it is to use that thinking to vastly improve your ability to select (not buy) the right stocks at the right time.

The key is* only *to own fundamentally strong stocks, but you want to own them only at the right time.

So with all this in mind, let's dig in to the nitty-gritty of why fundamentals are important and how to best use them to make stock selection decisions.

Why Risk Can Be Mitigated with Strong Fundamentals

To make consistent profits in the stock market, it is important to consistently measure net total return against the risk you had to take to make that return. All of us want to make the highest return possible for the lowest risk possible. One way to keep risk low is to only own stocks that have the strongest fundamentals. In general, the stronger the fundamentals of a company, the less risk there is that the company will go bankrupt or abruptly change from being very profitable to being very unprofitable.

Risk

The likelihood of a stock's price dropping low (perhaps to zero) can be tied somewhat to the stock's (actually the company behind the stock) volatility (pricing movement) over time. Risk can be extremely subjective and its measurement can depend significantly on the "risk tolerance" of each individual. Risk can be measured quantitatively as well. In this regard, one can generally assume that the higher the quality of a stock's fundamentals, the lower the likelihood that the stock's price will go to zero. On an individual stock basis, risk can be measured by comparing the stock's beta, which is a measure of the stock's volatility in relation to the rest of the market. Risk can also be mitigated or reduced through the use of diversification by industry and sector (see Rule 8). Further, risk can be contained through the use of stop losses (see Rule 4).

Also, stocks with strong fundamentals tend to have lower volatility or beta. Lower volatility generally means more consistent and predictable trends in share price movement. High-quality companies with strong fundamentals also tend to pay higher dividend yields and/or have stronger buyback programs, which add to shareholder value.

Beta

A statistical measure of the relative volatility of a publicly traded equity in comparison to the overall market. The beta for the market is considered to be 1.00. Equities, such as stocks, with betas above 1.0 tend to move with the market, but to a greater degree. Equities with a beta below 1.0 tend to move against or in the opposite direction of the overall market. For example, if the market moves up 10 percent, a stock with a beta of 4 will move up 40 percent, but a stock with a beta of 0.9 will move down 10 percent in that same market.

Shareholder Value

The equity portion of a company's capitalization, which is determined by multiplying the number of outstanding shares by current share price.

By analyzing a company's fundamentals, an investor should be able to make an informed decision about whether buying the company's stock is a good investment or a bad investment. In our case, we want to analyze a company's Demand Fundamentals so that we can make an intelligent, informed decision regarding the merits of owning shares of stock in that company.

We also make a giant leap of faith that analyzing a company's fundamentals provides us with an indication of how strong the company will be in the future. We want to own stock in a company that has the likelihood of strong future growth. We use the fundamental data published by public companies as an indicator of how well the company has done in the recent past, how it compares to its peer group, and how well it will do in the future. It is this future that most interests us.

Knowing how a company has performed in the past is important, but not nearly as important as knowing how a company will perform in the future. Fundamental analysts always use past performance as a guide of future performance. It is this "future performance" that we buy when we buy shares of stock in a company.

Unfortunately, fundamentals tend to be very lagging indicators. For example, the fact that a company reports that it beat street expectations does not necessarily guarantee that it will repeat that feat in the upcoming quarter.

Lagging Indicators

Information or trends that provide historical trends or accomplishments, but do not predict future events.

Street Expectations

The average estimates made by brokers and securities analysts regarding various components (generally revenue and earnings) of a company's fundamentals.

The best you can do with a fundamental analysis is to use the results to compare one company to another or one company to a group (industry, sector, or the entire market) of companies. If you can determine that the fundamentals of a company are improving, and perhaps improving more rapidly than its peers, you can reasonably conclude that the company's stock is potentially worth owning.

It is important to get the most reliable fundamental data available. Investors generally turn to publicly available financial reports, such as the annual 10K and quarterly 10-Q reports, where the actual performance of the company is spelled out in black and white. The numbers don't lie—or at least they shouldn't—and can be used as a basis for making investment decisions.

10-K

A Securities and Exchange Commission (SEC)-required and audited annual report that contains the financial results of the company for the past 12 fiscal months.

10-Q

An SEC-required document that contains the financial results of the company for the quarter, noting any significant changes or events. Usually, but not always, companies will also release forecasts on the expected financial results of future quarters, generally not more than one year into the future.

