Stock-picking strategies

When it comes to personal finance and the accumulation of wealth, a few subjects are more talked about than stocks. It's easy to understand why: playing the stock market is thrilling. But on this financial roller-coaster ride, we all want to experience the ups without the downs.

In this article, we examine some of the most popular strategies for finding good stocks (or at least avoiding bad ones). In other words, we'll explore the art of stock-picking - selecting stocks based on a certain set of criteria, with the aim of achieving a rate of return that is greater than the market's overall average.

Before exploring the vast world of stock-picking methodologies, we should address a few misconceptions. Many investors new to the stock-picking scene believe that there is some infallible strategy that, once followed, will guarantee success. 'There is no foolproof system for picking stocks!' This doesn't mean you can't expand your wealth through the stock market. It's just better to think of stock-picking as an art rather than a science. There are a few reasons for this:

- So many factors affect a company's health that it is nearly impossible to construct a formula that will predict success. It is one thing to assemble data that you can work with but quite another to determine which numbers are relevant.

- A lot of information is intangible and cannot be measured. The quantifiable aspects of a company, such as profits, are easy enough to find. But how do you measure the qualitative factors, such as the company's staff, its competitive advantages, company reputation, etc. This combination of tangible and intangible aspects makes picking stocks a highly subjective, even intuitive process.

- The human (often irrational) element inherent in the forces that move the stock market results in stocks not always performing as anticipated. Emotions can change quickly and unpredictably. And unfortunately, when confidence turns into fear, the stock market can be a dangerous place.

The bottom line is that there is no one way to pick stocks. Better to think of every stock strategy as nothing more than an application of a theory - a ‘best guess’ of how to invest. And sometimes two seemingly opposed theories can be successful at the same time. Perhaps just as important as considering theory, is determining how well an investment strategy fits your personal outlook, time frame, risk tolerance and the amount of time you want to devote to investing and picking stocks. At this point, you may be asking yourself why stock-picking is so important. Why worry so much about it? Why spend hours doing it? The answer is simple: wealth. If you become a good stock-picker, you can increase your personal wealth exponentially. Without further ado, let’s start by delving into one of the most basic and crucial aspects of stock-picking: fundamental analysis, whose theory underlies all of the strategies we explore in this article (with the exception of the last section on technical analysis). Although there are many differences between each strategy, they all come down to finding the worth of a company. Keep this in mind as we move forward.

Stock-picking strategy: Fundamental analysis

Theory

Doing basic fundamental valuation is quite straightforward; all it takes is a little time and energy. The goal of analyzing a company’s fundamentals is to find a stock’s intrinsic value, a fancy term for what you believe a stock is really worth - as opposed to the value at which it is being traded in the marketplace. If the intrinsic value is more than the current share price, your analysis is showing that the stock is worth more than its price and that it makes sense to buy the stock.

Although there are many different methods of finding the intrinsic value, the premise behind all the strategies is the same: a company is worth the sum of its discounted cash flows. In plain English, this means that a company is worth all of its future profits added together. And these future profits must be discounted to account for the time value of money.

The idea behind intrinsic value equalling future profits makes sense if you think about how a business provides value for its owner(s). If you have a small business, the value is the money you can take from the company year after year (not the growth of the stock). And you can take something out of the company only if you have something left over after you pay for supplies and salaries, reinvest in new equipment and so on. A business is all about profits, plain old revenue minus expenses - the basis of intrinsic value.

Greater Fool Theory

One of the assumptions of the discounted cash flow theory is that people are rational, that nobody would buy a business for more than its future discounted cash flows. Since a stock represents ownership in a company, this assumption applies to the stock market. But why, then, do stocks exhibit such volatile movements? It doesn't make sense for a stock's price to fluctuate so much when the intrinsic value isn't changing by the minute.

Putting theory into practice

The idea of discounting cash flows seems okay in theory but implementing it in real life is difficult. One of the most obvious challenges is determining how far into the future we should forecast cash flows. It's hard enough to predict next year's profits, so how can we predict the course of the next 10 years? What if a company goes out of business? What if a company survives for hundreds of years? All of these uncertainties and possibilities explain why there are many different models devised for discounting cash flows but none completely escapes the complications posed by the uncertainty of the future.

Stock-picking strategy: Qualitative analysis

Fundamental analysis has a very wide scope. Valuing a company involves not only crunching numbers and predicting cash flows but also looking at the general, more subjective qualities of a company. Here we will look at how the analysis of qualitative factors is used for picking a stock.

Management

The backbone of any successful company is strong management. The people at the top ultimately make the strategic decisions and therefore serve as a crucial factor determining the fate of the company. To assess the strength of management, investors can simply ask the standard five Ws: who, where, what, when and why?

Who?

Do some research and find out who is running the company. Among other things, you should know who its CEO, CFO, COO and CIO are. Then you can move onto the next question.

Where?

You need to find out where these people come from, specifically, their educational and employment backgrounds. Ask yourself if these backgrounds make the people suitable for directing the company in its industry. A management team consisting of people who come from completely unrelated industries should raise questions. If the CEO of a newly-formed mining company previously worked in the industry, ask yourself whether he or she has the necessary qualities to lead a mining company to success.

What and when?

What is the management philosophy? In other words, in what style do these people intend to manage the company? Some managers are more personable, promoting an open, transparent and flexible way of running the business. Other management philosophies are more rigid and less adaptable, valuing policy and established logic above all in the decision-making process. You can discern the style of management by looking at its past actions or by reading the annual report’s management, discussion and analysis (MD&A) section. Ask yourself if you agree with this philosophy and if it works for the company, given its size and the nature of its business.

Once you know the style of the managers, find out when this team took over the company.

Jack Welch, for example, was CEO of General Electric in the US for over 20 years. His long tenure is a good indication that he was a successful and profitable manager, otherwise, the shareholders and the board of directors wouldn't have kept him around. If a company is doing poorly, one of the first actions taken is management restructuring, which is a nice way of saying "a change in management due to poor results". If you see a company continually changing managers, it may be a sign to invest elsewhere.

At the same time, although restructuring is often brought on by poor management, it doesn't automatically mean the company is doomed. Management restructuring may be a positive sign, showing that a struggling company is making efforts to improve its outlook and is about to see a change for the better.

Why?

A final factor to investigate is why these people have become managers. Look at the manager's employment history and try to see if these reasons are clear. Does this person have the qualities you believe are needed to make someone a good manager for this company? Has s/he been hired because of past successes and achievements, or has s/he acquired the position through questionable means, such as self-appointment after inheriting the company?

Know what a company does and how it makes money

A second important factor to consider when analyzing a company's qualitative factors is its product(s) or service(s). How does this company make money? In fancy MBA parlance, the question would be "What is the company's business model?"

Knowing how a company's activities will be profitable is fundamental to determining the worth of an investment. Often, people will boast about how profitable they think their new stock will be but when you ask them what the company does, it seems their vision for the future is a little blurry: "Well, they have this high-tech thingamabob that does something with fibre-optic cables… ." If you aren't sure how your company will make money, you can't really be sure that its stock will bring you a return.