Chapter 1

The Importance of Screening and Backtesting

One of the reasons why so many people are not seeing the kinds of returns they hope to see in their stock investments is because they don't know which stocks to buy and sell. They find themselves invested in mediocre stocks because they don't know of anything better to get into. For some, their knowledge or "universe" of familiar stocks is relatively small, and this limits their opportunity to invest in better ones.

Worse, when they finally do pick a new stock (likely an all too familiar one) and that doesn't work out as planned either, it discourages them even more from going out and finding others.

But it doesn't have to be that way.

Why Should I Use a Stock Screener?

With over 10,000 stocks out there to pick and choose from, we all need a way to find the good ones.

Aside from buying stocks that are talked about on TV, written about in the newspaper, or touted on the Internet (not to mention tips from a friend)—how else are you going to find stocks that meet certain characteristics?

Even if you don't use a screener now, most people still do their own screening in one way or another. You may hear that a stock has a certain growth rate or a certain P/E ratio or sales surprise or whatever. You then find yourself listening for or reading about or surfing the Internet for stocks that meet this criteria. Well, if you want to find stocks that meet certain criteria, certain characteristics, you can find them quickly and easily with a stock screener.

But just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

Just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

But how will you know?

Backtesting!

Once you've created a screen, you can then backtest it to see how good or bad your screening strategy has performed in the past.

In other words, does your screening strategy generally find stocks that go up once they've been identified? Or does your screen generally find stocks that get buried once they've been identified?

This is good stuff to know. With backtesting, you can see how successful your stock picking strategy has performed in the past so you'll have a better idea as to what your probability of success will be now and in the future.

Of course, past performance is no guarantee of future results, but what else do you have to go by? Think about it. If you saw that a stock picking strategy did nothing but lose money year after year, trade after trade, stock after stock, over and over again, there's no way you'd want to trade that strategy or use that screen to pick stocks.

Why?

Because it's proven that it picks bad stocks. Sure, it may turn around and start picking winners all of a sudden, but it may also continue to pick losing stocks the way it always has. On the other hand, what if you saw that a strategy did great year after year, period after period, over and over again? You would, of course, want to trade that strategy.

Why?

Because it's proven to be a profitable stock picking strategy. And while it may start picking losers all of a sudden (now that you're using it—right?), it may also continue to pick winning stocks just like it had been doing over and over before.

Now, keep in mind that a screening and backtesting program isn't a box of magic, but it's a great way to see what works and what doesn't before you put your money at risk.

Backtesting is a great way to see what works and what doesn't before you put your money at risk.

Unfortunately, too many people have no idea how to pick the right stocks. And this often leads people into staying in the wrong stocks too long or never getting into new stocks altogether.

I remember I had a conversation with a friend several years ago who was stuck in a losing stock:

Me: Why are you still in that stock if it keeps going down, losing you money?

Friend: I don't think it'll go much lower from here.

Me: Did you think it would go this low when you first bought it?

Friend: No.

Me: Do you think it will go up from here?

Friend: Probably not right away. It may still go down some more.

Me: You know, there are plenty of stocks going straight up. Why don't you get out of that one that keeps going down and losing you money and get into a better one?

Friend: I don't know of any better stocks to get into.

Me: What if you did know of a better stock to get into, would you do it?

Friend: Yeah! (Pause) But I'm not sure *how* to find better stocks.

And that last comment said it all. He was in losing stocks because he didn't know how to pick better ones. But if he had a proven profitable stock picking strategy, he could.

Don't get me wrong. Just because you have a great strategy for picking winning stocks, it isn't going to preclude you from ever having another losing trade. On the contrary, even some of the best strategies "only" have win ratios of 65% or 70% or 80%—not 100%.

But if your stock picking strategy picks winners far more often than it picks losers, you can quickly cut your losses once you find yourself in a losing trade and feel confident that your next pick will have a high probability of succeeding.

If your strategy picks winners far more often than losers, you can feel confident that your next pick will have a high probability of success.

And that's why someone should use a screener and a backtester to pick stocks.