Keep in mind that even the most recently released reports contain data that are very lagging to the actual operation of the company. By the time a 10-K or 10-Q is published, the company is making material operational decisions that are months, if not years, ahead of the data in these reports. While quarterly and annual reports serve as excellent references of where the company has been, they do little to tell you where the company is going. When you buy stock in a company, the future share price of that stock is directly tied to the future of the company, not its past.

But as lagging as fundamentals are, they still provide an important measuring stick of how well the company has performed over time and in comparison to its peers.

Why I Am Not a Fundamental Purist

I would like to sidestep for a minute to express my differences with the pure fundamentalists, if I may. I am not sure where to delve into this subject, but perhaps now is the best time.

This next statement is not an opinion—it is a fact: The fundamentals of a company do not have anything directly to do with the price of shares of stock for that company.

That statement may surprise you, and for the pure fundamentalists out there, to say that strong fundamentals have nothing to do with the share price of a stock seems ludicrous. They would argue that share price and a company's fundamentals are inextricably connected, that, in fact, there is no other real way to determine share price.

I completely understand this line of reasoning, and on the surface it does seem logical. But if all it took for the share price of a stock to go up was for the company to have strong fundamentals, then ask yourself this question: Why does the price of a company's stock sometimes go down even when the fundamentals have not changed?

If the change in share price is tied only to the quality of the stock's fundamentals, then:

- Investors would only buy stocks with strong fundamentals.
- The share price of fundamentally strong companies would always go up.
- Investors would never lose money on a stock as long as the stock's fundamentals continued to be strong.

This, of course, is absolutely not what happens. The share price of fundamentally strong stocks often does drop in price, sometimes precipitously!

My argument with the fundamental purists is this: since the share price of fundamentally strong companies often moves lower, then higher, and then lower again, without the fundamentals of the company changing, then you cannot rely on fundamentals alone in stock selection.

So just what *does* make the share price of a stock move up or down? Let's look and see.

And Now a Little Physics Lesson

Newton's first law of physics is, "A body in motion tends to stay in motion unless acted upon by an outside force." Now, before your eyes glaze over, this physics lesson is merely to illustrate the importance of strong fundamentals.

Stay with me here—this concept is important. You see, we (you and I) investors have one primary goal (or should have) with regard to investing in the stock market. That goal is to make consistent profits. The problem is: *How* do we achieve that goal?

To solve this problem, the solution is simple: Sell stocks at a higher price than you buy them. Okay, now that we have the problem and the solution, we need to make sure the process used actually gets us to our goal.

Basically, that process (or investment methodology) is to buy stocks at lower prices and hold onto them long enough for them to gain in share price, and then sell them before they retreat back to lower prices.

It follows, then, that if we buy a stock that is moving higher in price, we want that stock to remain in that upward pricing movement long enough for us to achieve our primary goal, which is to sell it before it turns against us and moves lower.

One of the aspects of stocks and their market pricing trends is that the stronger the stock's fundamentals, the harder it is for it to suddenly reverse its upward pricing trend.

Think of it this way: If you consider a stock with superb fundamentals to be a battleship and a stock with weak fundamentals to be a dinghy, and both are headed from lower left to upper right, which one would be easier to turn into a movement from upper left to lower right? You are right—it is the dinghy. A dinghy can turn on a dime; a battleship takes many miles to get it to change direction.

So it is with stocks. The stronger the fundamentals of a stock, the more stable its pricing trend, the more predictive its direction, and the easier it is to make money by capitalizing on those trends. So stick with stocks that have the stronger fundamentals. This strategy will tend to generate more consistent profits through more predictable pricing trends.

Supply and Demand—the *Only* Reason Why Stock Prices Fluctuate

At any given time in the market, there will be a host of stocks with share prices that are trending lower. Some of these stocks will have incredibly strong fundamentals. For example, it is not uncommon for you to find 200 to 300 stocks with very strong fundamentals, but only a few of them have share prices that are climbing. *Your goal is to buy only fundamentally strong stocks when the share price is more likely to move up, not down.*

Strong fundamentals do not guarantee that a stock's share price is going to trend higher in the future. Strong fundamentals are important, but strong fundamentals are not enough of an indicator for you to use to buy a stock. In fact, fundamentals have nothing, directly, to do with the share price of a stock.

