

A Top Blogger's Market-Beating Strategy (MSN Money)



Last week's Barron's (April 3, 2006), the weekly stock market magazine, ran a story about Charles Kirk, who, according to Barron's, publishes one of the most widely-read investment blogs on the Internet (www.kirkreport.com).

If you're not familiar with the term, blogs are something like diaries, sort of stream of consciousness thoughts on a topic of interest to the author. Since blogs are easy to make with readily available free software, thousands of them populate the Internet.

Probably no one has counted, but it seems to me that a hefty percentage of blogs are about investing. Kirk's blog caught Barron's attention, because, according to Barron's, his picks have soundly beaten the market since he started blogging in 2000.

Kirk's results are indeed impressive. Here, again according to Barron's, are his calendar year returns:

<u>Year</u>	<u>Kirk</u>	<u>S&P 500</u>
2000	36.7%	-10.1%
2001	4.9%	-13.0%
2002	29.7%	-23.4%
2003	85.2%	26.4%
2004	65.3%	9.0%
2005	16.6%	3.0%

Barron's said that Kirk relies mostly on screens to find his stock candidates. One of his favorites, according to Barron's, is a screen that looks for "poor performing

shares with good fundamentals, strong earnings, and improving relative price performance,” among other factors.

Inspired by Kirk’s idea, here’s a screen for finding fundamentally strong stocks, with weak, but improving, stock charts.

I’ll start with the fundamentally strong part.

Strong Fundamentals

Strong fundamentals start with profitability.

Profitability

Many investors use the terms earnings and profitability interchangeably, but they are not the same thing. Profitability measures how efficiently a company uses its assets to generate earnings. At first this might seem like an arcane point, but it isn’t. Here’s why.

Return on equity (ROE), the most frequently used profitability gauge; compares net income to shareholders equity (book value).

The way the math works, a firm can’t grow earnings faster than its ROE without raising additional cash. For example, if its ROE is 15%, it can’t grow earnings faster than 15% annually without borrowing or selling more shares. Both of those options reduce profits to existing shareholders.

If a firm borrows to fund expansion, the loan servicing costs subtract from earnings. Similarly, selling more shares dilutes earnings per share, which is the bottom line number that most influences share prices.

Thus, ROE is, in effect, a speed limit on earnings growth. Many money managers I’ve talked to won’t consider stocks with ROEs below 15%, and higher is better.

For this screen, I've specified a minimum 15% ROE. Try increasing the minimum to 18 or 20 if you get too many hits or you want to limit your results to the most profitable stocks.

Screening Parameter: Return on Equity ≥ 15

Solid Balance Sheet

Strong fundamentals implies a solid balance sheet, which means low debt.

While working with borrowed money is not necessarily a bad thing if a firm can use the funds productively, firms carrying minimal long-term debt are inherently less problematic than those dealing with high debt servicing costs. That is especially true in a rising interest rate environment because increasing interest expenses will cut into earnings.

Leverage

The financial leverage ratio, which is total assets divided by shareholders' equity (book value), is a good debt measure. A leverage ratio of 1.0 means that the company has no debt. The higher the ratio, the more debt. The median leverage ratio of all companies making up the S&P 500 Index is around 5. I specified a maximum acceptable leverage ratio of 5. Try reducing it to 3 or 4 if you only want to see companies with the strongest balance sheets.

Screening Parameter: Leverage Ratio ≤ 5

Cash Flow

Cash flow measures real money flowing into, or out of, a company's bank accounts. Unlike reported earnings, which are subject to myriad accounting decisions, there is

little a company can do to overstate their bank balances. That's why many experts view cash flow as a better performance gauge than earnings.

To isolate the strongest stocks, I limited the field to companies reported positive cash flow, meaning the company's operations are generating surplus cash.

You can't screen for positive cash flow directly, but you can accomplish the same thing by requiring a positive price/cash flow ratio. The ratio won't be positive unless cash flow is a positive number.

Screening Parameter: Price/Cash Flow Ratio ≥ 0.1

Revenues & Revenue Growth

Annual Revenue

Although the market focuses mostly on earnings, a company has to sell products or services to make money. Most publicly traded corporations rack up revenues (sales) in the hundreds of millions, if not billions of dollars. I require at least \$40 million in annual revenues, which rules out stocks that don't have real businesses.

