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Hoosier Dispatch: Getting Started at Stock-Picking, Part II

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Charts

Charts show you the price movement of a stock. Using a chart is like taking a small plane up for an aerial view of the terrain. Not only can you get a picture of price movements over time, you can see how consistent they've been and in what direction they're moving. Charts are the bread and butter of what's called technical analysis. The whole idea is that the chart reflects you the psychology of the buyers and sellers, and it can show patterns that predict future moves. Indeed, technicians like TSC's Gary B. Smith often don't even know the name of a stock or what a company does. They just track its price movement and the volume of trading activity.

When you're getting started, you shouldn't go that far. But you should look at a stock's chart before plunging. If your library board hasn't squandered all its money paying ghost employees, you might be lucky enough to find some up-to-date chart books back at the investing section. (You'll want more detail than Value Line offers on this front.)

If you're ready to get out of the library already, you'll find what you need chart-wise right here at TheStreet.com. TSC offers charts of all iterations through Big Charts.

Those who say the data are just random noise and that past history is no indicator of future performance may be right from a theoretical standpoint. But these stodgy professors are ignoring a fundamental facet of human instinct - herd mentality. Usually, once a stock has started moving in a general direction, it continues moving that way for a while. Sure, a lone cowboy carrying some minor news can steer the stampede to a degree, but a sustainable 180-degree change of direction on a dime is pretty rare.

I look for a chart pattern with a consistent up-trend over five years or so (usually a gently sloping diagonal line from the bottom left to the top right corner of the page). I also look for a basing pattern of flat prices (a horizontal or slightly cup-shaped line) in the most recent three to nine months. I figure that these longhorns know how to run in the right direction but are just taking a little rest to graze before making their next charge. Steer clear of the charts that look like my 4-year-old nephew's rendition of a stormy seascape (random blue scribbles with

sharp peaks and valleys). Day traders can make money on these bucking broncos, but a beginning investor is likely to end up impaled on the corral fence post.

The Fundamentals

By this time, you should have a handful of five to 10 stocks that made it past the first hurdles. Now it's time to dig out some company data (I call this the "fundamental" part of the process).

Start with finding what you can that's been written about these stocks. Check TSC's search engine, www.fortune.com, www.forbes.com, www.businessweek.com. Also check search engines like AltaVista and company Web pages to gather as much information about company operations as you can. Read through the write-ups and get a sense of which way the evidence is stacking up.

Does the company have a viable business, scads of new products or services, competent management and a vision for the future? Or is the firm beset with legal problems, fleeing employees, declining sales or hangovers from stupid past decisions? This is the "art" part of the process, and there are no definitive lists of criteria to check off like a grocer taking inventory, as the *McMagazines* of the world would have you believe. Just get a feel for each company using the critical eye of a prospective owner (which you are).

Don't even bother with the annual report. Think of it as a glossy resume that's designed to paint the candidate in the best possible light. The financial information, on the other hand (balance sheet, income statement, cash flows), can be somewhat valuable if you know how to dissect it. You can get the latest updates for any publicly traded firm here at TSC, compliments of Edgar-Online.

If you're interested in getting your hands dirty, download the 10Q (quarterly statement) and 10K (annual statement). You'll probably need to dig out your college accounting book to make any sense of the numbers and calculate a few ratios, or pick up a copy of *Barron's Guide to Reading Annual Reports* (\$3.96 through Amazon.com).

If you don't want to bother with it, no biggie. Most of the important stuff was analyzed by the *Value Line* guys in the first place (makes you want to do something special for your college's math department, doesn't it?).

Brokerage houses can be a good source of additional research if you have an account with one. Our shop used to put out a monthly list of stocks with a regular history of beating the Street's earnings estimates (a sure sign of a vibrant company). In addition, a proprietary take on a firm or industry can serve to fill out your analysis.

Insider Buying and Selling

At this point, I usually try to scope out how the company execs truly feel about their business. Sounds impossible, right? I mean, even if by some miracle you get the head honcho on the phone, she's likely to give you the same PR department – approved party line she just spun to the reporter from *USA Today*. Au contraire. You can learn a lot about what's going on behind closed doors by checking the insider trading reports that all principals are required to file with the SEC every time they buy or sell their company's stock.

Technically, Edgar should have this information listed under “Form 144 filings,” but I've had a hard time finding it. You may be forced to check out some Web sites for the latest compilations, like Bloomberg Insider Trading. Look for executives who are buying your proposed stock as a screaming signal that you've found a true winner.

On the flip side, insider sells are all but meaningless since a huge part of an exec's compensation these days is through “incentive pay” like company stock and options. All a sale usually means is that somebody needed to cash in some shares to pay for that new house, buy a Jaguar XJ-6 or send his bratty kid off to boarding school.

Furthermore, a lack of buying doesn't mean much either considering the insiders are already wallpapering their bathroom with stock certificates to get them off the piles on the floor. But if you get a solid string of buys, it could be enough to spur a purchase (assuming the other criteria are met).

Getting the Gossip

Finally, and perhaps most importantly, do a reality check on your final candidates. Ask people involved in the respective industries to get their read on any trends or points of interest. For medical products, ask your doctor or pharmacist. Tech stocks? Call down to your buddy in the IT department or ask your office Alpha Geek. See if they've heard anything (good or bad), that might influence your decision. Then, when all is said and done, don't forget to ask yourself, “Does this make sense?”

At this point you should have at least one stock that's a viable opportunity with steadily growing or accelerating earnings, poised for a major price breakout. It also seems to have a bright future with no major skeletons in the closet (hopefully the insiders think so too). Most importantly, it checks out with people who know the industry and makes sense to you as a rational investor. What better combination of attributes can you think of to better your odds at making good money in the markets?

Assuming all signs are go, you're ready to buy.