Here is why.

Have you ever really thought about what makes a stock's share price move higher or lower? As simple as this may seem to you, I find that most investors don't have any idea why a stock's market price actually moves higher or lower.

They may think, wrongly, that it has to do with a stock's fundamentals, or its management team, or its products in the pipeline, or analyst upgrades and/or downgrades. In fact, none of these reasons "directly" make a stock's share price move higher or lower.

Don't get me wrong. Fundamentals do play an important role in picking the right stock to consider buying, but fundamentals do not determine share price. The company's management team does not determine share price. New products, new discoveries, new markets, and analyst upgrades or downgrades do not determine share price.

There is only one thing that can make a stock's share price move higher or lower. That one thing is directly based on the *demand for shares*. The more investors who want to own more shares, the higher the demand. The more investors who want to own fewer shares, the lower the demand. Shares of stock are just like anything else that people buy and sell. You know what I am talking about. You learned it in high school economics class. The more demand for something, the higher the price; the lower the demand, the lower the price.

It follows that if you could predict investor demand, you could predict movement in share price. If you knew that demand was going to fall off, you would correctly expect the stock's share price to move lower. Conversely, if you knew that demand was going to increase, you would correctly predict that the share price is going to move higher.

If you can consistently predict investor demand, you can consistently and accurately predict directional moves in a stock's share price.

So what drives investor demand higher or lower? Actually, there are many things that impact this "supply-and-demand" curve for stock shares, including significant geopolitical and socioeconomic news events. But, aside from the news of the day, investor demand (or the lack thereof) for stock shares can be directly tied to just a few stock fundamentals. Since these fundamentals have the most to do with investor demand for shares, I call these particular fundamentals the *Demand Fundamentals*.

Let's see what these are.

Demand Fundamentals: The Key to Stock Selection

Demand Fundamentals are just a small subset of all the "general Fundamentals" listed earlier in Table 1.1. These very special fundamentals will tell you more about a company more quickly than you might imagine. To illustrate this concept, I want you to pick one of your favorite stocks. Perhaps this is a stock you already own, one that you have previously owned, or one that you are considering buying. Next, go to Yahoo![1] and look up this stock and click on the news or headlines section. Read anything about the stock that includes information on one or more of the fundamentals listed in Table 1.1.

Now, while you are still in Yahoo!, look at the stock's chart and try to match up the date of the news and the price movement of the stock on or near those dates. See which of these fundamentals have the most impact on a change in the price of the stock.

You can spend hours and hours poring over these data, but in the end, you will find that only a relatively small set of fundamentals have the biggest impact on investor demand. Here are my Demand Fundamentals:

- Quarter-over-quarter revenue *growth rate*
- Year-over-year earnings *growth rate*
- Quarter-over-quarter earnings *growth rate*
- 5-year average earnings *growth rate*
- Return on equity
- Dividend yield

To understand why these few Demand Fundamentals are the key to finding great stocks, you have to know why a change in these fundamentals will cause a direct and sometimes significant impact on investor demand.

Investors buy stocks when they believe their investment in the shares will yield a profit at some point in the future. For shares in a company to become more valuable, the company has to become more valuable. By and large, all publicly traded companies are evaluated on one overwhelming yardstick. That yardstick is "growth."

[1]Go to http://finance.yahoo.com/ or any web site that provides free stock data and enter the ticker of your favorite stock in the lookup field.

If a company's earnings, revenue, return on equity, or dividend is growing steadily over time, the company is becoming more valuable over time. The more valuable a company, the more investors will demand shares in the company. Hence, the more demand for shares, the higher the share price.

No one wants to own shares in a company that has negative growth rates in revenue, earnings, return on equity, and dividend yield. Negative growth in these areas creates less demand for shares by investors. So, again, the less demand there is for shares by investors, the lower the price for shares of stock.

It is very important to understand that it is not the fundamentals themselves that are as important as it is the *rate of growth* (whether that rate of growth is positive or negative) of those fundamentals.

