

WHAT TO LOOK FOR IN GROWTH STOCKS

HISTORICAL SUCCESS

Although past results are no guarantee of future performance, they are the only certain data we have for judging a company's strength and a management's credibility.

REVENUE AND EPS: DO THEY MAKE MONEY?

The most quoted statistic is earnings per share (EPS), the bottom line. Generally I look for companies that have positive earnings, but the stated EPS can be misleading if it is the result of special circumstances or some creative accounting.

That's why I consider revenues, the top line, to be more indicative of a company's direction. Not just whether revenues have increased over the last quarter and year, but have they been increasing for several years in a row. There is seldom a good reason for a decline in sales, and a continual increase in revenues clearly indicates a business' strength.

ARE THEY A GOOD VALUE?

A commonly used measure for a company's value is the **P/E** (price divided by earnings per share). The P/E is sometimes called the "multiple" because that number times the earnings is the price investors are willing to pay for a stock.

The P/E for the S&P 500 Index fluctuated between 5 and 27 for over 100 years until 1998, when it surpassed 27 and continued upward into the 40s. It is now either 18, if you use pro forma or operating earnings from corporate reports, or 30, if you use net GAAP, generally accepted accounting principles. Therein lies the problem with using only P/E as a guide to value—it can be manipulated by accounting, limiting its usefulness as a measure of value.

A positive P/E means the company has positive earnings, but a **high P/E** could mean that the stock price is already higher than it should be. A **low P/E** could identify an attractively priced company. As a rule of thumb I look for stocks with P/Es lower than or not much higher than the S&P multiple, using GAAP.

If a stock's **P/E is very low**, selling pressure may have driven the price down because of a negative recent event, such as the loss of a successful CEO, devastating news about one of their products, or a scandal or major setback involving another company in the same industry. The key is to determine if there are real, ongoing problems for the company, or are the low prices excellent buying opportunities, because the bad news is temporary.

If the **P/E is high**, the stock may be over-valued, but it might also mean that this company is expected to achieve exceptional growth in the near future. See P/E/G later in this article.

For the reasons already mentioned, the P/E should not to be the only measure of a company's value. A more accurate, less likely to be manipulated measure is often the Price to Sales (**P/S**), the price per share divided by the sales per share. This is better because the top line, the revenues, cannot be tweaked by accounting. Also, if earnings are negative, the P/S ratio can still be used to compare performances, but the P/E ratio becomes useless. The P/S allows you to clearly compare how much companies cost per how much they make in revenues.

MANAGEMENT

This criterion is a difficult one to quantify, but is as important as any other. Although it is somewhat subjective, there are objective facts and statistics that will indicate a strong and trustworthy management: a) their predictions of the company's earnings are almost always accurate, which indicates their hands-on knowledge of their company and their honest assessment of its business; b) they have recognized any need for changes to the business model and made the changes needed to continue growth; c) their company has had consistently positive earnings and earnings growth, as well as increasing revenues; d) they have been with the company for a long time; and e) their compensation is reasonable, reflecting appropriately the state of the company.

PROMISING FUTURE

As stockowners we care most about future performance—will our growth stocks continue to grow? And as long-term investors we want to know how long they can sustain growth.

GROWTH FORECASTS ARE EDUCATED GUESSES

I use next year's **Earnings Estimates** and the **5-Year Growth Forecast** provided by equity research analysts that cover these stocks for brokerage firms. Theoretically these people are experts about the companies they follow, and I rely on their knowledge. Obviously we want earnings to be increasing going forward, and the growth forecast should be strong for a few more years. On the premise that their estimates are fairly accurate, I like to use **P/E/G** as a measure of a company's valuation based on the growth outlook.

P/E/G: IS FUTURE GROWTH PRICED INTO THE STOCK?

As a rule of thumb a stock is fairly valued when its P/E is the same as its future growth outlook, which results in a P/E/G of 1. A P/E/G greater than 1 indicates the P/E is greater than the growth outlook, and the stock may be overpriced. A stock could be considered undervalued if the P/E/G is less than 1.

There are reasons to avoid stocks with undervalued P/E/Gs. You may believe the growth forecasts are unrealistically high, or you may anticipate changes in the company, the industry, or the economy that will negate the positive outlook currently held. Often the price is low because so many shareholders have become

pessimistic and sold their shares. You must decide if they are right to be pessimistic.

Some companies are awarded higher P/Es because of their consistency over the years. Even if the near-term growth outlook has been hurt or stalled temporarily, a company with a healthy and promising product line or a history of overcoming obstacles might support a higher P/E.

Other circumstances that would justify buying a growth stock whose P/E is already two or three times its future growth rate, i.e. a P/E/G of 2 or 3 or higher, are: 1) if the current P/E is an aberration, because of an extraordinary reduction in EPS, resulting from what you consider to be a one-time event; 2) if you are buying for long term, think next year's growth outlook is the result of a one-time or short-lived problem, and are confident growth will resume a higher rate; 3) if you are buying for long term and think the long-term growth of the company will be stronger than is forecast for years to come.

MISCELLANEOUS/INTANGIBLES

There are always non-statistical considerations and circumstances that identify advantages for a company or reasons to avoid the stock. Here are a few examples:

Mergers – A proposed merger or acquisition changes everything about a company's future. Even after the transaction it takes some time to know if it will be successful.

Demographic Change - The “baby boomer” demographic—more people approaching their 60s and needing medicine in the coming years—impacts positively the outlook for pharmaceutical and health care companies.

Changing Trend - Manufacturers of generic drugs should be beneficiaries of the trend to use cheaper, generic drugs. The financial services industry is experiencing a trend toward consolidation and automation and from fees for transactions to fees based on assets for their revenues. Companies making these changes successfully should benefit.

Cyclical - The buying strength of the consumer over the last couple of years has helped this sector, when other sectors suffered.

Linda Stewart for www.fizone.com
May 27, 2003