Revenue Growth

Although a company can boost earnings by cutting costs, in the end, revenue growth propels earnings growth. The strongest stocks are those that are growing revenues the fastest. I set my minimum last quarter's year-over-year revenue growth at 20%. Most companies won't meet that requirement, so reduce it to 15% if you don't get enough candidates.

Screening Parameter: 12-Month Revenue \Rightarrow 40 million.

Screening Parameter: Rev Growth Qtr vs. Qtr ≥ 20

Now that we've limited the field to the fundamentally strongest stocks, on to

Weak, but improving stock chart

Weak Chart

Relative strength measures a stock's price performance over a specified timeframe compared to the overall market. For example, a 12-month relative strength of 70 means a stock has outperformed 70 percent of all stocks over the past 12 months.

I required a 6-month relative strength of 40 or less. That means that passing stocks must have underperformed 60% of all stocks over the past six-months.

Improving Chart

I made use of two of the screener's technical analysis parameters to isolate stocks with strengthening price charts.

On Balance Volume compares trading volumes on days that the stock moves up in price vs. days when it drops. If trading volume on 'up days' exceeds volume on 'down days,' 'buying volume' exceeds 'selling volume,' signaling that money is flowing into the stock, and the On Balance Volume indicator moves up. Conversely, OBV drops when 'selling volume' surpasses 'buying volume.'

By experimentation, I found that OBV values of 75 or higher generally selected stocks with strengthening price charts. It did turn up some charts that didn't fit the bill, but I found I could eliminate most of those duds by requiring that passing stocks must also be trading above their 50-day moving average.

The moving average is the average closing price over a specified timeframe. Most technical analysts consider a stock in an uptrend if it's above its moving average. MSN's screener provides two moving average parameters, 50-days and 200-days. I chose 50-days because the shorter timeframe best describes recent stock action.

Screening Parameter: On Balance Volume \geq 75

Screening Parameter: Last Price \geq 50-day Moving Average

My screen listed 28 stocks in a variety of industries. However, five were in the residential construction industry (homebuilders) and six stocks were in the energy sector. Those are two groups of fundamentally strong stocks that were out of favor, but have begun to show signs of life recently.

Here's the list.

Symbol	Company Name	Last Price	Industry Name
CVGI	Commercial Vehicle Group, Inc.	19.10	Auto Parts
HNI	HNI Corporation	59.17	Business Equipment
JH	John H. Harland Company	39.54	Business Services
DMLP	Dorchester Minerals L.P.	26.10	Diversified Investments
BPT	BP Prudhoe Bay Royalty Trust	72.00	Diversified Investments
CNL	Cleco Corporation	22.60	Electric Utilities
EGN	Energen Corporation	35.66	Gas Utilities
NJR	New Jersey Resources Corporation	45.57	Gas Utilities
YPF	YPF Sociedad Anonima S.A. (ADR)	54.33	Independent Oil & Gas
TZOO	Travelzoo Inc.	18.63	Internet Information Providers
VSTY	Varsity Group Inc.	4.23	Internet Service Providers
UBET	Youbet.com, Inc.	5.10	Internet Software & Services
CVX	Chevron Corporation	58.91	Major Integrated Oil & Gas
COP	ConocoPhillips	65.15	Major Integrated Oil & Gas
ELOS	Syneron Medical Ltd.	30.71	Medical Appliances & Equipment

PTEN	Patterson-UTI Energy, Inc.	32.59	Oil & Gas Drilling & Exploration
HEP	Holly Energy Partners, L.P.	41.50	Oil & Gas Pipelines
KMP	Kinder Morgan Energy Partners LP	48.10	Oil & Gas Pipelines
ABR	Arbor Realty Trust, Inc.	26.82	REIT - Diversified
VTR	Ventas, Inc.	32.19	REIT - Healthcare Facilities
OHB	Orleans Homebuilders	20.99	Residential Construction
TOL	Toll Brothers, Inc.	33.99	Residential Construction
MHO	M/I Homes, Inc.	46.77	Residential Construction
LEN	Lennar Corporation	59.57	Residential Construction
MDC	M.D.C. Holdings, Inc.	63.95	Residential Construction
NVR	NVR, Inc.	759.00	Residential Construction
BHO	B + H Ocean Carriers Ltd.	19.82	Shipping
TRMD	Dampskibsselskabet Torm A/S (ADR)	49.29	Shipping

Although I got the idea from the Barron's article, my screen isn't meant to replicate Kirk's screen, just his overall concept of looking for strong firms with a weak, but improving, price chart.

As with all screens, consider the results as candidates for further research, not a buy list.