Rate of Growth

Measured by comparing the change in value over time. For example, quarter-over-quarter earnings growth is calculated by subtracting last year's quarter-ending total earnings from the current year's quarter-ending total earnings and then dividing that difference by last year's quarter-ending total earnings. Here is the example in formula format:

- QELY = Quarter-ending earnings last year at this same time for the then most recent quarterly report
- QETH = Quarter-ending earnings as of the most recent quarterly report

Quarter-over-Quarter Earnings Growth Rate $= \left(\frac{(QETH - QELY)}{QETH}\right) \times 100\%$

I cannot overemphasize that *growth is the key!* It is *not* the actual value of the Demand Fundamental, but rather it is the *rate of change* of that Demand Fundamental from one reporting period to another that we want to use in this analysis process.

Let me give you an example of what I am talking about:

Take two companies, Company A and Company B. Last year, Company A had the best fundamentals of its peer group. It generated a 10 percent net profit. Company B had only a 2 percent net profit growth when it reported last year. From a purely fundamental analysis perspective, ignoring rates of growth, Company A is a far stronger company than Company B. The net value of each of the fundamentals was far better for Company A than Company B.

This year, Company A had another fantastic year. Once again, it had the best fundamentals of its peer group. It generated another solid 10 percent net profit. Company B generated only 4 percent net profit.

So, here is the question: With all other things being equal, which is the better company to own—Company A or Company B? If your answer is Company B, you are right!

You may be wondering why Company B is far better to own than Company A. Let me explain.

Company A had zero *growth* in net profit, whereas Company B *doubled* its net profit. Company B had a 100 percent growth rate in net profit—far, far better than Company A. As such, the demand for shares of Company B will almost always push the price of its shares proportionately higher than for those shares of Company A. Based on pure fundamentals (all of which are listed in Table 1.1), Company A is a far stronger and better company than Company B. But—and this is the key—*investors pay for* ***growth.*** So the demand for shares of Company B will be stronger than the demand for shares of Company A. As such, the share price for Company B will move higher and much more rapidly than those of Company A.

How to Use Demand Fundamentals to Find the Best Stock

Now that you understand that Demand Fundamentals are the key fundamentals to use when evaluating a stock, the next question should be, "How do I use these Demand Fundamentals to find the best stock?"

Remember, in Rule 1, you are finding *only* those stocks that, if the timing were right, would be good stocks to own. You are *not* to use Demand Fundamentals to determine when to buy, only what to buy.

The process to find the best stocks using Demand Fundamentals couldn't be simpler.

As a reminder, below are the six Demand Fundamentals:

- Quarter-over-quarter revenue *growth rate*
- Year-over-year earnings *growth rate*
- Quarter-over-quarter earnings *growth rate*

- 5-year average earnings *growth rate*
- Return on equity
- Dividend yield

All you have to do is place your universe of stocks in a list, with those having the best Demand Fundamentals at the top, and those with the worst Demand Fundamentals at the bottom. The higher the growth rates, the better. The higher the return on equity, the better. The higher the dividend yield, the better.

Using an Excel spreadsheet for this task makes the process very simple. Table 1.2 shows how I would use these fundamentals in such a spreadsheet.

After preparing a worksheet similar to the below, you only need to sort the columns to find the best stock of each Demand Fundamental.

You can take this one step further by scoring each of the Demand Fundamentals; then merely add up the scores, and then sort from best to worst. Table 1.3 is another example of the same five stocks, but with scores instead of actual values.

Table 1.4 is the same worksheet, but sorted based according to the "Total Score" column.

It doesn't really matter what criteria you use for scoring the Demand Fundamentals, but whatever scoring criteria you use, make it consistent. Then, when you sort your stocks by the total score, you can quickly determine which stocks have the best overall Demand Fundamentals.

Table 1.2 Demand Fundamental Spreadsheet Example

Stock	Quarter-over-Quarter Revenue Growth Rate	Year-over-Year Earnings Growth Rate	Quarter-over-Quarter Earnings Growth Rate	5-Year Average Earnings Growth Rate	Return on Equity	Dividend Yield
Ticker1	50%	20%	18%	12%	20%	0%
Ticker2	–8%	10%	5%	8%	4%	4%
Ticker3	15%	100%	10%	4%	8%	1%
Ticker4	4%	22%	50%	13%	15%	0%
Ticker5	–19%	–4%	–12%	3%	1%	0%

Table 1.3 Demand Fundamental Scoring Example (Unsorted)

Stock	Quarter-over-Quarter Revenue Growth Rate	Year-over-Year Earnings Growth Rate	Quarter-over-Quarter Earnings Growth Rate	5-Year Average Earnings Growth Rate	Return on Equity	Dividend Yield	Total Score
Ticker1	8	4	4	2	10	0	28
Ticker2	0	1	0	1	0	8	10
Ticker3	4	10	3	1	2	4	24
Ticker4	1	4	5	3	5	0	18
Ticker5	0	0	0	0	0	0	0

Table 1.4 Demand Fundamental Scoring Example (Sorted by Total Score)

Stock	Quarter-over-Quarter Revenue Growth Rate	Year-over-Year Earnings Growth Rate	Quarter-over-Quarter Earnings Growth Rate	5-Year Average Earnings Growth Rate	Return on Equity	Dividend Yield	Total Score
Ticker1	8	4	4	2	10	0	28
Ticker3	4	10	3	1	2	4	24
Ticker4	1	4	5	3	5	0	18
Ticker2	0	1	0	1	0	8	10
Ticker5	0	0	0	0	0	0	0

The higher the total score, the better the stock's Demand Fundamentals.

Now that you have mastered the concept of scoring Demand Fundamentals, you next need to apply this to your universe of stocks. As I said at the beginning of this rule, there are many thousands of stocks that are traded on stock exchanges every day.

But, even with all of this scoring and sorting accomplished, you still have a lot of stocks in your universe—too many, most likely. Let's get this universe down to a manageable size.

Reduce the Size of Your Universe

The first step in selecting a stock is to get the list of thousands of stocks down to just a handful—maybe only 30 to 100 stocks that you will concentrate on and from which you will select the one or two new stocks for your portfolio. Before you jump to the conclusion that I am insinuating that this 30 to 100 stocks are all the stocks you will ever have to consider, please understand that this exercise of narrowing down the universe of several thousand stocks to just a handful is something you will need to repeat every time you want to add a new stock to your portfolio. The ultimate, original goal, of using Demand Fundamentals to score and rank your universe of stocks in order to quickly narrow this list down to the one or two stocks that you will consider buying.

Remember, your first job is to find the few stocks out of the thousands that have the very best Demand Fundamentals. A simple and straightforward way to make this comparison is to simply score all the stocks in your universe,[2] and then sort your stocks from the highest score to the lowest score. My universe of stocks is about 6,000. You can see this list and how I score them for free on my web site. Just go to www.10EssentialRules.com, where you can see how I have scored these stocks using the same methodology described in this rule and expanded upon in subsequent rules throughout this book.

When you get ready to pick the 10 or 20 stocks to have in your portfolio, the first step is to *score* your universe of stocks. Make a list of those companies that you want to consider buying shares of stock in and assign a score to each of the Demand Fundamentals for each company, using the scoring system described above.

Once you have determined the scores for each stock in your universe of stocks, the next step is to add up each of the individual scores into a total "Demand Fundamental score." Using a scoring process gives you the ability to then rank the stocks from the highest score to the lowest.

Then sort the total Demand scores from the best to the worst. Of course, your objective is to own only the best. But, remember,

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[2]Your universe could be 20 stocks, it could be 200, or it could be all the stocks traded in the world. It all depends on how much time you can devote to doing the work required to adequately record and analyze the Demand Fundamentals of a stock.

the fact that a stock has the highest Demand Fundamental score does *not* mean that you should run out and buy it. Quite the contrary—all this last portion of Rule 1 does is to help you identify the companies that are the best to own.

And one more thing: **Don't buy any stocks yet!** You are not yet ready to buy any of these stocks you have just scored. All you have done is determine which stocks you would prefer to own *when the timing is right* to buy them.

You will learn when to buy in Rule 3, but first you will need to learn how to stay clear of overpaying for a stock, which I cover next, in Rule 2.

What You Learned in This Rule

You have completed Rule 1, where you learned:

- That you should own only stocks that are fundamentally strong.
- That a fundamental analysis tells you *what to buy,* not *when to buy.*
- That some fundamentals are more important than others when analyzing a company.
- That it is not fundamentals that make stock prices move higher or lower. Rather, it is investor demand that causes share prices to move higher or lower.
- That there are only a few fundamentals that have the largest impact on investor demand. These fundamentals are called Demand Fundamentals.
- That the most important aspects of Demand Fundamentals are rate of growth of earnings, revenue, return on equity, and yield, over time.